COMMISSION DECISION

of 20 October 2004

on aid from Germany for Westdeutsche Landesbank — Girozentrale (WestLB), now WestLB AG

(notified under document number C(2004) 3925)

(Only the German text is authentic)

(Text with EEA relevance)

(2006/737/EC)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community, and in particular the first subparagraph of Article 88(2) thereof,

Having regard to the Agreement on the European Economic Area, and in particular Article 62(1)(a) thereof,

Having called on interested parties to submit their comments pursuant to the provisions cited above [1] and having regard to their comments,

Whereas:

I. PROCEDURE

1. *ADMINISTRATIVE PROCEDURE*

(1) By a complaint dated 23 March 1993, the *Bundesverband deutscher Banken e.V.* ('BdB'), representing about 300 privately owned banks in Germany, urged the Commission to institute proceedings under Article 226 of the EC Treaty against Germany. It claimed that the German Banking Supervisory Authority (*Bundesaufsichtsamt für das Kreditwesen* — 'BAKred') had infringed Article 4(1) of Council Directive 89/299/EEC when accepting assets of the *Wohnungsbauförderungsanstalt des Landes North Rhine-Westphalia* ('Wfa'), which had been merged with *Westdeutsche Landesbank Girozentrale* ('WestLB'), as own funds of the latter.

(2) By letter dated 31 May 1994, BdB informed Directorate-General IV, responsible for competition, of the asset transfer, alleging a distortion of competition in favour of WestLB. On 21 December 1994 it filed a formal complaint requesting the Commission to initiate proceedings against Germany under Article 88(2) of the EC Treaty. In February and March 1995 and in December 1996 ten individual banks associated themselves with the complaint of their association.

(3) By letters dated 12 January, 9 February, 10 November and 13 December 1993 and 16 January 1996, the Commission asked the German authorities for further information in order to determine whether the asset transfer constituted state aid. The German authorities replied by letters dated 9 February and 16 March 1993, 8 March 1994, 12 April and 26 April 1996 and 14 January 1997. A number of further letters and documents were submitted by the different parties. Commission representatives met representatives of the German authorities, WestLB and other Landesbanks as well as of the complainant at various meetings during the period 1994-97.

(4) After this exchange of information, the Commission considered it necessary to initiate proceedings under Article 88(2) of the EC Treaty. This decision was taken on 1 October 1997. In it the Commission concluded that the measure in question probably constituted state aid within the meaning of Article 87(1) of the EC Treaty and that it needed additional information to carry out the necessary appraisal. This information related mainly to the measures taken by the Land of North Rhine-Westphalia (the 'Land') to ensure its proper participation in additional profits which WestLB can generate on the basis of the capital transferred, the effects of the inadequate liquidity content of the transferred capital, the effects of the fact that the Land's influence on WestLB had not increased, the effects of the preferential nature of the fixed remuneration and of any other aspect determining the appropriate level of remuneration, the level of Wfa capital available to underpin WestLB's commercial business, the value of the amount exceeding this sum but shown in WestLB's balance sheet, the tax exemptions, the waiver of liability, the profitability of WestLB and the alleged synergies.

(5) The Commission decision to initiate the procedure was published in the *Official Journal of the European Communities* [2]. The Commission invited interested parties to submit their comments on the measure. It received comments from WestLB (19 May 1998), the *Association Française des Banques* (26 May 1998), the British Bankers' Association (2 June 1998) and BdB (4 June 1998). By letter of 15 June 1998 it forwarded them to Germany for its

[1] OJ C 140, 5.5.1998, p. 9.

[2] See footnote 1.

reaction, which it duly received by letter of 11 August 1998 after an extension of the deadline.

(6) Meetings took place with representatives of BdB on 15 January and 16 September 1998 and with representatives of WestLB on 9 September 1998. By letters of 22 September 1998, the Commission departments invited the German authorities, WestLB and BdB to a joint meeting on various aspects of the case. BdB provided information by letter of 30 October 1998. The meeting with the three parties took place on 10 November 1998. Following that meeting the Commission departments requested additional information and documents from the German authorities and from BdB by letters of 16 November 1998.

(7) By letter dated 14 January 1999, BdB submitted the information requested after an extension of the deadline. The German authorities submitted some information by letters dated 15 January and 7 April 1999 after an extension of the deadline.

(8) Since the German authorities refused to provide certain information, the Commission enjoined Germany by decision of 3 March 1999, which was sent to Germany by letter dated 24 March 1999, to submit that information. Germany complied with this injunction by letter dated 22 April 1999 after an extension of the deadline.

(9) The Commission decided to arrange for an independent study to be carried out on the appropriate remuneration to be asked by the Land for the transfer of Wfa to WestLB. Representatives of the consultancy charged with that task also attended the meeting with the three parties on 10 November 1998 and submitted the study to the Commission on 18 June 1999. On 8 July 1999 the Commission adopted Decision 2000/392/EC on the measure implemented by Germany for WestLB in question (the 'challenged decision') [1]. The decision was notified to Germany on 4 August 1999. Germany forwarded it to the Land by letter of 6 August 1999. The Land informed WestLB by letter of 9 August 1999, which arrived the same day. Articles 1, 2 and 3 of the Decision read as follows:

'*Article 1*

The State aid which the Federal Republic of Germany has implemented for Westdeutsche Landesbank Girozentrale in the years 1992 to 1998, amounting to DEM 15 797 million (EUR 8 077 million), is incompatible with the common market.

Article 2

(1) Germany shall take all necessary measures to discontinue and recover from the beneficiary the aid referred to in Article 1 and unlawfully made available to the beneficiary.

(2) Recovery shall be affected in accordance with the procedures of national law. The aid to be recovered shall include interest from the date on which it was at the disposal of the beneficiary until the date of its recovery. Interest shall be calculated on the basis of the reference rate used for calculating the grant equivalent of regional aid.

Article 3

Germany shall inform the Commission, within two months of notification of this decision, of the measures taken to comply with it.'

2. *COURT PROCEDURE*

(10) On 12 October 1999 WestLB and the Land of North Rhine-Westphalia challenged this decision before the Court of First Instance of the European Communities. WestLB, the Land and Germany as intervening party requested that the challenged decision be annulled and that the Commission bear the procedural costs. In addition, the Land requested that BdB bear its own costs. The Commission and the BdB as intervening party requested that both legal challenges be rejected as unfounded and that the complainants bear the procedural costs (the BdB here included its own costs).

(11) In addition, Germany challenged this decision before the Court of Justice of the European Communities on 8 October 1999, likewise requesting that it be annulled and that the Commission bear the procedural costs. The challenge was, however, suspended on account of the substantially identical procedure before the Court of First Instance.

(12) The Court decided on 22 August 2000 to admit Germany as intervening party supporting the applicants and the BdB as intervening party supporting the Commission. By decision of the Court of 11 July 2001, the two cases were joined for the purposes of an oral hearing and ruling. The hearing took place on 5 and 6 June 2002.

(13) On 6 March 2003 the Court of First Instance delivered a ruling [2] annulling the challenged decision and ordering the Commission to pay the costs of the applicants and to bear its own costs and Germany and the BdB to bear their own costs.

(14) The Court annulled the Commission decision on the ground of insufficient justification of two points regarding calculation of the appropriate remuneration. Firstly, the annulment was based on the reasons stated for the remuneration for liquid equity capital as the starting point

[1] OJ L 150, 23.6.2000, p. 1.

[2] Joined Cases T-228/99 and T-233/99 *Westdeutsche Landesbank Girozentrale and Land Nordrhein-Westfalen* v *Commission* [2003] ECR II-435.

for the calculation, for which the Commission had set a rate of 12 % per annum (after corporation tax and before investor taxes). Secondly, it was based on the reasons stated for the top-up for this remuneration, for which the Commission had set a rate of 1,5 % per annum (after corporation tax and before investor taxes). These points apart, the Court confirmed in full the Commission decision.

3. *RESUMED ADMINISTRATIVE PROCEDURE*

(15) By letters of 20 and 29 January, 6 February and 28 May 2004, the Commission asked the German authorities for an update of the relevant information for this decision. This was provided on 10 March and 14 June 2004 after an extension of the deadline and orally discussed on 28 July 2004. A further letter from the Land of North Rhine-Westphalia was received on 26 August 2004. By letter of 6 October 2004, Germany provided additional information that had been requested.

(16) In July 2004 the complainant BdB, the Land of North Rhine-Westphalia and WestLB AG reached a preliminary understanding on the proper return that was submitted to the Commission on 19 July and that should, in their view, be used for the two points criticised by the Court. The definitive version of this understanding was submitted to the Commission on 13 October 2004.

(17) In the present new decision, the Commission has rectified in line with the Court's indications the two points criticised by it (justification for the basic remuneration and a possible top-up). These two points apart, it maintains in principle the basic assessment given by it in the original decision. However, the Commission has taken into account the results of the talks between the complainant BdB, the Land of North Rhine-Westphalia and WestLB AG regarding the appropriate remuneration. For the rest, it has updated as necessary the decision with respect to developments since the previous decision regarding the procedure, the description of the undertaking and the calculation of the aid element, including the fixing of the end of the state aid situation, using the new data provided by Germany for the years following the original decision. The Commission has also shortened a few passages no longer necessary for the new decision.

II. **DETAILED DESCRIPTION OF THE MEASURE**

1. *WESTDEUTSCHE LANDESBANK GIROZENTRALE (WESTLB)*

(18) During the relevant period for this decision, i.e. from the injection of Wfa on 31 December 1991 to the splitting up of WestLB on 1 August 2002, which ended the state aid situation, WestLB was a public-law institution (*Anstalt des öffentlichen Rechts*) under the law of the Land of North Rhine-Westphalia. On 31 December 1991 its recognised own capital amounted to DEM 5,1 billion. By law, three functions had been assigned to WestLB: it acted as central bank for the local savings banks in North Rhine-Westphalia and, since 17 July 1992, also as the central institution for savings banks in the Land of Brandenburg; it was engaged in the issuing of debt instruments and the handling of financial transactions for its public shareholders (state-bank function); it operated as a normal commercial bank in its own right. Irrespective of special provisions of the Land, WestLB was subject to banking supervision under the German Banking Law (*Kreditwesengesetz*).

(19) WestLB was 100 % publicly owned. The largest single stake in the nominal capital was held by the Land (43,2 %). Other shareholders were the municipal associations (*Landschaftsverbände*) of Rheinland and Westfalen-Lippe (11,7 % each) as well as the associations of local public savings banks (*Sparkassen- und Giroverbände*) of Rheinland and Westfalen-Lippe (16,7 % each). This ownership structure remained unchanged through the relevant period from 31 December 1991 to 1 August 2002.

(20) As a public-law institution, WestLB benefited from two forms of guarantees from its public owners: 'institutional liability' (*Anstaltslast*) and 'guarantor liability' (*Gewährträgerhaftung*). *Anstaltslast* means that the owners of WestLB are responsible for securing the economic basis of the institution and its function for the entire duration of its existence. This guarantee does not create a liability on the part of the owners vis-à-vis the creditors of the bank but only governs the relationship between the public authorities and the bank. Under the terms of the *Gewährträgerhaftung*, the owners meet all the liabilities of the bank which cannot be satisfied from its assets. It establishes a liability on the part of the guarantor vis-à-vis the creditors of the bank. Both guarantees were limited neither in time nor in value.

(21) Originally, WestLB was a regional institution that concentrated on supplementing the activities of local savings banks, which in turn focused initially on a primarily social function, providing financial services in sectors characterised by market failure. However, savings banks had long since developed into all-purpose credit institutions. Likewise, over the last few decades WestLB developed increasingly into an independent commercial bank and was a strong competitor on the German and European banking markets.

(22) When measured by balance-sheet total, the WestLB group ranked among the five largest German credit institutions during the relevant period. It offered financial services to enterprises and public institutions and was an important player on international capital markets, both for its own account and as manager of other issuers' debt instruments. Like many German all-purpose banks, WestLB held stakes in financial and non-financial enterprises. It also transacted a substantial part of its business activities outside Germany.

(23) Furthermore, under special legal provisions, WestLB, unlike private banks but in the same way as other public credit institutions, was able, until it was split up in August 2002, to conduct mortgage banking and building and loan association

business under one organisational roof along with its other operations. It ranked therefore, during the relevant period until it was split up, as one of Germany's most comprehensive all-purpose banks.

(24) On the other hand, WestLB did not operate a dense network of retail branches. This market segment was covered by the local savings banks, for which WestLB acted as the central institution.

(25) WestLB's profitability, measured by pre-tax profits as a percentage of capital and reserves at group level, did not exceed 6,6 % on average over the eight years preceding the transfer of Wfa (1984-91) and showed no clear upward tendency. This performance was substantially below the German as well as the European average.

(26) The WestLB group increased its balance-sheet total between 1991, i.e. before the transfer, and the end of 2001, when its last annual accounts before it was split up were prepared, from over DEM 270 million to over DEM 840 million, i.e. by more than 300 %.

(27) By the law of 2 July 2002, the Land of North Rhine-Westphalia split up WestLB as of 1 August 2002 (with retroactive effect under the accounting rules to 1 January 2002) into a public-law parent company, Landesbank Northrhein-Westfalen, and a private-law subsidiary, WestLB AG. WestLB AG took over the commercial activities of the former WestLB, while Landesbank Northrhein-Westfalen took over its public activities. According to Germany, WestLB AG is legally identical to WestLB and is to be considered the debtor for the entire recovery claim ([1]). Wfa was incorporated into Landesbank Northrhein-Westfalen at the time of the split-up and therefore withdrawn from the commercial activities taken over by WestLB AG. The rules of Landesbank Northrhein-Westfalen also stipulated that Wfa's capital cannot be used to underpin the mortgage bonds business remaining within the Landesbank and that, in future, a remuneration of 0,6 % per annum was to be paid to the Land in respect of a possible liability function.

2. *WOHNUNGSBAUFÖRDERUNGSANSTALT (WFA)*

(28) Wfa was founded in 1957 and operated until 31 December 1991 as a public-law institution (*Anstalt des öffentlichen Rechts*). As such, it was an independent entity with a nominal capital of DEM 100 million (EUR 50 million) and the Land of North Rhine-Westphalia as the sole shareholder. Under Section 6(1) of the former North Rhine-Westphalia Law on the promotion of housing (*Wohnungs-Wohnungsbauförderungsgesetz*) ([2]), *Wfa devoted itself exclusively to the promotion of housing by granting low-interest or non-interest-bearing loans. On account of its non-profit character, it was exempt from corporation tax (Körperschaftssteuer), property tax (Vermögenssteuer) and tax on business capital (Gewerbekapitalsteuer).*

(29) As a public-law institution, Wfa was covered by the Land's 'institutional liability' (*Anstaltslast*) and 'guarantor liability' (*Gewährträgerhaftung*) for all its liabilities. These guarantees remained in place as a result of the transfer.

(30) The largest single source of financing for the housing-promotion activities was — and still is — the Land Housing Promotion Fund (*Landeswohnungsbauvermögen*), which has been built up from interest income from housing loans granted by Wfa and annual cash injections from the Land budget. These resources, earmarked to serve exclusively as the funding base for housing loans by virtue of Section 16 of the Law on the promotion of housing, accounted for some 75 % of Wfa's refinancing, i.e. DEM 24 700 million (EUR 12 600 million) as at 31 December 1991.

(31) Prior to the transfer, Wfa guaranteed Land liabilities incurred for housing promotion purposes. Each year, in line with the Land's repayments of its liabilities, Wfa's guarantee was transformed into reimbursement claims of the Land against Wfa which reduced the value of the Land Housing Promotion Fund accordingly. These liabilities of Wfa would have fallen due only when it no longer needed its revenues from interest and loan recovery in order to perform its public tasks. They amounted to about DEM 7 400 million (EUR 3 780 million) by the end of 1991 and were not shown directly in the balance sheet but only 'below the line'.

3. *CAPITAL REQUIREMENTS UNDER THE OWN FUNDS DIRECTIVE AND THE SOLVENCY RATIO DIRECTIVE*

(32) Under Council Directive 89/647/EEC on a solvency ratio for credit institutions ([3]) ('Solvency Ratio Directive') and under the Own Funds Directive, banks must have own

([1]) Submission by Germany of 10 March 2004, p. 2.

([2]) *Wohnungsbauförderungsgesetz*, in the version published on 30 September 1979 (Official Gazette of North Rhine-Westphalia, p. 630).

([3]) OJ L 386, 30.12.1989, p. 14 (as repealed and replaced by Directive 2000/12/EC (OJ L 126, 26.5.2000)).

funds equivalent to at least 8 % ([1]) of their risk-adjusted assets and risk-bearing off-balance-sheet transactions ([2]). These Directives necessitated amendments to the German Banking Law which took effect on 1 January 1992. The new requirements entered into force on 30 June 1993 ([3]). Until that date German credit institutions were obliged to have own funds equivalent to 5,6 % of their risk-adjusted assets ([4]).

(33) As for the new threshold of at least 8 %, half of these own funds have to be 'original own funds' (*Basiseigenmittel*), which consist of capital items available to a credit institution for unrestricted and immediate use to cover losses as soon as they occur. Original own funds are therefore of crucial importance for the level of a bank's total own funds for prudential purposes since other own funds of lower quality, or 'additional own funds' (*ergänzende Eigenmittel*), are accepted only up to the amount of original own funds to underpin the risk-bearing business of a bank.

(34) Furthermore, the amount of own funds limits a bank's exposure to large risks. At the time of Wfa's transfer, the German Banking Law (Section 13) stipulated that no single loan granted may exceed 50 % of a bank's own funds and that the total of such loans exceeding 15 % of own funds may not be higher than eight times the bank's own funds. An amendment of the German Banking Law in 1994 to bring it into line with Council Directive 92/121/EEC ([5]) reduced the maximum loan to 25 % of a bank's own funds and stipulated that the sum of single loans exceeding 10 % of a bank's own funds may not be higher than eight times the total of own funds ([6]).

(35) Moreover, Article 12 of the Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions ([7]) limits the size of qualifying holdings in other credit and financial institutions. Furthermore, a special provision in the German Banking Law (Section 12), not based on Community legislation but found in other Member States, limits the total amount of long-term investments, including holdings in non-financial enterprises, to the total amount of the bank's own funds.

(36) German banks had to adapt to the new capital requirements by 30 June 1993. The own funds cushion of many Landesbanks, including WestLB, was already comparatively weak before transposal of the Solvency Ratio Directive into German law. According to test calculations made by *Deutsche Bundesbank* in December 1991 on the basis of the provisions of the Directives, the Landesbanks had an average solvency ratio of 6,3 %, compared with the 8 % required from 30 June 1993 ([8]). Therefore, there was an absolute need for these institutions to raise new capital in order to avoid restrictions on their business expansion and indeed to maintain their current level of activities. If a bank cannot demonstrate the necessary level of own funds, it will be ordered by the supervisory authorities to take immediate action to comply with the solvency rules either by raising additional capital or by reducing risk-adjusted assets.

(37) Private banks had to satisfy additional demand for own funds on the capital markets. Public banks could not move in the same direction since public shareholders decided not to privatise (even in part) their credit institutions. Yet, the generally tight budgetary situation meant that the public shareholders could not undertake cash injections of capital ([9]). Instead, other solutions were found to provide additional capital. In the case of WestLB, the Land decided to transfer Wfa to WestLB in order to strengthen the latter's own funds base. Similar transactions were carried out by some other Länder in favour of their respective Landesbanks.

4. *THE TRANSFER AND ITS EFFECTS*

a) THE TRANSFER

(38) On 18 December 1991 the Parliament of North Rhine-Westphalia passed the Law governing the promotion of housing (*Gesetz zur Regelung der Wohnungsbauförderung*) ([10]), Article 1 of which ordered the transfer of Wfa to WestLB. The transfer became effective on 1 January 1992.

(39) According to the grounds of the Law, the primary reason for the transfer was to increase WestLB's own funds in order to enable it to comply with the stricter capital requirements entering into force on 30 June 1993. By way of the transfer, this could be done without any financial burden falling on the Land's budget. Combining the housing promotion activities of Wfa with those of WestLB was to have the secondary effect of increasing efficiency.

(40) As part of the transfer, the Land waived Wfa's guarantee of about DEM 7 400 million (EUR 3 780 million) for liabilities of the Land in connection with funds raised for housing promotion (see Section II, point 2).

([1]) The capital requirements must be met by credit institutions on a consolidated, a subconsolidated and an unconsolidated basis.

([2]) The term 'risk-adjusted assets' is used below to describe all risk-bearing and risk-adjusted items.

([3]) In fact, the new capital requirements should already have entered into force on 1 January 1993 but were implemented late in Germany.

([4]) However, this figure was based on a definition of own funds that was narrower than the one set out in the Own Funds Directive.

([5]) Council Directive 92/121/EEC of 21 December 1992 on the monitoring and control of large exposures of credit institutions (OJ L 29, 5.2.1993, p. 1).

([6]) It should, however, be pointed out that not only the thresholds were changed but also the definitions of 'own funds' and 'risk-adjusted assets'.

([7]) OJ L 386, 30.12.1989, p. 1.

([8]) Deutsche Bundesbank, Monthly Report, May 1993, p. 49.

([9]) See, for example, Document 11/2329 of the Parliament of North Rhine-Westphalia.

([10]) *Gesetz zur Regelung der Wohnungsbauförderung* of 18 December 1991 (Official Gazette of the Land of North Rhine-Westphalia, No 61, 30 December 1991, p. 561).

(41) WestLB became the universal legal successor to Wfa (except for Wfa's liability vis-à-vis the Land for debts entered into by the Land for reasons of housing promotion, which was waived prior to the transfer). Wfa became an organisationally and economically independent public-law institution without legal capacity within WestLB. Wfa's nominal capital and reserves must be shown in WestLB's balance sheet as a special reserve (*Sonderrücklage*). The Land continues to guarantee Wfa's liabilities under the *Anstaltslast* and *Gewährträgerhaftung*.

(42) The assets transferred, i.e. nominal capital, capital reserves, the Land Housing Promotion Fund and other claims of Wfa, as well as any future return flows from housing loans remained earmarked for housing promotion under Article 2, Section 16 (2) of the Law even after their transfer to WestLB. The same provision established that the assets transferred serve at the same time as liable equity capital within the meaning of the German Banking Law (and hence the Own Funds Directive), on the basis of which a bank's solvency ratio is calculated. Therefore, they also underpin WestLB's competitive business.

(43) On the occasion of the transfer, WestLB's owners amended the covering agreement (*Mantelvertrag*) and agreed that the assets earmarked for housing promotion must always be preserved, even if WestLB suffered losses that absorbed the original capital. Internally, Wfa's capital should be subordinate in its liability only to WestLB's remaining equity. It was clarified in the agreement that WestLB owners' 'institutional liability' (*Anstaltslast*) also covered Wfa's special reserve. If WestLB were to be wound up, the Land would have a priority claim on Wfa's capital. It was also stated in the agreement that the increase in WestLB's equity base through the integration of Wfa constituted an act in money's worth (*geldwerte Leistung*) by the Land and that the annual remuneration for this act should be agreed on by the owners once the first financial results for the years from 1992 onwards were available ([1]). This was done in a protocol note to the covering agreement dated 11 November 1993. Notwithstanding the internal agreement to guarantee Wfa's assets and the internal subordination of Wfa's capital, no distinction is made in WestLB's external relationships between Wfa's housing promotion activities and its function as a provider of own funds to WestLB. The transferred assets are fully and instantaneously available to WestLB to cover losses or, in the event of bankruptcy, to cover creditors' claims.

(44) The management contract regarding the Law governing the promotion of housing (*Geschäftsbesorgungsvertrag zum Wohnungsbauförderungsgesetz*) concluded between the Land and WestLB lays down that WestLB will use the special reserve to underpin its own business activities only in so far as fulfilment of Wfa's legally binding tasks is guaranteed.

([1]) According to Germany, the expression 'act in money's worth' used there is in fact imprecise and was clarified later.

(45) Although Wfa lost its legal independence by becoming a housing promotion division of WestLB and was integrated into WestLB's accounts, it was not integrated operationally into WestLB. Wfa remained a distinct entity within WestLB under the name *Wohnungsbauförderungsanstalt Nordrhein-Westfalen — Anstalt der Westdeutschen Landesbank Girozentrale*. This new housing promotion division of WestLB is included in WestLB's accounts but also publishes separate ones. WestLB's existing housing promotion department was merged with Wfa.

(46) Wfa's transferred capital, reserves, assets and future profits are still earmarked for housing promotion and must therefore be administered separately from WestLB's other commercial activities. This separation is, at the same time, a prerequisite for continuing recognition of the housing promotion activities as non-profit-making under German tax legislation. Since the German authorities assumed that the integrated Wfa did indeed remain a non-profit-making entity, the tax exemptions mentioned in Section II, point 2 above were not abolished.

(47) WestLB's competitors also opposed the merger of the monopoly-like Wfa and WestLB because they feared that WestLB would be able to take advantage of information gathered in the housing promotion field to acquire new customers for its commercial business. The competent authorities have undertaken to ensure that distortions of competition are not caused by such proximity, in particular by separating the housing promotion division from the commercial divisions of WestLB in terms of personnel, information, etc ([2]).

(48) With the splitting up of WestLB on 1 August 2002 (with retroactive effect under the accounting rules to 1 January 2002) under a law of the Land of North Rhine-Westphalia of 2 July 2002, Wfa was allocated to Landesbank Northrhein-Westfalen and thus withdrawn from the commercial activities grouped together in WestLB AG.

b) VALUE OF WFA

(49) As at 31 December 1991, the nominal value of Wfa's capital transferred to WestLB was about DEM 24 900 million (EUR 12 730 million), of which nearly DEM 24 700 million (EUR 12 680 million) was accounted for by the Land Housing Promotion Fund. These resources served to finance housing promotion loans, which are either non-interest-bearing or low-interest loans and often have long grace periods. Therefore, in order to establish its actual value, the nominal capital had to be heavily discounted.

([2]) Section 13 of the Law concerning the asset transfer stipulates that the housing promotion division must carry out its tasks in a manner that is neutral in its effect on competition. The actual measures to be taken to this end are laid down in an agreement between WestLB and the Land authorities.

(50) On 1 January 1992 WestLB commissioned a valuation of Wfa which was delivered on 30 April 1992. It should be noted that this valuation was carried out only after the Land had decided on the transfer of Wfa.

(51) As to the valuation method, the auditor stated that, because of the continuing obligation to reinvest all future income of Wfa in low-interest or non-interest-bearing housing promotion loans, the institution would in fact have no capitalised earnings value. However, this obligation would cease in the event of the realisation of Wfa. The advantage of Wfa for WestLB was said to consist, firstly, in the increase in own funds and the resulting ability to expand business and, secondly, in the increase in its credit standing following the considerable strengthening of its equity capital. Since WestLB received no advantage from Wfa's regular activities, the latter's value had to be established as the possible proceeds in the event of its sale — without the reinvestment obligations that exist only in the internal relationship. The assets had to be valued at an amount which would result in a normal return, i.e. they had to be discounted to a value which could serve as a basis for considering their nominal return flows as a normal market return.

(52) The auditors revalued various items of Wfa's assets and liabilities — the housing loans were adjusted from DEM 30 700 million (EUR 15 700 million) to DEM 13 500 (EUR 6 900 million), i.e. by 56 % — and arrived at a net asset value for Wfa of DEM 5 900 million (EUR 3 020 million). This corresponds to an overall discount of 76 % when compared with Wfa's nominal net asset value of DEM 24 900 million (EUR 12 700 million) at that time. Following this revaluation, the amount of DEM 5 900 million (EUR 3 020 million) was entered in WestLB's accounts as a special capital reserve for housing promotion (*Sonderrücklage Wohnungsbauförderungsanstalt*).

(53) After being asked by WestLB to accept the amount of DEM 5 900 million (EUR 3 020 million) as WestLB's original own funds, BAKred commissioned another auditing firm to carry out a valuation. This valuation was delivered on 30 September 1992. The valuation for BAKred examined the plausibility of the one made for WestLB and accepted its methodological approach. However, mainly because of the choice of a different discount rate and differing treatment of possible redemptions before maturity (*Vorfälligkeitstilgungen*), the valuation for BAKred arrived at a net asset value for Wfa ranging from DEM 4 000 million (EUR 2 050 million) to DEM 5 400 million (EUR 2 760 million).

(54) On the basis of this valuation, BAKred finally accepted on 30 December 1992 DEM 4 000 million (EUR 2 050 million) as WestLB's original own funds within the meaning of the German Banking Law. Neither the amount shown in WestLB's balance sheet — DEM 5 900 million (EUR 3 020 million) — nor the amount accepted as original own funds has been changed since then.

(55) Both valuations of the assets transferred were based on the situation after the waiver of Wfa's liability vis-à-vis the Land, which they valued at around DEM 7 300 million (EUR 3 730 million).

c) EFFECTS OF WFA'S TRANSFER ON WESTLB

(56) On 31 December 1991 WestLB had recognised own funds of DEM 5 100 million (EUR 2 600 million), of which DEM 500 million (EUR 260 million) in profit participation certificates (*Genußrechte*). The bank's solvency ratio was around 6,1 % on the basis of the provisions of the German Banking Law before its adaptation to the Community Banking Directives, i.e. 0,5 percentage point above the minimum level stipulated by that Law.

(57) As a result of the acceptance of Wfa's capital as own funds of WestLB by BAKred, WestLB's total own funds were boosted to DEM 9 100 million (EUR 4 650 million), an increase of 79 %. Taking into account an allocation of DEM 100 million (EUR 50 million) to reserves from profits, WestLB's own funds amounted to DEM 9 200 million (EUR 4 700 million) at 31 December 1992. This corresponded to a solvency ratio of 8,7 %, including Wfa's capital and risk-adjusted assets.

(58) Table 1: Capital requirements and own funds of WestLB and Wfa (based on data provided by the German authorities)

(DEM million)

(at 31 December)	1991	1992
Risk-adjusted assets of WestLB (without Wfa)	83 000	91 209
Risk-adjusted assets of Wfa	13 497	14 398
Risk-adjusted assets of WestLB (with Wfa) (*)		105 607
Required own funds of WestLB (**) (= a)	4 611	5 867
Required own funds of WestLB without Wfa (**) (= b)		5 067
WestLB own funds (= c)	5 090	9 190
WestLB own funds without Wfa (= d)		5 190
Utilisation rate of WestLB own funds (= a/c)	91 %	64 %
Utilisation rate of WestLB own funds without Wfa (= b/d)		98 %

(*) The transfer of Wfa took effect on 1 January 1992.

(**) Based on the 5,6 % requirement in force at that time.

(59) This solvency ratio of 8,7 % included an increase in WestLB's risk-adjusted assets unrelated to housing promo-

tion of some DEM 8 200 million (EUR 4 190 million), or 9,9 %, in 1992. If this increase had taken place without the transfer of Wfa, WestLB's solvency ratio would have fallen to 5,7 % by 31 December 1992, i.e. to a level very close to the minimum requirement of 5,6 %.

(60) Whereas all of Wfa's capital is tied up in its housing promotion activities, only some of its own funds within the meaning of the solvency rules are needed to underpin its risk-adjusted assets. According to information provided by the German authorities, DEM 1 500 million (EUR 770 million) was needed for this purpose at the time when the new capital requirements entered into force. This means that the remaining DEM 2 500 million (EUR 1 280 million) could be used by WestLB at that time as own funds to underpin its competitive business.

(61) On 31 December 1991 the solvency ratio of the WestLB group was 5,8 %, i.e. 0,2 percentage point above the minimum. One year later, after the Wfa's capital had been accepted by BAKred, the ratio was about 8,1 %, including Wfa's risk-adjusted assets. If the asset transfer had not taken place and the group had increased its non-housing-related risk-bearing assets as it actually did, the group's solvency ratio would have fallen to 5,3 %, or 0,3 percentage point below the minimum level required at the time.

(62) On 30 June 1993, when the German credit institutions had to comply with the new capital requirements set by the Own Funds Directive and the Solvency Ratio Directive, the group's solvency ratio (including Wfa's capital requirements), calculated on the basis of the new provisions, was 9 %, i.e. 1 percentage point above the minimum level. (The original own funds accounted for 6,3 percentage points, additional own funds for 2,7 percentage points.) Excluding Wfa's capital contribution and its risk-adjusted assets, the group would have had a solvency ratio of about 7,2 % as at 30 June 1993. The ratio of 9 % was achieved by raising more additional own funds in the form of subordinated loans amounting to some DEM 2 900 million (EUR 1 480 million) in early 1993. Over the whole of 1993 WestLB raised DEM 3 100 million (EUR 1 590 million) of additional own funds, bringing the total own funds of the group within the meaning of the German Banking Law to DEM 12 900 million (EUR 6 600 million) by the end of that year. The solvency ratios had fallen slightly by the end of 1993, compared with 30 June.

(63) Table 2: Capital requirements and own funds of the WestLB group (based on data provided by the German authorities)

(DEM million)

Average amounts	1992 (*)	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 (#)
Total assets	271 707	332 616	378 573	428 622	470 789	603 797	693 026	750 558	782 410	844 743	519 470
Risk-adjusted assets	126 071	120 658	151 482	156 470	173 858	204 157	259 237	[...] (+)	[...]	[...]	[...]
Required original own funds (= a)	4 758	4 827	6 060	6 259	6 954	8 167	10 370	[...]	[...]	[...]	[...]
Required total own funds (= b)	9 351	9 653	12 119	12 517	13 908	16 333	20 739	[...]	[...]	[...]	[...]
Original own funds (= c)	5 117	8 818	9 502	9 769	9 805	10 358	11 378	[...]	[...]	[...]	[...]
Additional own funds	500	2 495	4 513	4 946	5 270	7 094	10 170	[...]	[...]	[...]	[...]
Total own funds (= d)	5 617	11 313	14 015	14 715	15 075	17 452	21 548	[...]	[...]	[...]	[...]
Utilisation rate of original own funds (= a/c)	93 %	55 %	64 %	64 %	71 %	79 %	91 %	[...]	[...]	[...]	[...]
Utilisation rate of total own funds (= b/d)	166 %	85 %	86 %	85 %	92 %	94 %	96 %	[...]	[...]	[...]	[...]

(*) Anomalies in this year should be attributed to the change in the method of showing Wfa's assets in the balance sheet, to changes in the definition of own funds and in the solvency ratios, and to the timing of the acceptance of Wfa's capital by BAKred.

(#) Figures relate to WestLB AG, into which the commercial activities of former Westdeutsche Landesbank Girozentrale were regrouped in 2002.

(+) Confidential information is indicated below by [...].

(64) In absolute figures, the original own funds of DEM 4 000 million (EUR 2 050 million) increased by DEM 72 000 million (EUR 36 800 million) the theoretical capacity to extend business volume with 100 % risk-adjusted assets under the former German Banking Law (5,6 % minimum solvency ratio). On the basis of the minimum solvency ratio of 8 %, applicable since 30 June 1993, the relevant figure would be DEM 50 000 million (EUR 25 600 million). Assuming that DEM 2 500 million (EUR 1 280 million) of Wfa's capital was available to the WestLB group's competitive business its 100 % risk-adjusted lending capacity was increased by DEM 31 300 million (EUR 16 000 million).

(65) However, since a bank's assets are normally not 100 % risk-adjusted, the actual credit volume capacity was increased by a greater amount. At the end of 1993 the WestLB group's risk-adjusted assets (including Wfa's business) amounted to DEM 148 600 million (EUR 76 000 million). The balance-sheet total came to DEM 332 600 million (EUR 170 100 million). This indicates an average risk weighting of 45 % ([1]). Given a constant risk structure, the DEM 2 500 million (EUR 1 280 million) of original own funds available permitted a total expansion (or coverage of existing business) of about DEM 69 400 million (EUR 35 500 million) on the basis of the 8 % threshold laid down in the EC Banking Directives. Since the increase in original own funds allowed WestLB to raise further additional own funds (up to an amount equal to the original own funds), its actual lending capacity was indirectly increased even further.

(66) Several conclusions can be drawn. Firstly, without a capital increase, WestLB would have had difficulties remaining above the minimum solvency ratio under the German Banking Law before its adaptation to the EC Banking Directives. Secondly, without Wfa's transfer, the WestLB group would have satisfied the minimum solvency ratio under the Solvency Ratio Directive only by reducing its risk-adjusted assets or by mobilising other sources of own funds (e.g. disclosure of hidden reserves). The raising of additional own funds could have provided only temporary relief because the level of such funds is limited by the amount of original own funds available. Thirdly, the capital increase, together with the fresh additional own funds raised in 1993, exceeded the amount needed by the group to meet the stricter capital requirements of the revised German Banking Law.

(67) As regards the supervisory restrictions on individual large loans, the 50 % threshold stipulated by the former German Banking Law was equivalent to about DEM 2 500 million (EUR 1 280 million) before the acceptance of Wfa's capital. After acceptance of Wfa's capital and a DEM 100 million (EUR 50 million) allocation to reserves from profits, the threshold rose to nearly DEM 4 600 million (EUR 2 350 million). The 15 % threshold stipulated for large loans, which in total may not be higher than eight times the bank's own funds, was equivalent to about DEM 760 million (EUR 390 million) at 31 March 1992. One year later, i.e. after the acceptance of Wfa's capital, the threshold had risen to nearly DEM 1 400 million (EUR 720 million). WestLB's capacity to grant such large loans was increased by DEM 32 000 million (EUR 16 400 million) (i.e. eight times the increase of own funds) as a result of the transfer of Wfa ([2]).

d) REMUNERATION FOR THE TRANSFER OF WFA

(68) The transfer of Wfa did not lead to a change in the ownership structure of WestLB. Therefore, the Land is not remunerated for the capital provided, either by way of a higher share in dividends paid or by way of a higher share in the capital gains of the holdings in WestLB.

(69) The agreement governing the relationship between the owners of WestLB (*Mantelvertrag*) was amended on the transfer of Wfa. Under Section 5(2) of that agreement, the owners agree that the enlargement of WestLB's capital basis by the Land constitutes a financial advantage for them. The level of remuneration for the capital provided was to be fixed after WestLB's first financial results for 1992 were known, i.e. a short time after the transfer. The grounds for the law on the transfer contain similar wording as regards the value of the transfer and the remuneration.

(70) The remuneration for the capital provided was finally fixed at an annual rate of 0,6 %. It must be paid by WestLB from profits after tax, giving a pre-tax burden of around 1,1 % for WestLB ([3]). It is payable only if profits are made.

(71) The basis for this remuneration is the capital of Wfa recognised by BAKred as original own funds, i.e. DEM 4 000 million (EUR 2 050 million). The remuneration is paid only on the part of this capital not needed by Wfa to underpin its housing promotion activities. This part, available for WestLB to underpin its commercial business, amounted to DEM 2 500 million (EUR 1 280 million) after the new capital requirements entered into force and has been increasing since then ([4]).

([1]) This calculation leaves out of consideration the risk-bearing, off-balance-sheet transactions.

([2]) It should be borne in mind that, under the new rules, not only the ratios changed but also the definitions of 'own funds' and 'risk-adjusted assets'.

([3]) According to a study submitted by Germany on the remuneration paid by WestLB, the corporation tax rate was 46 % until 1993 and 42 % thereafter. To this must be added a solidarity surcharge rate of 3,75 % in 1992, 0 % in 1993 and 7,5 % thereafter.

([4]) For the sake of clarity, where the amount on which the remuneration is to be paid is discussed, reference is always made to the situation at the end of 1993, i.e. the split between DEM 1 500 million (EUR 770 million) and DEM 2 500 million (EUR 1 280 million), irrespective of the fact that the division between the capital tied up in Wfa business and the amount available for WestLB changes.

(72) Table 3: Special capital reserve for housing promotion and own fund requirements needs of Wfa (based on data provided by the German authorities).

(DEM million)

(At 31 December)	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Special reserve for housing promotion	5 900	5 900	5 900	5 900	5 900	5 900	5 900	5 900	5 900	5 900	5 900
Of which accepted as original own funds	4 000	4 000	4 000	4 000	4 000	4 000	4 000	4 000	4 000	4 000	4 000
Needed for housing promotion loans of Wfa	1 668	1 490	1 181	952	892	888	887	[...]	[...]	[...]	[...]
Available for WestLB	13 (*)	2 510	2 819	3 048	3 108	3 112	3 113	[...]	[...]	[...]	[...] (#)

(*) Since BAKred accepted Wfa's capital only on 30 December 1992, the capital share of DEM 2 322 000 million (EUR 1 200 million) was available for WestLB in 1992 for two days only. This results in an average available capital for WestLB of DEM 13 million (EUR 7 million) for that year.

(#) Since Wfa's capital could be used for underpinning commercial activities only until 1 August 2002 as a result of the split-up of WestLB, the difference of [...] between the total amount of recognised original own funds of [...] and the amount of DEM 632 million tied up by Wfa needs to be multiplied by a factor of 7/12. This gives the amount of [...] as the average capital available for the commercial activities of WestLB.

III. COMMENTS FROM INTERESTED PARTIES

1. *COMPLAINT AND OBSERVATIONS BY BDB*

(73) BdB submits that the application of the 'market-economy investor principle' is not limited to enterprises which are loss-making or in need of financial restructuring. Such an investor is guided not by the question of whether the enterprise in question is profitable at all but rather by whether the profitability corresponds to the market rate. If capital injections by the public authorities were examined only in the case of loss-making enterprises, this would discriminate against private enterprises and thus infringe Article 86(1) of the EC Treaty.

(74) It also submits that Article 295 of the EC Treaty cannot be used to exempt the transfer of Wfa's assets from the competition rules, arguing that the article in question may well protect the freedom of the Land to create such a special asset but, as soon as it is transferred to a commercial enterprise, the competition rules must be applied.

a) APPROPRIATE REMUNERATION FOR THE CAPITAL

(75) BdB argued that, like any other original own funds, the recognised original own funds of DEM 4 000 million (EUR 2 050 million) can be used to underpin business and, at the same time, to raise additional own funds for solvency reasons. Thus, by way of the transfer, the Land enabled WestLB, which was operating at the very edge of its equity base, to avoid reducing its business activities and even to expand those business activities open to risk. Furthermore, the amount by which the own funds exceed actual requirements also influences the funding costs on the financial markets. According to BdB, a market-economy investor would not inject capital into his company if its financial results had been consistently poor for years and there were no signs of a considerable improvement, i.e. no indications that a higher return could be expected in the future.

i) *Level of the remuneration*

(76) BdB stressed that WestLB was in urgent need of original own funds and that the transfer of Wfa nearly doubled WestLB's original own funds from DEM 4 700 million (EUR 2 400 million) to DEM 8 700 million (EUR 4 450 million). No private investor would have brought such a huge amount of equity capital into WestLB, given its weak financial performance at that time. In return for providing capital under such conditions, a private investor would have demanded a premium of at least 0,5 percentage point on top of the normal return on equity capital. BdB quoted WestLB's profitability as an average of 5,6 % before tax for the ten years prior to the transfer. This compared with profitability figures for large private German banks of between 12,4 % and 18,6 %, with an average of 16,8 % (before tax) for the same period. Other Landesbanks are said to have generated profits of between 9 % and 11 %. BdB submitted a calculation of the return on equity of German banks made on its behalf by an external consultancy.

(77) As regards the appropriate method of calculating a comparison of returns on equity, BdB submitted that historical return rates should be calculated as an arithmetic average, not as a compound annual growth rate. The latter method implies that the investor reinvests dividends and takes the additional income from these reinvestments into account for the calculation. However, the way in which

dividends are reinvested cannot influence the original investment decision but has to be considered as a new, separate decision. A method based on an arithmetic average should therefore be used.

(78) If, however, the compound annual growth rate method is used, the average return of some large German private banks for the period from 1982 to 1992 comes to 12,54 % after taxes. In calculating this figure, BdB took into account all possible holding periods for investments and sales between 1982 and 1992 in order to avoid any possible bias as a result of taking only one base year, if share prices were unusually high or low in that year. Applying many holding periods simultaneously is said to smoothen the effect of stockmarket fluctuations. BdB submitted that the corresponding figures given by WestLB were too low because income from the sale of subscription rights was not taken into account.

(79) As regards the capital asset pricing model, which is used in the central study provided by WestLB to justify the remuneration of 0,6 %, BdB submitted its own external study, which arrives at returns on equity of 12,21 % (on the basis of the normal risk premium on the German market for the period 1982-91) and 14,51 % (on the basis of a higher expected risk premium), these figures being higher than the ones provided by WestLB. The difference could be attributed to two facts. Firstly, BdB applied a higher risk premium for equity (3,16 % and 5 % respectively). Secondly, it applied a higher beta factor for credit institutions (1,25). The risk-free basic rate used is the same as in WestLB's calculation. Considering the various methods of calculating return on equity, BdB finally quoted a range of 14 % to 16 % as a normal return on equity.

(80) BdB further stated that a private minority shareholder would not inject additional capital without requesting an increase of his share in the company. Only with such an increase could he duly participate in the profit of, and exercise greater influence on, the company.

(81) BdB also stressed that the agreement between WestLB's shareholders whereby Wfa's capital should be subordinate in its liability only to the other equity of WestLB had, in fact, no real effect because the Land, by virtue of its institutional liability (*Anstaltslast*), had to step in if WestLB were in difficulties. In fact, as owner of WestLB, the Land now guaranteed not only WestLB's entire liabilities but also Wfa's equity that it itself injected, without receiving any remuneration. That means that any reduction in the risk attaching to the transferred capital would merely be the result of an increased risk for the Land as a WestLB shareholder. Thus, the risk profile of Wfa is no different from that of normal equity.

(82) As regards the comparison with equity instruments on the financial market submitted by Germany and WestLB, BdB stressed that profit participation certificates (*Genußrechte*) and cumulative perpetual stocks could not be compared to Wfa's capital. Firstly, they were not accepted as original own funds. (Cumulative perpetual stocks were not even accepted as additional own funds in Germany.) Because it qualifies as original own funds, Wfa's capital allowed WestLB to increase further its own funds by raising additional own funds. Secondly, the instruments referred to were limited in time and profit participation certificates lost their additional own funds character two years before maturity. Wfa's capital was, however, at WestLB's disposal for an unlimited period. Thirdly, such instruments normally provided only a limited part of a bank's own funds and required a considerable share of original own funds. Fourthly, capital markets instruments could be traded on the markets, which meant that an investor could terminate his investment whenever he wished. The Land does not have this opportunity. In return for accepting such a lack of trading possibilities, a private investor would demand a premium of at least 0,5 percentage point on his normal return.

(83) BdB also provided the Commission with data on the equity components and solvency ratios of some large German private banks from 1990 onwards. These data show that, at the beginning of the 1990s, no hybrid original own funds instruments were in fact available to (or at least used by) German banks. It also transpires from that information that these credit institutions generally had solvency ratios well above the minimum requirements of 4 % for original own funds and 8 % for total own funds.

(84) BdB also commented on the covering agreement between the shareholders of WestLB, which stipulated that, internally, Wfa's capital was subordinate in its liability only to the other liable equity capital. Since the expression 'other liable equity capital' also covered additional own funds instruments like profit participation certificates and subordinated loans and was therefore detrimental to their position, it argued that the agreement was a 'contract at the expense of third parties' (*Vertrag zu Lasten Dritter*) and thus void. Therefore, the risk profile of Wfa's special reserve was therefore said to be higher than that of profit participation certificates and subordinated loans.

(85) For all these reasons, BdB assumed that the remuneration of 0,6 % paid by WestLB did not constitute a market rate. Taking into account WestLB's need to raise liquid funds in order to use Wfa's capital in full and the lack of participation in the accumulated reserves because the Land's share in WestLB did not increase, BdB suggested a rate within the range of 14 % to 17 % as correct remuneration. This rate was to be paid on the total accepted amount of DEM 4 000 million (EUR 2 050 million).

ii) ***Liquidity costs***

(86) In its complaint BdB accepted the 'liquidity costs' so that a reduction of about 7 percentage points should be applied when calculating the appropriate remuneration for the capital. However, it claimed that, because the equity also served to underpin off-balance-sheet business not requiring liquid funds, this figure of 7 percentage points should, in fact, be lower.

(87) In its observations on the Commission decision to initiate the procedure laid down in Article 88(2) of the EC Treaty, BdB argues that 'liquidity costs' should not be taken into account in calculating the appropriate return on Wfa's capital. These costs are said to have already been taken into account when discounting Wfa's assets to the value of DEM 5 900 million (EUR 3 020 million). Moreover, several banking activities, e.g. guarantees, do not need any liquidity at all. Therefore, if any costs at all are taken into account, then it should only be a small margin of 2,7 percentage points in order to offset the fact that the Wfa assets are locked up in unprofitable business. BdB submitted an outside expert's opinion on this point.

(88) The BdB further mentioned that the 7,5 % for refinancing costs claimed by WestLB was questioned as being too high in any case. On the basis of an analysis of the average market rates in the different years for the various refinancing instruments and in accordance with WestLB's balance-sheet structure, the actual rate for WestLB's refinancing on the markets was said to be an average of between 6,07 % and 6,54 % for the years 1992-96. BdB also provided the Commission with figures for the refinancing costs of some large German private banks at the time of the transfer, which were considerably lower than the 7,5 % claimed by WestLB as appropriate refinancing costs at an earlier stage of the procedure. Moreover, according to BdB, a distinction had to be drawn between figures before tax and figures after tax. Refinancing costs reduced the taxable profit. So, if any refinancing costs are taken into account, only rates applied after tax should be considered.

iii) ***Capital basis for the calculation of the remuneration***

(89) As already mentioned, BdB suggested that the appropriate remuneration should be paid on the total accepted amount of DEM 4 000 million (EUR 2 050 million). However, it claimed in its observations that not only this amount, recognised by BAKred as original own funds, but also the excess amount of DEM 1 900 million (EUR 970 million), which cannot be used to underpin business but is nevertheless shown as equity in the balance sheet, benefited WestLB. Rating agencies and investors did not look at the accepted original own funds but at the total equity shown in the balance sheet, as the latter formed the basis for commercial estimates of what was available to cover losses. This amount therefore increased WestLB's credit standing, and a remuneration comparable to a guarantee premium should be paid for it.

iv) ***Synergy effects***

(90) According to BdB, the claimed synergy effects did not constitute the real reason for the transfer. This was said to be apparent from the fact that the law on the transfer justified the measure on the grounds of the need to strengthen WestLB's competitive position and from the agreement that a remuneration should be paid for the act in money's worth.

(91) Furthermore, BdB questioned how synergy effects could be achieved while Wfa's and WestLB's commercial businesses are separated from each other in economic, organisational and personnel terms, as provided for in the relevant legal provisions. If synergies did emerge in Wfa's activities, they would reduce the costs of housing promotion but could not be regarded as remuneration for the Land from WestLB.

b) TAX ASPECTS

(92) BdB pointed out that Wfa remained exempt from property tax, tax on business capital and corporation tax even after the transfer. Tax exemptions for public-law credit institutions were justified only as long as these institutions were engaged exclusively in promotional activities and thus did not operate in competition with private taxable institutions.

(93) According to BdB, a normal bank increasing its capital would each year have to pay on this additional capital 0,6 % property tax and 0,8 % tax on business capital. WestLB was therefore in a favourable position compared with other banks. The exemption from corporation tax was said to benefit WestLB indirectly. The waiver of tax income constituted state aid within the meaning of Article 87(1) of the EC Treaty.

c) WAIVER OF LIABILITY

(94) Prior to the transfer, Wfa was released from liabilities of DEM 7 300 million (EUR 3 730 million) vis-à-vis the Land, which waived them without asking for any consideration for this either from Wfa or from WestLB. A market-economy investor would have asked for a consideration for such a waiver. The waiver was also a decisive prerequisite for the acceptance by BAKred of DEM 4 000 million (EUR 2 050 million) of capital. WestLB therefore profited directly from the waiver.

2. *OBSERVATIONS FROM OTHER INTERESTED PARTIES*

(95) Besides WestLB and BdB, two other interested parties commented on the Commission decision to initiate the procedure laid down in Article 88(2) of the EC Treaty.

a) ASSOCIATION FRANÇAISE DES BANQUES

(96) The *Association Française des Banques* states that the transfer of own funds to WestLB, for which only an insignificant remuneration was sought, and the continuing guarantee for the bank from the Land lead to distortions of competition detrimental to French credit institutions. Since WestLB's owners demanded a return on their capital that was clearly below the normal level, WestLB could offer its services at below cost ('dumping'). As it benefits from guarantor liability, WestLB has a triple-A rating which allows it to refinance on the markets on very favourable terms.

(97) These advantages place French banks operating in Germany at a disadvantage. At the same time, WestLB can, under these special conditions, develop its business in France, especially in the sector of municipal finance. Competition within the banking sector is distorted in Germany, France and other Member States.

b) BRITISH BANKERS' ASSOCIATION

(98) The *British Bankers' Association* argues that WestLB is an active competitor against non-German banks within Germany and across the European market. Therefore, any aid granted to WestLB has a distorting effect on trade within the Community. The Commission is called upon to uphold the principles of the single market and not to exempt publicly owned banks from the competition rules of the Treaty.

3. *OBSERVATIONS FROM WESTLB*

(99) Following publication of the Commission decision to initiate the procedure laid down in Article 88(2) of the EC Treaty, WestLB submitted as its position a copy of Germany's observations on the same question and declared itself fully in agreement with that statement. Thus, the arguments of Germany generally reflect the position of WestLB, which is therefore presented only briefly.

a) GENERAL OBSERVATIONS ON THE TRANSFER

(100) According to WestLB, the market-economy investor principle is not applicable to investments in economically sound and profitable enterprises. This is said to be confirmed by the Court, which had in the past applied this principle only in cases where, at the time of the investment decision, the enterprise in question had already been operating at a significant loss for a considerable time and was active in a sector characterised by structural overcapacity. It is claimed that there is no basis in case law for applying the principle to sound and profitable enterprises.

(101) WestLB submits that, given Wfa's special purpose, its assets are not comparable to normal funds. The transfer to WestLB of Wfa's otherwise unusable assets represents the most commercially sensible use of these assets. By means of the transfer the Land has optimised the use of funds earmarked for housing promotion. A private owner would have acted in the same way.

(102) According to WestLB, an increase in the Land's participation following the transfer would be not only unnecessary but also incompatible with the particular risk profile of Wfa's capital. Given the lack of liquidity, the transfer cannot be compared to other capital injections. Other equity instruments on the market do not carry voting rights either.

(103) It is claimed that, since the remuneration received by the Land was a reasonable price, there was no need to ask for any increase in WestLB's profitability. Furthermore, it was not apparent why a market-economy investor would require a certain target profit if he invested in a profitable company. Since WestLB had made a profit in the past, there was also no need to establish any restructuring plan. Such a plan was required by the Court only in cases of restructuring aid for loss-making enterprises.

b) APPROPRIATE REMUNERATION FOR THE CAPITAL

(104) According to WestLB, the remuneration paid for the capital in question is appropriate. In support of this opinion, WestLB submitted a report from an investment bank which had been commissioned by WestLB to assess the remuneration. The expert report compares the risk profile of Wfa's capital with that of other equity instruments on the capital markets and, on the basis of this comparison, identifies a rate within the range of 0,9 % to 1,4 % as appropriate remuneration for Wfa's capital. This compared with costs of about 1,1 % (before tax) for WestLB for the use of Wfa's capital. WestLB stresses that, in order to be used in full, the capital requires additional refinancing costs, which are given in different documents in the range of 7,5 % to 9,3 %.

(105) WestLB also submits that the figures presented by BdB on the return on equity of German banks are not correct for several reasons. On account of specific stock exchange developments, the investment period used by BdB for the calculation led to particularly high returns. The arithmetic average used by BdB did not provide correct results as the compound annual growth rate method should be used for such calculations. BdB included in its calculations investment periods which were not relevant for an investment decision in 1992 and, because it took into account all possible holding periods, it counted individual years several times over. The banks used by BdB for computing an average rate of return on equity for large German banks

could not be compared to WestLB because of differing core businesses. According to WestLB, the average return on equity of 16,6 % presented by BdB falls to 5,8 % after adjustment for all these factors.

c) SYNERGY EFFECTS

(106) According to WestLB, the integration of Wfa into WestLB led to considerable cost savings for Wfa. In the first two years Wfa's staff of 588 (personnel within the 'old' Wfa as well as in the housing promotion division of WestLB, the costs of which had to be borne by Wfa before the transfer) was reduced by 53. In the early years the transfer led to annual savings of DEM 13 million (EUR 7 million) for Wfa as a result of synergies. The reduction in staff numbers should continue and annual savings were expected to increase to around DEM 25 million (EUR 13 million) from 1997 onwards. These amounts were said to benefit exclusively the housing promotion business of the Land. Another document refers to a synergy effect of at least DEM 35 million (EUR 18 million) annually.

(107) Furthermore, in the course of the merger, changing the pension scheme for Wfa employees cost WestLB DEM 33 million (EUR 17 million) in payments to the pension institution of the Federation and the Länder. The payments would reduce Wfa's subsequent expenses.

d) TAX EXEMPTIONS

(108) According to WestLB, the exemption of Wfa from certain taxes is in line with the system of German tax law, under which the taxes in question do not apply to institutions that serve public purposes and do not compete with other, tax-paying institutions. WestLB itself is liable in full to all these taxes and does not derive any benefit from the exemption of Wfa. It is also pointed out that property tax has not been levied since 1 January 1997 and tax on business capital not since 1 January 1998.

e) WAIVER OF LIABILITY

(109) As WestLB points out, the waiver of the liabilities in question was made before the transfer and subsequent valuation of Wfa's assets. The value of DEM 4 000 million (EUR 2 050 million) therefore reflects the situation without liabilities. Since the remuneration is based on this value, WestLB does not receive any advantage from the waiver.

IV. COMMENTS FROM GERMANY

(110) Germany submitted that the transaction does not include any elements of state aid for WestLB within the meaning of the EC Treaty. The Land of North Rhine-Westphalia received an appropriate remuneration which corresponded to the terms of the market. Nor did the transaction constitute state aid for the other shareholders of WestLB as the preservation of the shareholder structure after Wfa's transfer was justified by the appropriate remuneration paid by WestLB. Furthermore, the tax exemptions for Wfa do not include elements of state aid for WestLB because they did not affect the commercial business of the bank.

(111) In Germany's opinion, the Commission may examine the case only on the basis of the circumstances obtaining at the time of the investment, i.e. at the end of 1991. Only these circumstances could have been the basis for the Land's investment decision. Subsequent questions and developments such as the acceptance of own funds by BAKred or the annual valuation and integration of Wfa's assets and liabilities into WestLB's accounts fell outside the scope of the Commission's investigation.

(112) According to Germany, the ideas on integrating Wfa into WestLB dated back to the 1970s and the 1980s and were prompted by the view that housing promotion could be made more efficient. Before the transfer, the procedure for receiving a housing loan was very complicated as both Wfa and WestLB were involved alongside the relevant public authorities. Within WestLB, a special housing promotion department was set up, with the costs being borne by Wfa. This structure led to duplication of posts and files and other inefficiencies. Since the transfer, the beneficiaries of housing loans have had to deal with only one party and not two.

(113) Germany states further that WestLB could also have met the new solvency criteria by raising additional own funds but that, with a view to securing the long-term functioning of the bank, it seemed reasonable to increase the original own funds. All this shows that the prime reason for the transfer was not to increase WestLB's equity but to achieve potential synergy effects and improve housing promotion procedures. The change in solvency rules merely triggered the process.

(114) The legislative initiative in question already laid down that the resources of the Land Housing Promotion Fund would have to remain earmarked, that its substance would have to be secured and that the instruments for housing promotion would have to be maintained. In accordance with these principles, Wfa must be managed by WestLB as an organisationally and economically independent entity which draws up its own annual accounts. In the event of WestLB being wound up, the Land has a preferential claim on Wfa's net assets. All of Wfa's income is still given over to housing promotion. Only that part of Wfa's own funds which it does not itself need to underpin its assets can be used by WestLB for solvency purposes. The Land retains a special influence over Wfa by way of specific supervisory, information and cooperation rights.

(115) Externally, liability in respect of the special reserve is unlimited. In the event of WestLB's liquidation or bankruptcy, creditors would have direct access to it. Losses could

also be offset against the special reserve without limitations. Internally, however, WestLB's owners have laid down other arrangements regarding the order in which liable capital is called on, with Wfa's capital being ranked after the remaining equity capital of WestLB. Since this internal agreement does not affect external legal liability, BAKred accepted the special reserve as original own funds amounting to DEM 4 000 million (EUR 2 050 million) on 30 December 1992.

1. *MARKET-ECONOMY INVESTOR PRINCIPLE*

(116) Germany notes that the Land was in no way obliged to consider privatisation as an alternative to the transfer. Privatisation would have allowed WestLB to approach the capital markets in order to raise the necessary equity. The Land was not obliged to open up WestLB for private investors. Such an argument would infringe Article 295 of the EC Treaty.

(117) An increase in the total return on WestLB's equity is said to be unnecessary because measures to increase the return are required only if the State invests in loss-making companies. Germany claims that the Court applied the market-economy investor principle in the past only to state interventions in loss-making companies and sectors suffering from structural overcapacity. It cannot be inferred from the case law that the Commission may examine state investments in sound and profitable public enterprises in order to determine whether they generate at least an average return. The State may take into account long-term and strategic considerations and enjoys a certain latitude for entrepreneurial decisions and, within those confines, the Commission is not allowed to vet such decisions. Therefore, the Commission may not request a certain minimum return as long as it can be assumed that the enterprises in question will not be loss-making in the long run. The concept of average returns necessarily implies that the profitability of many enterprises is below the average in their industry. Furthermore, it is not clear which enterprises and which periods of time should be used as a basis for computing average returns. The State is not obliged to be guided only by profitability considerations when taking entrepreneurial decisions. Even a private investor might take other aspects into account. It is part of the entrepreneurial freedom to continue to operate enterprises with a below-average return and to inject additional capital into them. The limit for the State is reached only when such behaviour can no longer be economically justified by the private-investor test.

(118) However, the transaction can also be justified on the basis of the market-economy investor principle as a measure which would also have been taken by a private owner. By virtue of being earmarked for a special purpose, the capital cannot be compared to a normal equity injection and the transfer constitutes the commercially most sensible and efficient utilisation of Wfa's capital. The Land has optimised the value of Wfa's assets by the transfer. If Wfa is compared to a private, non-profit-making entity (e.g. a foundation), the private owner of such an entity would have acted in the same way in order to put the assets, which cannot be used for any other purpose, to a commercial use.

(119) According to Germany, the public purpose of Wfa's assets constitutes a task of general economic interest which, under Article 295 of the EC Treaty, is not subject to Commission supervision. The Member States are free to create such special-purpose assets.

(120) Germany submitted that the way in which an adequate remuneration is paid was of no relevance under the state aid rules. Since the Land received an adequate remuneration, an increase in its participation in WestLB was neither necessary nor justified and would, in fact, have provided the Land with an additional economic advantage without additional consideration. Nor would such a redistribution of shares correspond to the special nature of Wfa's assets (lack of liquidity, internal subordinate liability). Equity instruments on the capital markets which are comparable to Wfa's assets do not carry voting rights either. Since the agreed remuneration is adequate, the other owners of WestLB would receive no additional income which they would not receive under normal market-economy conditions and WestLB's attractiveness for other investors is, therefore, not increased. Moreover, because the shareholder structure of WestLB is fixed and no new (private) shareholders are possible, a remuneration which was hypothetically too low would, in fact, have no influence on possible private investors. Even if the other shareholders received an advantage, any effect on the savings banks would be too small to be perceptible.

(121) Since the Land receives a fixed and adequate remuneration and since WestLB was and still is a profit-making enterprise which can undoubtedly pay the agreed remuneration, the actual level of WestLB's total return on capital is, in fact, of no relevance and there was no need for the Land to ask for an increase in the bank's profitability.

2. *APPROPRIATE REMUNERATION FOR THE CAPITAL*

(122) Germany submitted that WestLB paid an appropriate remuneration for the transferred assets. The fact that a remuneration would have to be paid by WestLB for the capital provided had always been regarded by the Land as a prerequisite for the transfer. The level of and basis for assessing such remuneration was intensively discussed between the parties involved. Since it was not yet clear in 1991 what amount would be accepted by BAKred as original own funds, a remuneration was fixed only in

principle, but not in detail, at the time of the transfer. The actual level of 0,6 % was fixed in 1993 after negotiations with the other owners of WestLB ([1]). Germany did not provide the Commission with any documents explaining how this figure was determined. Instead, it argued that the decisive factor from a state aid point of view was not the considerations on which the rate was based but only the result, which was said to be appropriate. The fixed remuneration was to be paid from distributable profits, i. e. before any dividends were paid. If, owing to a lack of profits, the remuneration was not paid in any one year, there was no right to recovery payments in future years ([2]). The figure of 0,6 % corresponds to pre-tax costs of about 1,1 % for WestLB.

(123) The following table shows the payments made by WestLB to the Land as remuneration for the capital transferred:

(124) Table 4: Remuneration paid by WestLB for the transfer of Wfa (data provided by Germany)

(DEM million)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Remuneration (before tax)	0,0	27,9	30,8	33,4	33,9	34,0	34,0	[...]	[...]	[...]	[...]
Payment for pension entitlement of Wfa staff	33,1	0,0	0,0	0,0	0,0	0,0	0,0	[...]	[...]	[...]	[...]
Total remuneration paid to the Land	33,1	27,9	30,8	33,4	33,9	34,0	34,0	[...]	[...]	[...]	[...]

(125) Germany presented studies by an external consultancy that had been commissioned by WestLB to assess what would have been an adequate remuneration in 1991 for a capital investment with the same risk profile as Wfa's assets. These expert opinions examined the external and internal risk exposure of the capital and the conditions governing the remuneration payments, comparing these features to those of various equity instruments found on the international capital markets in order to determine an appropriate remuneration. This comparison is explained in the following section. The studies arrive at a spread of between 0,9 % and 1,4 % as an appropriate remuneration. Since the pre-tax costs for WestLB of the remuneration of 0,6 % amount to 1,1 %, this rate is regarded as being adequate. In addition to this direct remuneration, the synergy effects arising from the transfer have to be taken into account.

a) COMPARISON WITH OTHER EQUITY INSTRUMENTS

(126) The studies state that the return on an equity instrument is determined by its risk profile. The higher the risk, the higher the risk premium, i.e. the interest spread that has to be paid over secure government bonds. In analysing the risk profile, three elements are therefore particularly important: the arrangements for current interest payments, the investor's position in the event of current losses and his position in the event of liquidation or bankruptcy. The studies describe various features ([3]) of several equity capital instruments on the market (ordinary shares, dormant holdings, profit participation certificates, perpetual preferred shares, trust preferred securities and subordinated bonds) and compare them to Wfa's capital. According to the studies, Wfa's capital can best be compared to profit participating certificates, perpetual preferred stock and dormant holdings ([4]). Of the instruments mentioned above, trust preferred securities and perpetual preferred shares are not accepted in Germany. According to the studies, at the end of 1991 the following capital instruments qualifying as original own funds were available in Germany: ordinary shares, preferred shares (*Vorzugsaktien*) and dormant holdings (*Stille Beteiligungen*).

(127) The studies stress that Wfa's assets would be available for WestLB's creditors in the event of WestLB's bankruptcy (liability function — *Haftungsfunktion*). At the same time, WestLB can offset losses without limitations against Wfa's special reserve (loss compensation function — *Verlustausgleichsfunktion*). The internal agreements and the earmarking

([1]) The 0,6 % rate was laid down in a protocol notice to the covering agreement dated 11 November 1993.

([2]) Germany has explained that there was an agreement between the owners that such recovery payments should take place but that there was no corresponding legal obligation on WestLB.

([3]) The following features are described: country of issue and of issuer, treatment of the instrument by banking regulators, its typical maturity, treatment in the event of bankruptcy/liquidation and for loss absorption, whether it is callable, whether it is possible to defer interest/dividend payments and whether a cumulative deferral is possible.

([4]) Wfa's capital is compared in one version only to profit participation certificates and perpetual preferred stock and in another to all three instruments.

of Wfa's assets are of no relevance in this connection. However, internally the special reserve is subordinate in its liability to the other equity of WestLB and this internal situation would be decisive for the decision of an investor.

(128) As regards the loss compensation function, Wfa's special reserve can be compared to perpetual preferred shares. However, since it would be used, in parallel with profit participation certificates (which are additional own funds), only once WestLB's other original own funds had been exhausted and, since some of the profit participation certificates would already have been used in parallel, it is less risky than the profit participation certificates. The same applies to dormant holdings.

(129) As regards the liability function, the special reserve would be used after the other original own funds but before dormant holdings, profit participation certificates and other additional own funds. Wfa's special reserve is therefore said to present a higher level of risk than profit participation certificates and dormant holdings. Once again, it can be compared in terms of its risk to perpetual preferred shares. However, according to the studies, because of the extremely low probability of a bankruptcy of WestLB, this risk can in fact be disregarded and an investor would heavily discount the corresponding risk costs.

(130) In the case of Wfa's capital, interest payments would be made from distributable profit and have priority over dividends. If the profit is not sufficient, no remuneration is paid. This arrangement corresponds in principle to that for perpetual preferred stock. Profit participation certificates are less risky because missed interest payments would be deferred on a cumulative basis and paid in later years. For silent dormant holdings too, cumulative repayments are possible. In the case of Wfa's capital, the risk of non-payment is limited to the risk premium (because of the 'liquidity costs'; see below) whereas, in the case of the other two instruments, the full coupon (i.e. risk-free return plus risk margin) is at risk. Therefore, as regards interest payments, the risk attaching to Wfa's capital is slightly lower then that attaching to the other three instruments.

(131) The studies conclude that the risk premium for Wfa's special reserve should be below that for profit participation certificates and dormant holdings as well as below that for perpetual preferred shares. A historical margin before tax of between 1,0 % and 1,2 % is quoted for profit participation certificates, one of between 1,1 % and 1,5 % for dormant holidays and one of between 1,5 % and 2,0 % for perpetual preferred shares ([1]). For Wfa's special reserve a remuneration of 1,1 % is calculated for the years 1993 to 1996 ([2]). For 1992 a rate of 255 % is quoted ([3]). Synergy effects should also be taken into account. The studies conclude that the remuneration paid by WestLB was too high in 1992 and appropriate for the years 1993 to 1996.

b) LIQUIDITY COSTS

(132) According to Germany, a cash injection increases own funds and provides liquidity. This liquidity can be reinvested and earn interest, for which the investor would demand a remuneration. The transfer increases WestLB's own funds but does not provide liquidity. Wfa's liquidity is locked up in the housing promotion business. Unlike with a cash injection, WestLB cannot reinvest the liquidity but has to raise liquidity on the capital market to achieve the same result. This results in additional interest expenses. Because of this lack of liquidity, the Land can, as shown by the expert opinions provided, demand a remuneration corresponding only to the risk margin, i.e. the difference between the total return on an investment and the return on a corresponding government bond.

(133) Furthermore, it is stated that practically all risk-related, assets-side banking business requires some liquidity, e.g. swap contracts, forward contracts and derivatives. Only guarantees and sureties do not require liquidity, but the corresponding transactions are not shown in the credit institution's balance sheet.

(134) The relevant refinancing costs which have to be taken into account should be based on the return on long-term (i.e. ten-year) risk-free German Government bonds. The secondary-market rate for such bonds at the end of 1991 was 8,26 %. The actual average refinancing costs of WestLB in November 1991 stood at 9,28 %.

c) CAPITAL BASIS FOR THE CALCULATION OF THE REMUNERATION

(135) Germany takes the view that, according to a protocol note to the covering agreement, the remuneration has to be paid on the annual average portion of Wfa's special reserve used by WestLB to underpin its own business. The first payment was to be made in 1993. However, in reality WestLB pays the remuneration not on the amount used but on the amount usable, i.e. not needed to underpin Wfa's own business.

([1]) Data from the US and British markets were used for perpetual preferred shares because these instruments are not available in Germany.

([2]) This is based on the rate of 0,6 %, a corporation tax rate of 46 % until 1993 and 42 % thereafter, plus a solidarity surcharge rate of 3,75 % in 1992, 0 % in 1993 and 7,5 % thereafter.

([3]) This is based, firstly, on the fact that the special reserve was accepted by BAKred only on 30 December 1992, resulting in a figure for usable capital (for calculation purposes) of only DEM 2 million (EUR 1 million) and, secondly, on the payment in 1992 by WestLB of DEM 33 million (EUR 17 million) for future pension entitlements of Wfa staff, which is taken as remuneration paid by WestLB to the Land in that year.

(136) The remainder of the capital, i.e. the part needed for Wfa's own business plus the sum of DEM 1 900 million (EUR 970 million) entered as equity in WestLB's balance sheet but not accepted by BAKred, is of no economic use to WestLB because it cannot be used to underpin additional risk-bearing assets. The balance-sheet entry of DEM 1 900 million (EUR 970 million) is simply the result of a difference in valuation. Since rating agencies and experienced investors look only at the accepted amount, the DEM 1 900 million (EUR 970 million) is of no economic relevance for WestLB. No private investor could demand remuneration for it on the market because the bank would always have alternative possibilities to raise equity capital on the market that would be accepted as original own funds (e.g. normal cash injection).

(137) According to Germany, Wfa's assets and liabilities would be newly discounted each year in order to be entered in WestLB's balance sheet at their actual value. Since repayments and interest would be granted again as new long-term, lower-interest housing loans, it is possible that the nominal amount of Wfa's assets would increase while the discounted value and the risk-adjusted amount would decrease.

d) SYNERGY EFFECTS

(138) According to Germany, the Land expected synergies from the transfer amounting to more than DEM 30 million (EUR 15 million) annually in the longer term. These were to come from a simplification of housing promotion procedure, e.g. the elimination of duplication, easier and faster communication, and less need for coordination. Since the transfer, Wfa needs fewer staff and saves on compensation payments for work carried out in the past by WestLB's housing promotion department for Wfa. It is claimed that the Land's expectations were indeed fulfilled and that, from a management point of view, the merger of Wfa with WestLB was the only way to achieve these synergy effects. Furthermore, the way in which synergies are achieved falls within the economic freedom of the Land, as protected by Article 295 of the EC Treaty.

(139) Germany points out that in 1992 WestLB paid DEM 33 million (EUR 17 million) to cover existing and future pension entitlements of Wfa employees, which reduced the future costs of Wfa. These payments are depreciated in WestLB's accounts over a period of 15 years by DEM 1,6 million (EUR 0,8 million) annually.

3. *TAX EXEMPTIONS*

(140) The exemption of Wfa from property tax (*Vermögenssteuer*), tax on business capital (*Gewerbekapitalsteuer*) and corporation tax (*Körperschaftssteuer*) is provided for in the German tax system. Wfa and other public-law entities are exempt because they do not compete with taxable financial institutions but are used by the State to pursue certain objectives. Because of the tax savings, the State has to provide fewer funds for Wfa's activities. WestLB is fully taxed on its income (and thus also on the commercial activities underpinned by Wfa's capital) and does not receive any financial advantage from Wfa's exemptions because the amount accepted as original own funds is not increased as a result. Even if the tax exemptions were to lead to an increase in accepted capital, WestLB would not benefit as it would then have to pay an adequate remuneration on any additional amount.

(141) As regards property tax and tax on business capital, an asset can be subject to such taxation only once and is taxed where it is used directly. Since Wfa's assets are exempt regarding their primary use, i.e. the housing promotion business, they cannot be subject to taxation when put to an additional, secondary use. This would be contrary to the system underlying German tax law. The same applies to the integration of a private tax-exempt entity into a private bank. Since these exemptions do not provide WestLB with an unpaid-for advantage, they do not constitute state aid. Furthermore, tax on business capital and property tax have not been levied since 1997 and 1998 respectively as the Federal Constitutional Court ruled that they were anti-constitutional.

4. *WAIVER OF LIABILITY*

(142) According to Germany, the waiver of liability serves to avoid a situation where the Land Housing Promotion Fund is constantly reduced because of the liability created each year. The waiver does not reduce the Land's assets because, in the event of Wfa's liquidation, the Housing Promotion Fund would be correspondingly higher. Since the liability of Wfa which has been waived would only have become due in the case of such liquidation, the waiver does not change the economic position of the Land. In fact, the Land is only waiving a liability against itself.

(143) The waiver was taken into account in the valuation of Wfa's equity capital by BAKred and, on this basis, WestLB was paying an adequate remuneration. The waiver therefore produces no financial benefit for WestLB.

5. *OBSERVATIONS ON THE COMMENTS FROM INTERESTED PARTIES*

(144) As to the comments from the two bankers' associations Germany remarks that the general accusations made are not substantiated by facts or any actual cases of complaints of credit institutions concerning the way in which WestLB operates on the markets. The questions regarding *Anstaltslast* and *Gewährträgerhaftung* raised in one of the two observations are in no way linked to the present case and should be regarded separately.

(145) As to the comments from BdB, Germany stresses that the transfer of Wfa was no ad hoc solution but the result of long-term strategic considerations, especially the increase in Wfa's efficiency. The case law of the Court contains no ruling whereby investment by the State in a sound and profitable enterprise has been regarded as state aid. The case referred to by BdB concerns enterprises which were loss-making. Since WestLB has been a profitable enterprise since its formation, the market-economy investor principle is not applicable. Germany believes that this is confirmed by the case law of the Court, where that principle has never been applied to sound and profitable enterprises. Moreover, a private investor not only looks at the return but takes other, strategic considerations into account. In the case of rescue and restructuring aid, other considerations have to be weighed up than in the case of a capital injection into a profitable enterprise. Investments by the State cannot be assessed simply by looking at the average return in a sector. Otherwise, state investment in a bank with a below-average return would constitute state aid even though at the same time private investors were, in fact, investing in that enterprise. An investor is guided by prospects rather than sectoral averages.

(146) The state aid rules allowed an examination only of the terms of the asset transfer, not of the particularities of Wfa's assets, which are protected by Article 295 of the EC Treaty. Since the special character of Wfa's assets is protected by that Article, the capital transferred must not be compared to a normal liquid capital injection. A private-law foundation could be used in the same way as Wfa without any effect on the use of its revenues for its special purpose.

(147) Regarding the risk profile of Wfa's capital, a distinction must be drawn between the role of the Land as an owner of WestLB and as an investor in Wfa's special reserve. As an investor in Wfa, the Land bears a lower risk because of the internal subordination agreement between the shareholders of WestLB. The risk borne by the Land as an investor in Wfa is limited to the assets transferred and is not higher, as claimed by the BdB.

(148) Germany submits that the return calculations provided by BdB (and taken from an outside expert's opinion) are incorrect and supports this view by reference to a study commissioned by WestLB. According to this study, the main errors are a wrong calculation method (arithmetic average instead of compound annual growth rate) and the use of irrelevant investment periods. After adjustment for these errors, the return of 16,86 % before tax for large private banks in Germany comes down to 7,0 %. Furthermore, the five German private banks taken into consideration cannot be compared to WestLB because of their differing business emphasis. Taking banks which are comparable, the return on equity falls to 5,8 %. Furthermore, the study for BdB is said to use an unrepresentative reference period, viz. 1982-92, which includes two market rallies. Shortening the reference period would thus further lower the return figures.

(149) As to the liquidity aspect, Germany rejects BdB's argument that, on account of a lack of liquidity, no refinancing costs would arise because the discounting of Wfa's assets already took that liquidity cost into account. It states that this discount is in no way connected to the liquidity aspect but is the result of the low-interest or non-interest-bearing character of Wfa's assets and liabilities. It also rejects BdB's argument that, if any refinancing costs are accepted, only a small rate of 2,7 % before tax is justified. The expert opinion submitted by BdB in this connection is said to be wrong because it confuses in an inadmissible manner the revenues of the bank with the revenues of an external investor. Furthermore, the study of BdB compares gross revenues whereas net revenues should be compared. The German Government submitted its own study produced by an outside consultancy.

(150) The synergies were said to arise only within Wfa, and not within WestLB, as the duplication of work and existence of parallel departments could be eliminated (transfer of the former housing division of WestLB). These effects were, therefore, independent of the economic, organisational and personnel separation between Wfa and WestLB. They led to a reduction in the capital grants by the Land to Wfa and were the direct result of the transfer of Wfa to WestLB.

(151) The difference between Wfa's special reserve shown in the balance sheet and the amount accepted by BAKred was clearly communicated to third parties. According to Germany, creditors do not assign a liability function to the part not accepted for solvency purposes. Since only the part which can be used by WestLB to underpin its business is of economic use to the bank, the Land cannot ask for remuneration in respect of the excess amount.

(152) The waiver of the liability was taken into account in the valuation of Wfa's assets by BAKred, and it is on this basis that WestLB pays the remuneration. Furthermore, the overall economic position of the Land is not affected by the waiver and the tax exemption does not yield any benefit for WestLB.

V. UNDERSTANDING BETWEEN BDB, THE LAND OF NORTH RHINE-WESTPHALIA AND WESTLB

(153) On 13 October 2004 the complainant BdB, the Land of North Rhine-Westphalia and WestLB AG submitted to the Commission an understanding on the state aid procedure in the WestLB case. Irrespective of their basic interpretations of the legal situation, which remained unchanged, the parties to the understanding agreed on what they themselves regarded as suitable parameters for determining an appropriate remuneration and on the appropriate remuneration itself. The parties asked the Commission to take account of this understanding in its decision.

(154) Applying the capital asset pricing model (CAPM), the parties first determined the minimum expected remuneration for a hypothetical own-capital investment in WestLB at the relevant transfer date. On this basis, the appropriate minimum remuneration for the part of Wfa's capital recognised by BAKred as core capital and not used by Wfa to underpin its housing promotion activities should amount to 10,19 %.

(155) In calculating this figure, the risk-free long-term interest rates computed by the Landesbanks on the basis of the REX10 Performance Index of the Deutsche Börse AG and the beta factors estimated on the basis of a KPMG study of 26 May 2004 commissioned by the Landesbanks were used. In practical terms, this resulted for WestLB in a risk-free interest rate of 7,15 % at the time of the transfer. On the basis of the KPMG study, a beta factor of 0,76 was determined for the time of the transfer. A market-risk premium of 4 % was determined across the board.

(156) The initial interest rate of 10,16 % (1 January 1991) was calculated as follows: risk-free interest rate of 7,15 % + (general market-risk premium of 4,0 % × beta of 0,76).

(157) A deduction was then made to take account of the lack of liquidity of the special fund. For this, the risk-free interest rate of 7,15 % was applied generally as gross refinancing costs. To determine the key net refinancing costs, the overall tax rate for WestLB is fixed at 50 %, resulting in a deduction for lack of liquidity of 3,57 %.

(158) Lastly, a premium of 0,3 % is added because no new voting rights were granted.

(159) This produces overall an appropriate remuneration of 6,92 % (after tax) for the part of Wfa's capital which was recognised by BAKred as core capital and was not used by Wfa to underpin its own housing promotion activities.

(160) Both parties agree that, with the parent-subsidiary model taking effect on 1 January 2002, the aid situation arising from the transfer of Wfa's capital has ceased.

VI. ASSESSMENT OF THE MEASURE

(161) The first step in appraising the measure under the state aid rules of the EC Treaty is to assess whether it constitutes state aid within the meaning of Article 87(1) of the EC Treaty.

1. *STATE RESOURCES AND FAVOURABLE TREATMENT OF A CERTAIN UNDERTAKING*

(162) Wfa was a public-law institution owned entirely by the Land of North Rhine-Westphalia and with the task of promoting housing by granting low-interest or non-interest-bearing loans. The Land guaranteed its total liabilities under *Anstaltslast* and *Gewährträgerhaftung*. Wfa's main source of financing, the Land Housing Promotion Fund, had been created by annual cash injections from the Land budget and by interest income from housing loans.

(163) If state assets of this kind, which have a commercial value, are transferred to an enterprise without sufficient remuneration being paid, it is clear that state resources within the meaning of Article 87(1) of the EC Treaty are involved.

(164) In order to verify whether the transfer of state resources to a public enterprise favours the latter and is therefore liable to constitute state aid within the meaning of Article 87(1) of the EC Treaty, the Commission applies the market-economy investor principle. This principle has been accepted (and developed) by the Court in a number of decisions. The assessment under that principle will be made in Section 3 below. If state aid is involved, WestLB, i.e. an undertaking within the meaning of Article 87(1) of the EC Treaty, will clearly have been favoured.

2. *DISTORTION OF COMPETITION AND EFFECT ON TRADE BETWEEN MEMBER STATES*

(165) As a result of the liberalisation of financial services and the integration of financial markets, banking within the Community has become increasingly sensitive to distortions of competition. This development is intensifying in the wake of economic and monetary union, which is dismantling the remaining obstacles to competition on financial services markets.

(166) In its 1997 annual report, WestLB defines itself as a universally and internationally active commercial bank, as a

central bank for the savings banks and as the bank for the Land and the municipalities. It describes itself as a European banking group in the wholesale banking sector with activities in the important financial and economic centres around the world. Its presence abroad is concentrated in Europe, where it has subsidiaries, branches and representative offices in all major countries. WestLB is present in over 35 countries worldwide.

(167) Despite its name, tradition and legally stipulated tasks, WestLB is not at all a local or regional bank. Its presence in Europe and on international markets has already been described in Section II, point 1. In 1997 the group's foreign business contributed 48 % of non-consolidated revenues. According to the 1997 annual report, the bank's growth in that year can be attributed mainly to the expansion of its foreign business.

(168) These facts clearly show that WestLB offers its banking services in competition with other European banks outside Germany and, since banks from other European countries are active in Germany, inside Germany. This has been confirmed by the observations of the bankers' associations of two Member States. It is clear, therefore, that aid given to WestLB distorts competition and affects trade between Member States.

(169) It should also be recalled that there is a very close link between the equity of a credit institution and its banking activities. Only on the basis of sufficient accepted equity capital can a bank operate and expand its commercial operations. Since the state measure provided WestLB with such equity capital for solvency purposes, it directly influenced the bank's business possibilities.

3. *MARKET-ECONOMY INVESTOR PRINCIPLE*

(170) In deciding whether elements of state aid are involved in a financial measure taken by a public owner of an enterprise, the Commission applies the market-economy investor principle. This principle has been applied by the Commission in many cases and has been accepted and developed by the Court in several decisions ([1]). It allows the Commission to bear in mind the specific circumstances of each case, e.g. to take into account certain strategies of a holding company or group of companies or to distinguish between the short- and long-term interests of an investor. The market-economy investor principle will also be applied in the case at hand.

(171) According to the principle, no state aid is involved if funds are made available on 'terms which a private investor would find acceptable in providing funds to a comparable private undertaking when the private investor is operating under normal market economy conditions' ([2]). In particular, a financial measure must be considered unacceptable to a market-economy investor if the financial position of the company is such that a normal return (in the form of dividends and capital gains) cannot be expected within a reasonable period of time ([3]).

(172) The Commission has, of course, to base its appraisal of a case on the data available to the investor at the time he took his decision on the financial measure in question. The transfer of Wfa was decided in 1991 by the relevant public bodies. The Commission has, therefore, to assess the transaction on the basis of the data available and economic and market circumstances obtaining at that time. The data in this decision that relate to later years are used only to show the effects of the transfer on WestLB's situation and in no way to justify or question the transaction with the benefit of hindsight.

(173) Germany reminded the Commission to examine the case purely on the basis of the situation at the time of the transfer decision, i.e. the end of 1991, and not to take later developments into account. Such a view might imply that the Commission could not take into account either the fact that only DEM 4 000 million (EUR 2 050 million) of original own funds instead of the requested DEM 5 900 million (EUR 3 020 million) were accepted by BAKred or the fact that a remuneration of 0,6 % was agreed in 1993. However, at the time of the transfer, although the value of Wfa agreed on by the Land and WestLB was DEM 5 900 million (EUR 3 020 million), no level of remuneration was fixed. The Commission therefore considers it appropriate, when assessing the operation, also to take into account the situation prevailing when the parties finally fixed the remuneration.

(174) The Commission does not agree with Germany and WestLB that the market-economy investor principle is not applicable to sound and profitable undertakings and that this is supported by the case law. The fact that the principle has, in the past, been applied mainly to firms in difficulties in no way restricts its application to this category of firm.

(175) Restructuring aid for firms may be granted only in cases where a restructuring plan restores the firm's viability, i.e. leads to a 'normal' rate of return that allows the aided firm to continue by its own efforts, because this 'normal' market

([1]) See, for example, Cases C-303/88 *Italy* v *Commission* [1991] ECR I-1433 and C-305/89 *Italy* v *Commission* [1991] ECR I-1603.

([2]) Commission communication to the Member States: Application of Articles 92 and 93 of the EEC Treaty and of Article 5 of Commission Directive 80/723/EEC to public undertakings in the manufacturing sector (OJ C 307, 13.11.1993, p. 3, point 11). While this communication deals explicitly with the manufacturing sector, the principle can undoubtedly be applied in the same way to all other sectors. As regards financial services, this has been confirmed by a number of Commission decisions, e.g. Crédit Lyonnais (OJ L 221, 8.8.1998, p. 28) and GAN (OJ L 78, 16.3.1998, p. 1).

([3]) Public authorities' holdings in company capital — The Commission's position, Bull. EC 9-1984, pp. 93 and 94.

rate of return is acceptable to a market-economy investor. In cases where such matters have been brought before the Court, it has never called into question the fact that the Commission required not only a break-even situation or a token return but also a full 'normal' market rate.

(176) There is no provision to the effect that, if a company makes a profit, this rules out a priori the possibility that the provision of capital contains elements of state aid. Even if a company is profitable, a market-economy investor might refrain from injecting (further) capital if he could not expect an appropriate return on his capital contribution (in the form of dividends and an increase in the value of the investment). Should the company not show the appropriate expected return at the time of the investment, a market-economy investor would call for measures to increase the return. Therefore, the market-economy investor principle is applicable in the same way to all public enterprises, whether profitable or loss-making.

(177) The adequacy of the likely return on capital depends in turn on what a market-economy investor can expect from similar investments with a similar exposure to risk. It is evident that a constantly underperforming enterprise showing no signs of recovery is not viable in the long term. New investors would decline to meet the company's demand for further capital and existing investors would eventually disinvest, even accepting a loss, if necessary, in order to reallocate their capital to more profitable investments. Thus, in a communication to the Member States on the application of the state aid rules to public undertakings, the Commission stated that, when comparing the actions of the State with those of a market-economy investor, 'in particular when a company is not making a loss', it would evaluate the financial situation of the company at the time an additional capital injection is proposed ([1]).

(178) It should also be borne in mind that 'sound and profitable firms' cannot be equated with firms which do not make a loss. A firm which generates only small profits or generates neither profits nor losses cannot in fact be regarded as sound and profitable. It is certainly difficult to determine 'average profitability' as this is dependent on a number of factors, i.e. the level of risk in the industry in which the firm operates. However, firms which, over a certain period, generated a profit lower than that generated by firms with a similar risk structure would, as mentioned, be eliminated from the market in the long run. The position taken by Germany and WestLB would lead to a situation where the State could invest in firms operating with an annual profit of EUR 1, regardless of the state aid rules in the EC Treaty.

([1]) OJ C 307, 13.11.1993, p. 3, point 37.

(179) It is clearly not the Commission's task to initiate procedures systematically and immediately if a public enterprise shows below-average profitability. Even private firms may, from time to time, have lower-than-average profitability. (The existence of an average logically implies deviations in both directions.) However, in such circumstances a normal firm operating on the market would try to increase its profitability and carry out restructuring and other measures in order to prevent this situation from becoming chronic. Market investors would expect appropriate measures to be taken in this respect.

(180) Furthermore, as already indicated above, a distinction must be drawn between existing and new investments because the starting points for the investment decision in question are different, but not the basic principles. In the case of an existing investment, the investor might be more willing to accept a lower (or even negative) return in the short run if he expects the situation to improve. Certainly, an investor might also increase his investment in a firm with low profitability. However, he would not do so unless he expected an improvement in the situation and a reasonable return in the long term. If, on the other hand, he expects the combination of risk and return to be poorer than in comparable firms, he will consider terminating his investment. In the case of a new investment, the investor may be less willing to accept lower profitability from the very outset ([2]). However, as already stated, the principles are the same in all decision-making situations: the return expected in the long run from the investment (taking into account the risk and other factors) must at least be equal to that from comparable investments. Otherwise, the company will not be able to find the necessary funds and will therefore not be viable in the long run.

(181) According to WestLB, the question of whether the bank generated average profits in the years before the transfer can, in principle, remain unanswered if a fixed and appropriate remuneration is agreed and if profitability is sufficient to maintain this remuneration in the long run. This view can be accepted in principle. However it should also be borne in mind that viability in the long run depends on the company achieving an average rate of return on its equity capital.

(182) With respect to the probable behaviour of a market-economy investor, it is of no relevance that other banks also had to raise additional capital as a consequence of the stricter rules of the Solvency Ratio Directive. The Directive does not impose any obligation on banks to raise additional capital. It merely stipulates a minimum ratio of capital to risk-adjusted assets, i.e. it establishes a legal presumption of

([2]) It cannot be said that investments are made only in profitable companies on the market. High-risk investments e.g. in innovative or new technology companies, are quite common. However, in these cases too the investor invests his capital on the expectation that the start-up losses and the risks can subsequently be offset by high profits. Even in the case of such investments, the benchmark is the expected long-term return.

what is necessary for a bank's viability. In other words, a market-economy investor might have urged his bank to restructure its risks in order to comply with the new solvency rules instead of increasing the bank's capital. Such step would directly reduce the bank's volume of business and hence its market presence.

(183) If a public shareholder decides that a capital injection is an appropriate way for the bank to meet the capital requirements, the question is whether the particular circumstances under which the capital is provided would be acceptable for a market-economy investor. If a capital measure is needed to meet the solvency requirements, a market-economy investor might be willing to carry out this measure in order to preserve the value of investments already made. But he would insist on receiving an appropriate return on the newly injected capital. It is likely that a market-economy investor would expect a higher return on a capital investment in a bank whose capital resources are depleted and which is in urgent need of new capital because this circumstance exposes him to higher risk.

(184) In the light of the market-economy investor principle, the key question is whether such an investor would have supplied WestLB with capital that had the specific characteristics of Wfa's assets and under the same conditions, especially in view of the probable return on the investment. This question will be examined below.

a) ARTICLE 295 OF THE EC TREATY

(185) Germany argues that the Land of North Rhine-Westphalia was not obliged to consider privatising WestLB in order to increase the latter's equity, that the Land was, in principle, free to transfer Wfa to WestLB in order to achieve synergies and that the Land was not obliged under Community law to consider the transfer of Wfa to a private credit institution. This argument can be accepted. Germany also claims that Wfa's public remit constitutes a task of general economic interest and that Wfa is, therefore, not subject to supervision by the Commission under Article 295.

(186) As long as public entities carry out only public tasks and do not compete with commercial enterprises, the competition rules do not apply to them. The situation changes when there are implications for competition. Article 86(2) of the EC Treaty deals with situations where it might be necessary to deviate from the competition rules in order to ensure the provision of services of general economic interest. It is discussed at point V.6. On the other hand, Article 295 of the EC Treaty protects the national systems of property ownership but this cannot justify any infringement of the Treaty's competition rules.

(187) The German authorities and WestLB claim that, because of the constraints imposed by the special purpose assigned to Wfa's assets, as laid down by the Housing Promotion Law, the only possible profitable use of these resources was to transfer them to a similar public-law entity. Thus, the transfer represented the most commercially sensible use of the assets in question. It is therefore argued that any remuneration for the transfer, i.e. any additional return on Wfa's capital, is sufficient to justify the transfer in view of the market-economy investor principle. This argument cannot be accepted. It may be true that Wfa's transfer to WestLB, which subsequently allowed WestLB to use part of Wfa's capital for solvency purposes, was the most commercially sensible use. Member States are free to use public funds for public sovereign purposes, demanding no or low profits in return. The Commission does not question the right of the Member States to create special-purpose funds in order to fulfil tasks of general economic interest. However, as soon as such public funds and assets are used for commercial competitive activities, normal market-economy rules have to be applied. This means that, as soon as the State decides to assign public-purpose assets (also) to a commercial use, it should seek a remuneration corresponding to market terms.

b) SPECIFIC NATURE OF THE MEASURE

(188) In carrying out the above transfer operation in response to WestLB's need to expand its original own funds, the Land authorities chose a method of increasing capital that had very special features. The general idea was to merge a non-profit credit institution pursuing a particular task (Wfa) with a normal commercial bank operating under conditions of competition, with the aim of utilising surplus capital (from the point of view of the solvency rules) within the non-profit institution for the purposes of the entity exposed to competition. At the same time, the assets transferred remained earmarked for their original purpose. Consequently, the approach of an 'entity within an entity' was chosen, with Wfa's assets forming an independent and 'closed' circuit in which profits generated by Wfa accrue to and are retained by that institution only.

(189) The Commission is not aware of any precedents for a capital increase involving such an 'imperfect' merger in so far as this might be relevant from a state aid viewpoint. In its opinion, however, if a construction like the one at issue is chosen by a Member State, a thorough analysis of its financial and economic impact on the competitive part of the entity is imperative so as to ensure that non-transparent mechanisms are not used to circumvent the EC Treaty's state aid rules. It is necessary to assess to what extent the integration carried out is economically advantageous to the competitive divisions of WestLB despite the creation of 'closed circuits'.

(190) It should be pointed out here that the complexity of the case and the lack of directly comparable transactions on the free market make this judgement a rather difficult one. Therefore, the Commission devoted a considerable amount

of time to gathering information and analysing the case. Furthermore, it arranged for an outside expert to deliver an opinion on the transaction and on the remuneration that can be regarded as corresponding to market terms. Only on the basis of all the data available and after a careful examination has the Commission finally drawn its conclusions and come to the present decision.

c) NO CHANGE IN OWNERSHIP STRUCTURE

(191) When injecting equity capital into a bank, a market-economy investor demands an appropriate share in the bank's profits. One way of ensuring such participation is via a corresponding change in the structure of ownership, giving him an appropriate share in the bank's dividends and in a possible increase in its disclosed and non-disclosed value as a result of its enhanced earning capacities. Therefore, one way of ensuring an adequate return on the capital provided would have been to increase the Land's participation in WestLB accordingly, provided that the bank's overall profitability corresponds to the normal rate of return that a market-economy investor would expect from his investment. This would have avoided the discussion of whether the 0,6 % rate of remuneration is appropriate. However, this course was not taken by the Land.

(192) According to the German authorities, a redistribution of shares in WestLB was not possible owing to the specific character of the transaction, especially the closed-circuit arrangement and the Land's prerogative (only valid internally) as regards the net assets of Wfa in the event of the liquidation of WestLB, which was agreed on by WestLB's shareholders.

(193) In this case, however, the Land should have demanded appropriate remuneration for the transfer in another form, in accordance with the market-economy investor principle. Otherwise, if the Land forgoes a remuneration which the market normally demands, it is not behaving like a market-economy investor and is thereby granting an advantage to WestLB which constitutes state aid.

d) CAPITAL BASIS FOR THE CALCULATION OF THE REMUNERATION

(194) Germany and WestLB submit that only the part of the accepted original own funds which can be used by WestLB to underpin its commercial business has an economic value for the bank, with the result that a remuneration can be demanded by the Land in respect of this part only. BdB claims that the whole amount of DEM 5 900 million (EUR 3 020 million) is at risk and therefore a remuneration should be paid on that amount. The level of this remuneration should be different for the accepted original own funds of DEM 4 000 million (EUR 2 050 million) and the remaining amount of DEM 1 900 million (EUR 970 million).

(195) The Commission's consultants based their assessment on the assumption that, at the time of the transfer, the value of Wfa was established by the Land and WestLB at DEM 5 900 million (EUR 3 020 million) and that a market-economy investor would therefore, in principle, seek a remuneration in respect of that figure, regardless of any later developments such as the acceptance of the capital (or only part of it) as original own funds by BAKred. The only decisive factor for the fixing of a remuneration for a capital investment is the circumstances obtaining at the time of the investment decision, and not subsequent events. However, the Commission's consultants also accept that the transaction would have taken a different course if normal commercial practice had been followed.

(196) In the Commission's view, the sequence of steps in which the transfer was carried out could, in fact, point to an equal remuneration for the whole capital shown in WestLB's balance sheet. The transfer was first decided and carried out, and then BAKred was requested to accept Wfa's special reserve as original own funds and the remuneration was fixed only close on two years after the transfer decision. However, under normal market conditions no bank would have agreed to include Wfa in its balance sheet for the sum of DEM 5 900 million (EUR 3 020 million) and to pay a uniform remuneration on that amount before first checking whether that amount would also be accepted as original own funds by the supervisory authority. Furthermore, as is also stressed by the Commission's outside experts, a rational investor would certainly not behave in this way, i.e. consent to a substantial capital injection without first agreeing on an appropriate remuneration mechanism. However, in the Commission's view, the sequence of events can be explained by the special circumstances of the case. The Land had long-term financial relations with the bank and was its main owner. There were only a small number of shareholders (all of them public), which means in practice less need for transparency and openness compared with a company that has a large number of ('outside') shareholders or is listed on the stock exchange. These special circumstances made it possible to decide on the transfer while leaving the decision on the final remuneration open until it was established that Wfa's capital could actually be used for commercial banking purposes.

(197) For the purpose of establishing an appropriate remuneration, a distinction should be made between the different parts of Wfa's special reserve according to their use to WestLB. An amount of DEM 5 900 million (EUR 3 020 million) was entered as equity on WestLB's balance sheet. An amount of DEM 4 000 million (EUR 2 050 million) was accepted by BAKred as original own funds. Of these amounts only DEM 2 500 million (EUR 1 280 million) allows WestLB to expand its activities and should be the primary basis of a remuneration for the Land. The remaining DEM 1 500 million (EUR 770 million) of the accepted original own funds are shown in the balance sheet but are needed to underpin Wfa's housing promotion business. An amount of DEM 1 900 million (EUR 970 million) is shown in the balance sheet but not accepted as own funds for solvency purposes. Therefore, the amount shown in WestLB's balance sheet but not usable by WestLB to expand its commercial business totals DEM 3 400 million (EUR 1 740 million).

(198) However, equity is necessary not only for supervisory reasons. The amount of equity shown in the balance sheet is also an indication for the bank's lenders of its soundness and thus influences the conditions under which the bank is able to raise outside funds. Contrary to the arguments of Germany and WestLB, creditors and rating agencies look not only at accepted own funds but also at the overall economic and financial situation of the bank. Accepted own funds form only part of such an analysis of the bank's credit standing. The amount of DEM 5 900 million (EUR 3 020 million) has been established by the Land and WestLB as a probable value which could be achieved in the event of Wfa being sold to a third party. If this assessment had not been reasonable, WestLB's auditors would not have allowed it to stand in the balance sheet. The amount of DEM 4 000 million (EUR 2 050 million) accepted by BAKred reflects the supervisory body's very cautious approach to its valuation. It should be borne in mind that the valuation made for BAKred also gives a spread of between DEM 4 000 million (EUR 2 050 million) and DEM 5 400 million (EUR 2 760 million). Therefore, the total amount of DEM 5 900 million (EUR 3 020 million) would be viewed by a potential creditor as security for his monies and would increase the credit standing of WestLB. This positive effect of the transfer on the bank's creditworthiness was also stated in the valuation of Wfa made for WestLB in 1992. Since the amount of DEM 3 400 million (EUR 1 740 million) cannot be used to expand business but improves the bank's appearance in the eyes of creditors, its economic function may be compared in that respect to at least that of a guarantee, even if shown as equity in the balance sheet.

(199) Since, therefore, the amount of DEM 3 400 million (EUR 1 740 million) is also of economic use to WestLB, a market-economy investor would have asked for a remuneration to be paid on it. Certainly, the level of this remuneration will be lower than that for the DEM 2 500 million (EUR 1 280 million), which is of greater use to WestLB since it can also be used under the solvency rules as own funds to expand its commercial business.

e) APPROPRIATE REMUNERATION FOR THE CAPITAL

(200) Investments of differing economic quality require differing returns. In analysing an investment's acceptability to an investor acting under normal market conditions, it is important therefore to bear in mind the special economic nature of the financial measure in question and the value of the capital provided for WestLB.

(201) The complainant originally claimed that the transaction at issue constituted a state guarantee by the Land of North Rhine-Westphalia for WestLB's debt. But WestLB shows the assets transferred as equity capital in their accounts and BAKred accepted an amount of DEM 4 000 million (EUR 2 050 million) as original own funds within the meaning of the Own Funds Directive, of which DEM 2 500 million (EUR 1 280 million) can be used by WestLB to underpin its commercial business. Consequently, a coherent appraisal of the financial measure in the light of Article 87(1) of the EC Treaty calls for its principal classification as a capital injection and for payment of an appropriate remuneration. The very same financial measure cannot be regarded as a capital injection under banking supervisory rules and as a guarantee under the EC Treaty's state aid rules. This principal classification does not, however, rule out the possibility that the Commission might, because of its particularities, liken part of that equity which cannot be used by WestLB in the same way as 'normal' equity to a guarantee for the purpose of calculating an appropriate remuneration.

i) ***Comparison with other equity instruments***

(202) Germany claims that, since no direct comparison with other transactions is possible, the appropriate remuneration for the capital provided should be established by comparing the transfer with various equity instruments on the markets. To this end, it submitted outside studies the findings of which are given above and which conclude that Wfa's capital can best be likened to profit participation certificates, perpetual preferred stock and dormant holdings.

(203) In the Commission's opinion, it is, in fact, difficult to liken Wfa's transfer to any instrument available on the market at that time because of its special nature. The transfer might resemble certain instruments in some respects, but there are also enough differences compared with each instrument to assign only a limited value to this comparison. Furthermore, the studies submitted by Germany are not really comprehensive because they leave out several relevant instruments such as non-voting shares.

(204) It should be borne in mind that the instruments used for the comparison by Germany normally provide a bank with only a very limited part of own funds. They are additional instruments, supplementing the 'basic equity capital', which consists mainly of share capital and open reserves. By contrast, Wfa's capital boosted WestLB's own funds for solvency purposes from DEM 5 090 million (EUR 2 600 million) to DEM 9 090 million (EUR 4 650 million), i.e. by 80 %. Taking into account only the increase of DEM 2 500 million (EUR 1 280 million) usable by WestLB to underpin its commercial business, this still represents an increase of 50 %. Hybrid instruments were usually issued up to a maximum of 20 %. It would not have been possible to increase WestLB's capital in the same way — and on a permanent basis — by one of the instruments compared ([1]).

([1]) This point is also stressed by the Commission's outside experts, who criticise the fact that the studies submitted by the German Government omit any reference to the size of the transaction and compare the transfer to what are — in terms of size — marginal instruments. According to those experts, Wfa's capital should therefore be compared instead to original own funds instruments like non-voting shares.

(205) It should also be noted that rating agencies pressed for some sort of 'voluntary restriction' to be applied regarding the share of equity from hybrid instruments, which they monitored closely.

(206) In this connection, it should be stressed that the relatively wide range of hybrid equity instruments now available to credit institutions in several countries for use as original own funds and additional own funds did not exist in Germany back in 1991, when the transfer of Wfa was decided, or in 1993, when WestLB had to comply with new, stricter capital requirements. Some of these instruments were developed in the meantime, while others already existed but were not accepted in Germany. In practice, the main instruments which were available and used were profit participation certificates and subordinated loans (both of which are additional own funds, the latter being accepted only since 1993). It is therefore, inappropriate to compare Wfa's capital to such hybrid instruments, most of which have been developed in the meantime and some of which are available only in other countries. Germany itself also (indirectly) rejects such a comparison, claiming that the Commission must examine the case on the basis of the facts available at the time of the decision at the end of 1991.

(207) Germany's studies claim that, in the case of WestLB, the likelihood of bankruptcy is so low that it could, in fact, be practically disregarded. However, if this argument were followed strictly, it would mean that an investor should not require any top-up on the rate of return on risk-free government bonds when investing in companies considered as safe investments. This certainly does not correspond to market reality. Even though the risk of bankruptcy might be low in the case of a particular investment, it is taken into account by a market-economy investor, who will demand a significant top-up for such investment in banks, as in the case of any other 'safe' equity investment.

(208) As to the two instruments which, as the closest benchmarks, play the central role in the comparison undertaken by Germany, namely perpetual preferred shares and profit participation certificates, a number of specific points should be stressed. Perpetual preferred shares constitute original own funds (core capital) in some countries but are still not accepted in Germany. Profit participation certificates constitute only additional own funds, whereas Wfa's capital qualifies as original own funds. The latter is therefore of much greater use to WestLB because it can be used to raise additional own funds (such as profit participation certificates) up to the same amount in order to increase the bank's own funds. Moreover, if profitable years followed loss-making ones, profit participation certificates would be replenished before Wfa's capital. In addition, Wfa's capital is available to WestLB without any time limitation, while profit participation certificates are usually issued for a period of ten years. It is also worth recalling the enormous, atypical size of the capital injection and that the ranking in the event of losses must be seen in this context. Since the share of Wfa's capital is rather large, it will be used relatively quickly when major losses occur.

(209) For all these reasons, the Commission is of the opinion that, because of the peculiarities of Wfa's capital, the comparison with hybrid equity instruments submitted by Germany is not a suitable way to determine the appropriate remuneration to be paid for Wfa's capital ([1]).

(210) As to the relationship between Wfa's capital and other equity instruments, BdB claims that the subordination agreement in the covering agreement between WestLB's shareholders is void because it encroaches on the rights of third parties by laying down that, in the event of losses at WestLB, Wfa's special reserve can be used only subordinate to WestLB's other equity capital. However, the argument by Germany and WestLB can be followed, namely that this agreement covers only the relationship between Wfa's special reserve and the other original own funds provided by shareholders, i.e. in practice nominal capital and reserves, but that there was no intention to make Wfa's capital subordinate to additional own funds like profit participation certificates and subordinated loans.

ii) ***Liquidity costs***

(211) The arguments of Germany and WestLB on the liquidity costs can, in principle, be accepted. A 'normal' capital injection into a bank provides it both with liquidity and with an own funds base which it requires for supervisory reasons to expand its activities. In order to use the capital in full, i.e. to expand its 100 %-risk-adjusted assets by a factor of 12,5 (i.e. 100 divided by a solvency ratio of 8) of the capital provided, the bank must refinance itself on the financial markets 11,5 times over. Put simply, the difference between 12,5 times the interest received and 11,5 times the interest paid minus other costs of the bank (e.g.

([1]) The external study carried out for the Commission supports this view and comments on various individual assessments in the study submitted by Germany. For example, it sheds a different light on the 'coupon effect' by stating that, in the event of ongoing losses or liquidation, the whole capital and not only part of it would be lost. The study also points to two subjective elements of the studies submitted by Germany: market data are said to be used selectively and, in some places, they are simply replaced by data from the authors' own experience, without this being stated explicitly.

administration) gives the profit on the equity ([1]). Since Wfa's capital does not provide WestLB with initial liquidity because the assets transferred and all the income of Wfa remain earmarked by law for housing promotion, WestLB faces additional funding costs equal to the amount of the capital if it is to raise the necessary funds on the financial markets in order to take full advantage of the business opportunities opened up by the additional capital, i.e. to expand risk-adjusted assets by 12,5 times the capital amount (or to maintain existing assets at that level) ([2]). Because of these extra costs, which do not arise in the case of normal equity capital, the appropriate remuneration must be reduced accordingly. A market-economy investor could not expect to be remunerated in the same way as for a cash injection.

(212) However, in the Commission's view and contrary to the opinion of WestLB and Germany, the entire refinancing interest rate does not have to be taken into account. Refinancing costs constitute operating expenses and therefore reduce taxable income. This means that the bank's net result is not reduced by the amount of additional interest expenses incurred. These expenses are offset in part by reduced corporation tax. Only the net costs should be taken into account as an additional burden on WestLB because of the special nature of the capital transferred. Overall, the Commission accepts therefore that WestLB incurs additional 'liquidity costs' to the extent of 'refinancing costs minus tax'.

iii) ***Appropriate remuneration for the amount of DEM 2 500 million (EUR 1 280 million)***

(213) There are no doubt different ways of calculating the appropriate remuneration for the amount of DEM 2 500 million made available. However, as will be shown, all the methods for calculating the remuneration for capital made available apply the same basic principles. Taking these basic principles, the Commission here carries out the calculation in two stages: first, it determines the minimum remuneration that an investor would expect for a (hypothetical) investment in WestLB's capital. It then examines whether, in view of the particularities of the transaction at issue, the market would have agreed on a premium or a discount and, if so, whether it can produce a sufficiently robust quantification of that amount.

Determination of a likely minimum remuneration for an investment in the capital of WestLB

(214) The expected return on an investment and the risk attaching to the investment are essential determinants of the decision to invest on the part of a market-economy investor. In order to determine the level of these two elements, the investor takes into consideration all available company and market information. He here bases himself on historical average returns, which generally also give him an idea of what the company's future performance is likely to be, as well as — among other things — on the analysis of the company's business model for the period of the investment, the strategy and quality of its management, and the prospects for the economic sector concerned.

(215) A market-economy investor will invest only if the investment permits a higher return or a lower risk compared with the next-best alternative use of the capital. Accordingly, an investor will not invest in a company whose expected returns are lower than the average expected returns of other companies with a similar risk profile. In such a case, it can be assumed that there are sufficient alternatives to the alleged investment that promise a higher expected return with the same risk profile.

(216) There are various methods for determining the appropriate minimum remuneration, ranging from different versions of the financing approach to the CAPM method. For the purpose of illustrating the different approaches, it makes sense to differentiate between two components: a risk-free return and a project-specific risk premium:

appropriate minimum return on a risky investment

=

risk-free basic rate + risk premium for the risky investment

The appropriate minimum return on a risky investment is therefore the sum of the risk-free rate of return and the additional risk premium for assuming the investment risk.

(217) Accordingly, the basis for any determination of return is the existence of a default-risk-free form of investment with an assumed risk-free return. The expected return on fixed-rate securities issued by the State is normally used to determine the risk-free basic rate (or an index based on such securities) since those constitute a similarly low-risk form of investment. The risk premium, however, is determined differently depending on the method used:

— *Financing approach*: from the point of view of the bank using the capital, an investor's expected return on capital represents future financing costs. Under this

([1]) Of course, in reality the situation is much more complex because of off-balance-sheet items, different risk weightings of assets or zero-risk items, etc. However, the principal reasoning holds.

([2]) The situation does not change if one takes into account the possibility of raising additional own funds up to the same amount of original own funds (a factor of 25 instead of 12,5 for original own funds).

approach, the historical capital costs incurred by comparable banks are first determined. The arithmetic average of the historical capital costs is then compared with the future expected equity capital costs and thus with the investor's requirement as to the expected return.

— *Financing approach with the compound annual growth rate*: At the heart of this approach stands the use of the geometric rather than the arithmetic mean value (compound annual growth rate).

— *Capital asset pricing model (CAPM)*: The CAPM is the best-known and most frequently tested model of modern financial economics, by which the return expected by an investor can be determined using the following formula:

minimum return on capital

=

risk-free basic rate + (market risk premium × beta)

The risk premium for the equity investment is obtained by multiplying the risk premium on the market by the beta factor (market risk premium × beta). The beta factor is used to quantify the risk of a company relative to the overall risk of all companies.

(218) The CAPM is the predominant method of calculating investment returns in the case of large listed companies. However, since WestLB is not a listed company, it is not possible to derive its beta value directly. The CAPM can be used therefore only on the basis of an estimation of the beta factor.

(219) The Commission possesses six expert reports in which the risk premium and the minimum return on capital were calculated using different approaches, with all of them calculating the risk premium for the transfer of Wfa's capital to WestLB not directly but on the basis of a (hypothetical) investment in WestLB's capital.

— *Ernst&Young studies* of 11 September 1995 and 28 August 1997: In the Ernst&Young studies (1995), which apply the financing approach, the actual capital costs stemming from changes in last-trading-day prices (gains and losses) and dividends paid (dividend returns) are determined for the period 1982-92. The arithmetic average of the historical capital costs is then compared to the investor's requirement as to the expected return.

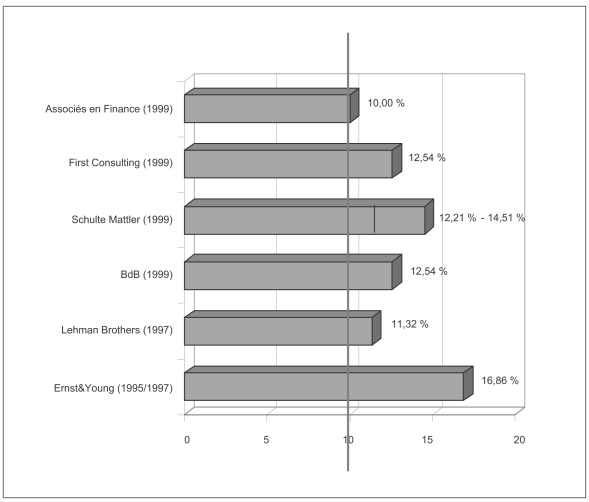
— The study by *Associés en Finance* (October 1999), which had been commissioned by BdB, arrived on the basis of the Securities Market Line Model at a minimum return of 10 %-11 % for an investment akin to a share capital investment in WestLB at the relevant time.

— *BdB study* of 14 January 1999: In line with the financing approach, BdB determined, using the compound annual growth rate and the data pool of Ernst&Young, the geometric mean values of the capital costs of the four leading German commercial banks (Deutsche Bank, Dresdner Bank, Commerzbank and Bayerische Vereinsbank) for all conceivable investment periods between 1982 and 1992. The average capital costs of these banks (12,54 %) correspond to the investor's expected return.

— *Lehman Brothers study* of 8 July 1997 commissioned by WestLB, *expert opinion of Professor Schulte-Mattler* of 14 January 1999 commissioned by BdB, and *First Consulting study* of 18 June 1999 carried out on behalf of the Commission: These consultants, who all apply the CAPM, first determined a general market-risk premium for the German share market at the end of 1991. They arrived on average at a premium of 4 %-5 % (Lehman Brothers 4 %, Professor Schulte-Mattler 5 % and First Consulting 4 %-5 %). In their understanding submitted to the Commission on 13 October 2004, the Land of North Rhine-Westphalia, WestLB and the complainant BdB took as the basis a market-risk premium of 4 %. The consultants then estimated the beta value, i.e. the individual risk premium for WestLB. Using this value, the general market-risk premium was adjusted for WestLB. Since WestLB was not a listed company at the end of 1991, its beta value could not be statistically estimated. For this reason, the consultants assumed that WestLB's beta value was the same as that for comparable listed banks. Professor Schulte-Mattler determined, using Deutsche Bundesbank data, a beta factor for commercial banks in Germany at the end of 1991 of 1,25 (on the basis of annual data) and of 1,1 (on the basis of monthly data). By contrast, the consultant commissioned by WestLB, Lehman Brothers, took as a basis the betas not of all German credit institutions but of IKB Deutsche Industriebank and BHF-Bank, which was 0,765. Lehman Brothers thus arrived at altogether lower risk premium for WestLB. The complainant too accepted in the understanding submitted on 13 October 2004 a beta value of 0,76 as still appropriate and thus arrived at a minimum remuneration of 10,19 %, which differed from the figure given in its statement of 14 January 1999.

(220) The following table summarises the findings of these studies. If the methods mentioned above for deriving the

expected return on a risky investment are applied, the following minimum returns on an investment in the share capital of WestLB are obtained:



(221) The studies and opinions submitted come to the conclusion that a minimum return for a (hypothetical) investment in the share capital of WestLB at the relevant time ranges from 10 % to 13 % ([1]). Only two studies arrive at a much higher figure. In the discussions between the complainant BdB, the Land of North Rhine-Westphalia and WestLB in July 2004, the parties agreed on a rate of 10,19 % as the appropriate remuneration. This figure falls within the market range just identified. Deviating from its first WestLB decision in 1999, which set a minimum of 12 %, the Commission has therefore decided to use the rate of 10,19 % per annum as the appropriate market remuneration for an investment in the share capital of WestLB at 31 December 1991. As a result, the Commission determines a rate of 10,19 % per annum (after corporation tax and before investor tax) as the appropriate minimum remuneration for the transfer of Wfa's capital.

Return discount on account of lack of liquidity

(222) During the proceedings, WestLB first claimed that its refinancing costs on the basis of its financial structure at the time of the transfer were 9,2 %. Subsequently, refinancing rates of 7,0 % and 7,5 % were suggested in several documents and at several meetings by WestLB and Germany ([2]). In the understanding, the parties agreed, on the basis of the long-term risk-free basic interest rate at 31 December 1991 determined by them, to use a rate of 7,15 %. They also agreed to apply an overall tax rate of 50 %. Accordingly, the parties arrived at a net refinancing rate of 3,57 % for the part of Wfa's capital available to underpin commercial business, resulting in a liquidity discount.

(223) Since the figures mentioned are still within the range indicated by Germany, the Commission does not see any grounds for not regarding them as appropriate and therefore bases its calculation of the aid element on them. Although the Commission had, in its first WestLB decision, accepted as the minimum gross refinancing costs the long-term, risk-free interest rate for 10-year Federal Government bonds, which stood at 8,26 % at the end of 1991, this rate is a balance-sheet date that ignores the fact that Wfa's assets were to be at the disposal of WestLB on a long-term basis. In their discussions about the long-term, risk-free basic interest rate, the parties thus abandoned the use of a risk-free return observable on the market at the time of the investment in favour of a fixed investment period, the reasoning being that such an approach would take no account of the reinvestment risk, i.e. the risk of not being able to invest at the same risk-free interest rate after the investment period had expired. The parties consider that the investment risk is best taken into account using a total return index. They have therefore used the REX10 Performance Index of Deutsche Börse AG, which shows the performance of an investment in 10-year Federal Government bonds. The index series used contains the year-end value of the REX 10 Performance Index as of 1970. The parties have then determined the per annum return reflecting the trend as it is depicted in the period 1970-91 and, in this way, arrived at the aforementioned risk-free basic interest rates of 7,15 % (31 December 1991).

(224) Since the investment in WestLB was indeed to be made available on a permanent basis, it seems fitting in this special case to apply this method of determining the risk-free basic interest rates. In addition, the REX 10 Performance Index used is a generally recognised data source. The risk-free basic interest rates determined thus seem appropriate.

(225) The Commission has therefore decided in this case to take as a basis the long-term, risk-free interest rate of 7,15 % at 31 December 1991 determined by the parties as the minimum gross refinancing costs. Assuming an overall tax rate of 50 % ([3]) at the time of the investment, it arrives at a net refinancing rate and thus at a liquidity discount of 3,75 % per annum for Wfa's capital that was available for underpinning commercial business.

Return premium on account of the particularities of Wfa's transfer

(226) In practice, when remuneration is determined, atypical circumstances which depart from a normal investment in the share capital of the company concerned generally give rise to discounts or premiums. It must therefore be

([1]) The chosen minimum remuneration is also supported by statements and studies on actual and expected returns on equity made by investment banks and consultancy firms. Salomon Brothers puts the equity return for most European banks at between 10 % and 14 %, Merryl Lynch estimates a figure of some 11,8 % for different German banks and WestLB Panmure gives a figure of between 11,8 % and 12,3 %.

([2]) In the decision to initiate proceedings under Article 88(2) of the EC Treaty, the Commission, on the basis of information provided at the time by WestLB, indicated a provisional rate of 7 %.

([3]) According to documents provided by the German Government, the corporate income tax rate was 42 % in 1995 and 1996, with a solidarity surcharge of 7,5 %, i.e. 49,5 % in total. The overall rate dropped to 47,5 % in 1998. It is only since 2001 that the overall tax rate has been 30,5 %.

examined whether the particularities, and especially the specific risk profile of the transfer of Wfa's capital, constitute grounds for adjusting the minimum remuneration of 10,19 % — determined above — which a private investor would expect for a (hypothetical) investment in the capital of WestLB and whether the Commission can produce a methodically robust quantification of that adjustment. In this connection, three aspects should be considered: first, the non-issuance of new shares in the company with the associated voting rights; second, the exceptional volume of the asset transfer; and, third, the non-marketability of the assets.

(227) The Land did not obtain any additional voting rights through the transfer. By forgoing voting rights, an investor renounces a say in decisions taken by the bank's board. If the Land's voting rights had been increased, it would have possessed more than 70 % of those rights, moving from being a minority (with 42 % of shares) to a majority shareholder. To compensate for this acceptance of a higher risk of loss without a corresponding increase in influence over the company, a market-economy investor would demand a higher remuneration (even if the potential risk were cushioned by internal agreements with the other shareholders). This is clearly so in the case of non-voting preference shares. A higher remuneration is demanded as well as preferential ranking for forgoing voting rights. On the basis of the higher remuneration for preference shares compared with ordinary shares and in agreement with the complainant BdB, the Land of North Rhine-Westphalia and WestLB, which, after their discussions in July 2004, consider a rate of 0,3 % per annum (after tax) as appropriate remuneration, the Commission considers a premium of at least 0,3 % per annum (after corporation tax) to be appropriate.

(228) The size of the amount transferred and its effect on WestLB from the point of view of the Solvency Directive have already been mentioned. Through the transfer of Wfa's capital, WestLB's core capital doubled without any acquisition or administration costs. In the present case, however, the large volume of Wfa's capital was viewed as an indication — albeit not sufficient on its own — that the transfer was akin to an injection of share capital. To that extent, applying a top-up (premium) in respect of the volume of Wfa's transfer would inadmissibly allow for this aspect twice over. Thus, in the present case and departing from its position as expressed in the first WestLB decision, the Commission rejects the idea of a premium for the volume of Wfa's capital.

(229) Lastly, attention must be drawn to the non-marketability of the assets, i.e. the impossibility of withdrawing the invested capital at any time from the company. Normally, an investor can sell an equity instrument on the market to third parties, thereby terminating his investment. To be more precise, a normal transfer of capital takes place as follows: The investor brings in assets (either in cash or in kind) which are entered on the assets side of the balance sheet. As a rule, these are matched on the liabilities side by a tradable interest registered in the name of the investor and taking the form, in the case of a limited company for example, of shares. The investor can sell these shares to a third party. He cannot withdraw the assets he originally brought in as these now form part of the net worth of the company and are no longer at his disposal. But by selling the shares he can realise their economic countervalue. His assets have thereby become marketable. Because of the special circumstances surrounding the transfer of Wfa's assets, this option was not available to the Land. Nevertheless, departing from the first WestLB decision, the Commission does not see any grounds for a further top-up. Although the Land did not have the possibility of trading the assets freely and receiving the economic countervalue, it always had the possibility, at least in principle, of withdrawing Wfa's capital from WestLB by law and reinvesting in other institutions offering higher returns.

(230) Overall, the Commission considers a premium of at least 0,3 % per annum (after tax) to be appropriate for forgoing additional voting rights ([1]).

No reduction in the remuneration on account of the agreement of a fixed amount

(231) In the case of shares, the remuneration depends directly on the performance of the company and is expressed mainly in the form of dividends and a share in the increased value of the company (e.g. expressed by share price increases). The Land receives a fixed remuneration the level of which should reflect these two aspects of remuneration for 'normal' equity injections. It could be argued that the fact that the Land receives a fixed remuneration instead of one directly linked to WestLB's performance constitutes an advantage which justifies a reduction in the rate of the remuneration. Whether such a fixed rate actually constitutes an advantage as compared with a variable, profit-linked rate depends on the company's performance in the future. If the performance deteriorates, a fixed rate benefits the investor but, if it improves, it places him at a disadvantage. However, actual developments cannot subsequently be used

([1]) The study from First Consulting quoted in footnote 49 of the first WestLB decision had taken a flat-rate top-up of 1 %-2 % for the various above-mentioned aspects. It had, however, not acknowledged that the volume should have been taken into consideration when determining what was akin to share capital. In so far as the fungibility aspect is concerned, First Consulting had, in the view of the Commission, not recognised that the asset was not sellable but that, by law, it was possible to withdraw it from WestLB and reinvest it elsewhere.

to assess the investment decision. It should also be borne in mind that, in the event of losses, no remuneration is paid at all and a decision on cumulative recovery payments is a matter for WestLB. The fixed nature of the rate accordingly does not benefit the investor in such a way that he would have agreed to a reduction in the remuneration. In aggregate, the Commission believes that the rate of remuneration should not be reduced for this reason.

(232) It should also be mentioned that the remuneration of equity injected is normally a matter to be agreed between the company and the investor. However, in the case at hand, the level of the remuneration to be paid by WestLB was obviously agreed on between the shareholders of WestLB, which seems unusual. It should not depend on what the other shareholders are willing to accept but on the risk for the Land and the usability for WestLB. Germany moreover did not provide any documents about these negotiations on the remuneration and the way in which it was calculated. It is certainly right in claiming that only the result, i.e. the level of the remuneration, is decisive for the Commission's assessment under the state aid rules and not the way in which this result was achieved. However, in the Commission's view, the way the remuneration was fixed and the considerations that played a part in that respect can certainly provide pointers to the extent to which the Land behaved like a market-economy investor.

(233) Furthermore, it was agreed between the shareholders of WestLB that the remuneration should be fixed once WestLB's financial results for 1992 onwards were available. In the Commission's view, the financial results of the bank should not, in fact, be of any relevance in determining the level of the fixed remuneration, which should be based not on the profits actually generated by WestLB but on the risk for the Land and the potential benefits of the transfer for the bank. A market-economy investor would not be prepared to accept a lower level of fixed remuneration because the results of the company in question were poor. This agreement does not therefore suggest behaviour corresponding to that of an investor acting under normal market-economy conditions.

(234) During the Commission's preliminary investigations, negotiations took place between the complainant and WestLB with a view to finding a solution, i.e. to establishing on a common basis a remuneration regarded as being in line with the market, without recourse to the procedure laid down in Article 88(2) of the EC Treaty. These negotiations were not successful. During them, however, WestLB proposed that, in the event of its liquidation, the Land should be granted the right to receive, in addition to the existing fixed remuneration of 0,6 %, an appropriate consideration for the increase in value of WestLB due to the additional business made possible by the transfer of Wfa, i.e. the Land would be given an additional share in WestLB's open and hidden reserves. This fact suggests that the value to WestLB of the transferred capital actually exceeded the agreed remuneration. However, no such share in the break-up value was agreed. Nor would a market-economy investor accept such a hypothetical remuneration since, in the case of a perpetual company like WestLB, he would never be able to encash it; it would thus have no value.

Total remuneration

(235) On the basis of the above considerations and in agreement with the complainant BdB, the Land of North Rhine-Westphalia and WestLB, the Commission considers that an appropriate remuneration for the investment in question would be 6,92 % (after corporation tax), i.e. 10,19 % (after corporation tax) normal return on equity plus a premium of 0,3 percentage point (after corporation tax) on account of the particularities of the transaction less 3,75 percentage points (after corporation tax) on account of the financing costs resulting from the transferred assets' lack of liquidity for WestLB.

iv) ***Appropriate remuneration for the amount of DEM 3 400 million (EUR 1 740 million)***

(236) As already mentioned, the equity of DEM 3 400 million (EUR 1 740 million) is also of material value to WestLB and its economic function may be compared to that of a guarantee. A market-economy investor would demand an appropriate remuneration in return for exposing himself to a risk of this sort.

(237) In the decision to initiate the procedure laid down in Article 88(2) of the EC Treaty, the Commission quoted a rate of 0,3 % as having been indicated by Germany as the appropriate commission on a bank guarantee ('*Avalprovision*') for a bank like WestLB. However, two factors in particular must be taken into account here. Firstly, the amount of DEM 3 400 million (EUR 1 740 million) exceeds what is normally covered by such bank guarantees. Secondly, bank guarantees are normally associated with certain transactions and limited in time. By contrast, Wfa's special reserve is at WestLB's disposal without any time limit. These two factors require an increase in the premium to about 0,5 % 0,6 %. Guarantee premiums normally count as operating expenses and therefore reduce taxable profit, but the remuneration for Wfa's capital is paid to the Land from after-tax profits, so the rate must be adapted accordingly. In view of all this, the Commission is of the opinion that a rate of 0,3 % after tax is a correct remuneration for this kind of capital.

v) ***Synergy effects***

(238) The German authorities claim that the real reason for the transfer was to achieve potential synergies and not to increase WestLB's equity. It might be true that a discussion on the efficiency of housing promotion had already begun in the 1970s. However, despite this lengthy debate, the transfer did not take place until 1991, when WestLB's capital requirements forced its public owners to take such action. It is clear from the documents — especially the

relevant material on the Transfer Law, such as the grounds of the law and the minutes of the parliamentary debates — that the actual purpose of the transfer was to provide WestLB with the equity base needed to comply with the new solvency rules. Synergy effects were seen as a positive (side-)effect but were certainly not the main driving force behind the transaction at that time.

(239) The German authorities and WestLB claim that the Land had not only received the payment of 0,6 % on the amount of DEM 2 500 million (EUR 1 280 million) but also benefited from synergy effects worth about DEM 30 million (EUR 15 million) annually as a result of the transfer and integration of Wfa and WestLB's takeover of Wfa's pension obligations totalling DEM 33 million (EUR 17 million). The cost savings from synergies arise from the merger of Wfa with the former housing promotion division of WestLB, which led to an organisational streamlining of the Land's housing promotion activities and a reduction in staff.

(240) Synergy effects are the normal consequence of a merger. However, it is not clear how such synergies dovetail with the closed-circuit approach claimed by the Land and the competitive neutrality of Wfa. In so far as they were achievable after the transfer, despite the clear separation between the two entities, and arose from the merger of Wfa with the housing promotion division of WestLB, which had already in the past worked exclusively for Wfa, it is difficult to understand why it should not also have been possible to obtain such synergies without the transfer.

(241) Furthermore, if such synergies and cost savings accrue to Wfa, this will help the housing promotion activities (and hence the Land) by reducing costs but cannot be regarded as consideration paid by WestLB for the provision of the original own funds. Since these synergies neither reduce the usability of the transferred capital for WestLB nor increase WestLB's costs from the transfer, they should also not influence the level of remuneration for the equity provided which a market-economy investor can demand from the bank. Even if an actual benefit accrued to the Land as a result of synergies, any competitor would have been forced by competition to 'pay' to the Land, on top of the appropriate consideration for the equity provided, a 'remuneration' in the form of benefits for the financial instrument (Wfa).

(242) For the rest, synergy effects as result of a merger operation normally arise in both merged entities. It is difficult to understand why WestLB should not profit at all from such advantages.

(243) If WestLB made payments for Wfa's pension obligations which reduce Wfa's annual costs, such payments cannot be regarded as synergies from the merger. Nevertheless, they can be regarded as indirect remuneration for the Land paid by WestLB. The benefits should arise within the housing promotion business and therefore increase the funds available there.

(244) The Commission takes the view, therefore, that the claimed synergy effects do not represent a remuneration paid by WestLB for the transfer of Wfa, but it is prepared to regard the amount of DEM 33 million (EUR 17 million) paid by WestLB in 1992 for Wfa's pension costs as part of the remuneration paid by WestLB for the transfer.

f) INCLUSION OF THE YEAR 2002

(245) Contrary to the view taken by the parties to the agreement, the Commission furthermore came to the conclusion that the year 2002 needs to be taken into account when determining the aid element, on a proportional basis up to 1 August 2002. Germany, it is true, has stated repeatedly that, because of the retroactive accounting effect of the merger on 1 January 2002 of Wfa and Landesbank Nordrhein-Westfalen, which was ordered by law, the state aid element was to be regarded as having ceased to exist on that date. However, irrespective of the accounting effect, Wfa's capital was at the disposal of WestLB for underpinning its competitive business until 1 August 2002. This is the decisive point as regards the question to be addressed here.

(246) In particular, it has been argued that not only the profits of Wfa and the areas assisted but also the entire business involving public bonds were transferred to the Landesbank on 1 January 2002 as part of the reorganisation, with the result that the losses of WestLB regarded as being linked directly to the solution for the future of Wfa have been considerably higher than the appropriate remuneration for Wfa's capital, and this should be recognised as appropriate compensation. However, this argument is unconvincing. The Commission has thus come to the conclusion that the disadvantage stemming from the separation of the areas assisted as well as of the business involving public bonds does not represent remuneration for the use of Wfa's capital up to 1 August 2002. It is precisely not only the areas assisted and the business involving public bonds that are underpinned by Wfa's capital but also the full range of WestLB's competitive activities. WestLB will therefore have to pay a remuneration of 6,92 % on a pro rata basis until 1 August 2002.

g) AID ELEMENT

(247) As calculated above, the Commission considers the following remuneration to be in line with market conditions: 6,92 % per annum after tax for the part of the capital which could be used by WestLB to underpin its commercial business, i.e. DEM 2 500 million (EUR 1 280 million) at the end of 1993, and 0,3 % after tax for the difference between this part and the amount of DEM 5 900 million (EUR 3 020 million) shown as equity in WestLB's balance sheet, i.e. DEM 3 400 million (EUR 1 740 million) at the end of 1993.

(248) WestLB paid a remuneration of 0,6 % only on the amount which it could use for underpinning its commercial business. This remuneration was first paid for 1993. As explained above, the Commission accepts the payments by WestLB in 1992 for Wfa's pension claims as additional remuneration for the Land.

(249) The aid element can be calculated as the difference between the actual payments and the payments which would correspond to market conditions.

(250) Table 5: Calculation of the aid element

(DEM million)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
1. Part of special reserve available to WestLB	13	2 510	2 819	3 048	3 108	3 112	3 113	[...]	[...]	[...]	[...]
2. Remainder (difference vis-à-vis DEM 5 900) in 2002 at a proportional rate of 7/12	5 887	3 390	3 081	2 852	2 792	2 788	2 787	[...]	[...]	[...]	[...]
Remuneration of 6,92 % (after tax) on point 1	0,9	173,7	195,1	210,9	215,1	215,4	215,4	[...]	[...]	[...]	[...]
Remuneration of 0,3 % (after tax) on point 2	17,7	10,2	9,2	8,6	8,4	8,4	8,4	[...]	[...]	[...]	[...]
Total remuneration in line with market conditions	18,6	183,9	204,3	219,5	223,5	223,8	223,8	[...]	[...]	[...]	[...]
Actual remuneration (after tax)	33,1	15,1	16,9	18,3	18,6	18,7	18,7	[...]	[...]	[...]	[...] [1]
Aid element	- 14,5	168,8	187,4	201,2	204,9	205,1	205,1	208,6	209,3	209,3	128,6

(Amount: DEM 1 913,80 million = EUR 978,51 million)

[1] According to Germany, WestLB paid DEM [...] for the whole of 2002. In terms of the relevant period from 1 January to 1 August 2002 ([...] multiplied by the factor of 7/12), an amount of [...] was thus paid as remuneration.

4. *TAX EXEMPTIONS*

(251) As stated in the Commission decision to initiate the procedure laid down in Article 88(2) of the EC Treaty, state aid may be involved if a particular enterprise is exempt from taxes whereas its competitors are subject to normal taxation. If the construction of an 'entity within an entity' involves a non-profit, tax-exempt entity, steps have to be taken to ensure that the economic effects of tax privileges are limited strictly to the non-profit entity and do not spill over to the enterprise in the competitive sector.

(252) WestLB was subject to neither property tax (*Vermögenssteuer*) nor tax on business capital (*Gewerbekapitalsteuer*) on the transferred capital. Furthermore, the profit from Wfa's activities remained exempt from corporation tax (*Körperschaftssteuer*) after the transfer. According to Germany, these tax provisions are not intended to favour and do not favour WestLB over other taxable persons.

(253) Profits accruing within WestLB's competitive business as a result of the use of Wfa's capital for solvency calculations are being taxed normally. Only profits in the housing promotion sector are exempt from tax. Similarly, the exemptions from taxes on business capital and on property are limited to the housing promotion business. It is not the Commission's task to decide whether the German tax laws regarding exemptions for non-profit oriented activities have been infringed but only to assess the measure under the state aid rules of the EC Treaty.

(254) The exemption from property tax, tax on business capital and corporation tax enjoyed by Wfa within WestLB boosted Wfa's profits (or reduced its losses), alleviated the

potential need for the Land to inject additional funds into housing promotion and subsequently increased Wfa's net assets. Since Wfa needed only a certain part of this (enlarged) capital base as original own funds for its own business, the part available to WestLB to underpin its competitive activities also increased over time. However, had this share increased, the basis for the remuneration to be paid to the Land would also have increased. If the remuneration were fixed at an appropriate level, there would have been no distortion of competition in favour of WestLB as a result of the tax exemptions for the housing promotion business. According to the above calculations, an appropriate level would be 6,92 % per annum and 0,3 % per annum respectively.

5. *WAIVER OF LIABILITY*

(255) Germany argues that the waiver of liabilities did not adversely affect the Land's financial position and did not confer any competitive advantage on Wfa or WestLB. Following the transfer, Wfa's assets (the Land housing promotion fund) were not reduced each year by this liability, so that higher proceeds would have been possible in the event of Wfa being wound up, with such higher proceeds accruing to the Land. The German authorities also state that, without the waiver, BAKred would not have accepted DEM 4 000 million (EUR 2 050 million) as original own funds of Wfa.

(256) The waiver has certainly increased Wfa's value. However, since the remuneration to be paid by WestLB was based on the valuation of Wfa after the waiver, i.e. taking into account this increase in its value, the waiver did not confer an advantage on WestLB in so far as the remuneration was in line with the market.

6. *COMPATIBILITY OF THE MEASURE WITH THE EC TREATY*

(257) On the basis of the foregoing considerations, it can be stated that all the criteria laid down in Article 87(1) of the EC Treaty are met and the transfer of Wfa therefore involves state aid within the meaning of that Article. On this basis, an assessment has to be made as to whether that aid can be considered compatible with the common market. It should be pointed out that the German Government did not invoke any exemption clause of the EC Treaty with regard to possible state elements in connection with the transfer of Wfa.

(258) None of the exemption clauses of Article 87(2) of the EC Treaty are applicable. The aid is not of a social character, is not granted to individual consumers, does not make good the damage caused by natural disasters or exceptional occurrences, and does not compensate for economic disadvantages caused by the division of Germany.

(259) Given that the aid has no regional objective — it is designed neither to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment nor to facilitate the development of certain economic areas — neither Article 87(3)(a) nor Article 87(3)(c) of the EC Treaty, as regards the latter's regional aspect, is applicable. Nor does the aid promote the execution of an important project of common European interest. The aid is not aimed either at promoting culture or heritage conservation.

(260) Since the economic survival of WestLB was not at stake when the measure took place, there is no need to consider whether the collapse of a single large credit institution like WestLB could lead to a general banking crisis in Germany, which might possibly justify aid to remedy a serious disturbance in the German economy under Article 87(3)(b) of the EC Treaty.

(261) Under Article 87(3)(c) of the EC Treaty, aid may be found compatible if it facilitates the development of certain economic activities. This might, in principle, also apply to restructuring aid in the banking sector. However, in the case at hand, the conditions for the application of this exemption clause are not met. WestLB is not described as an undertaking in difficulty whose viability should be restored with the support of state aid.

(262) Article 86(2) of the EC Treaty, which allows exemptions from the state aid rules of the Treaty under certain conditions, is, in principle, also applicable to the financial services sector. This has been confirmed by the Commission in its report on 'Services of general economic interest in the banking sector' ([1]). However, it is clear that the transfer was effected in order to allow WestLB to comply with the new own funds requirements and with no regard to any services of general economic interest. Furthermore, Germany did not claim that the transfer of Wfa was designed to indemnify WestLB for the provision of certain services of general economic interest. Therefore, this exemption clause does not apply either in the case at hand.

(263) Since no exemption from the principle of the ban on state aid pursuant to Article 87(1) of the EC Treaty applies, the aid in question cannot be found compatible with the Treaty.

VII. **CONCLUSIONS**

(264) The Commission finds that Germany has unlawfully implemented the aid in question in breach of Article 88 (3) of the EC Treaty. This aid is therefore illegal.

(265) The aid cannot be found compatible either under Article 87 (2) or (3) or under any other provision of the EC Treaty. It

([1]) This report was presented to the ECOFIN Council on 23 November 1998 but has not been published. It can be obtained from Competition Directorate-General IV of the Commission and can also be found on the Commission's website.

is therefore declared incompatible with the Treaty and must be discontinued and the aid element of the measure illegally put into effect must be recovered by the German Government.

HAS ADOPTED THIS DECISION:

Article 1

The state aid which Germany implemented for Westdeutsche Landesbank-Girozentrale, now WestLB AG, between 1 January 1992 and 1 August 2002, amounting to EUR 978,51 million, is incompatible with the common market.

Article 2

Germany shall take all necessary measures to recover from the beneficiary the aid referred to in Article 1 and unlawfully made available to the beneficiary.

Article 3

Recovery shall be effected without delay and in accordance with the procedures of national law provided that they allow the immediate and effective execution of the Decision.

The aid to be recovered shall include interest from the date on which it was at the disposal of the beneficiary until the date of its recovery.

Interest shall be calculated in accordance with the provisions laid down in Chapter V of Commission Regulation (EC) No 794/2004 ([1]).

Article 4

Germany shall inform the Commission, within two months of notification of this Decision, of the measures taken to comply with it, using the questionnaire attached in the Annex to this Decision.

Article 5

This Decision is addressed to the Federal Republic of Germany.

Done at Brussels, 20 October 2004.

For the Commission

Mario MONTI

Member of the Commission

([1]) OJ L 140, 30.4.2004, p. 1.

ANNEX

INFORMATION REGARDING THE IMPLEMENTATION OF THE COMMISSION DECISION

1. **Calculation of the amount to be recovered**

1.1 Please provide the following details regarding the amount of unlawful state aid that has been put at the disposal of the recipient:

Date(s) of payment (°)	Amount of aid (*)	Currency	Identity of recipient

(°) Date or dates on which the aid or individual instalments of aid were put at the disposal of the recipient; if the measure consists of several instalments and reimbursements, use separate rows.
(*) Amount of aid put at the disposal of the recipient, in gross grant equivalent.

Comments:

1.2 Please explain in detail how the interest payable on the amount to be recovered will be calculated.

2. **Recovery measures planned or already taken**

2.1 Please describe in detail what measures have been taken and what measures are planned to bring about the immediate and effective recovery of the aid. Please also explain which alternative measures are available in national legislation to bring about recovery of the aid. Where relevant, please indicate the legal basis for the measures taken or planned.

2.2 By what date will the recovery of the aid be completed?

3. **Recovery already effected**

3.1 Please provide the following details of aid that has been recovered from the recipient:

Date(s) (°)	Amount of aid repaid	Currency	Identity of recipient

(°) Date or dates on which the aid was repaid.

3.2 Please attach supporting documents for the repayments shown in the table at point 3.1.