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Agenda

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When is a bank capital injection state aid? Insights from the *Helaba* judgment

The market economy investor principle (MEIP) is a test for determining the existence of state aid. When the state expands a bank's core capital, as has occurred in several instances in recent years, the question arises as to whether it is providing state aid or merely acting in the manner of a private investor. Taking the recent case of the German bank Helaba, how has the General Court interpreted the state contribution made to the bank, and what lessons does this yield for the MEIP?

In March 2010, the General Court issued two judgments in relation to investment fund contributions made by the German state (*Land*) of Hessen to Landesbank Hessen-Thüringen Girozentrale (Helaba).[1] In both cases, the Court found that the European Commission had been correct in its application of the MEIP when finding that the assets made available to Helaba to underpin its competitive business do not constitute state aid.

The MEIP tests whether state aid exists when the state acts as a market participant. According to the principle, funds that are provided 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] are deemed not to grant an advantage to the recipient. Such funds would therefore not be classified as state aid.

A key question here is whether the test is most appropriately used from the perspective of a private investor or the perspective of the recipient of the investment, or whether the two are equivalent. In the present context, the question is whether the same conclusions would be reached if one evaluated (i) whether the *Land* behaved equivalently to a private investor, or (ii) whether Helaba, as the recipient, gained an advantage from the transfer.

This question of appropriate perspective is at the centre of both judgments handed down by the General Court. The Court's judgments appear to prioritise the second test in applying the MEIP, in the sense that the primary determinant of whether state aid exists is said to be whether the recipient receives an advantage. On the other hand, from an economic perspective, the two tests should be equivalent if they are correctly applied. This article explains why the economic perspective addresses a main conflict within the *Helaba* cases, and discusses the implications for the application of the MEIP going forward.

Challenged decisions of the European Commission

The decisions at issue both concern the *Land*'s transfer to Helaba of investment funds comprising a portfolio of loans at below-market interest rates (the Housing and Future Investment Fund and the Hessian Investment Fund). Neither contribution involved the transfer of liquid resources to Helaba since the capital in the investment funds was already lent out and any interest payments or redemptions were made available for additional loans. Despite being non-liquid, the contributions were recognised as part of the bank's core capital (the buffer that the bank is required to hold in order to protect depositors and other stakeholders from any decline in the value of the bank's assets). The expansion of Helaba's core capital meant that it was able to increase its assets (for example, by making more loans) without breaching regulatory requirements concerning the ratio of core capital to risk-weighted assets.

In both cases, Helaba remunerated the *Land* at a rate that the Commission judged (on the basis of expert reports and analysis of comparable transactions) to be in line with market rates. In the *Housing and Future Investment Fund* case, the remuneration applied to the

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full amount of the contribution only from 2003 onwards, while for the first four years (1998–2002) the *Land* and Helaba agreed that remuneration would be paid only on smaller amounts (€310m, €610m, €820m and €1.02 billion).

The reason for this phased arrangement concerned Helaba's capital needs; at the time of the transfer, Helaba did not need capital to meet regulatory requirements. Its business plan put the bank's capital needs to meet growth targets at approximately €150m per year for the period from 1998 to 2002, whereas the fund was valued at €1.26 billion at the time of the transfer. The phased compensation arrangement was meant to reflect this difference between the size of the fund and Helaba's capital needs. In its contested decision, the Commission broadly accepted this arrangement, finding that the contribution did not create an advantage for Helaba and hence was not state aid. The Commission did consider that, while a private investor might have accepted a phased approach to compensation in a case where, like the *Land*, it did not wish to split its investment, it would have demanded some form of remuneration on the full amount of the contribution, regardless of Helaba's needs. This is because the private investor would be exposing the full amount of the investment to the risk of loss in the event of insolvency. The Commission therefore imposed a rate of remuneration of 0.3% on the share of the contribution above the annual tranches and ordered the *Land* to recover past unpaid amounts of €6.09m.

Challenge and decisions of the General Court

The Bundesverband deutscher Banken (BdB; Federal Association of German Banks) challenged both of the Commission's decisions, arguing that the Commission was wrong to conclude that the contributions did not create an advantage for Helaba. In both cases, the BdB argued that the rate paid by Helaba to the *Land* was lower than what a private investor would have accepted, and therefore that the capital contribution amounted to state aid. The arguments and the Court's reasoning are explored in more detail below.

Riskiness of investment

The BdB argued that, in both cases, the investment funds posed higher risk to the investor than the comparable transactions used by the Commission, due primarily to the size of the transaction relative to the total capital of Helaba (40%), as well as the size of the investment relative to the *Land*'s total investments.

While the Court accepted in the *Housing and Future Investment Fund* case that the significance of the contribution does increase the risk faced by the *Land*, it noted that Helaba would not gain an advantage since it did not need a contribution of this size and so did not need to compensate the *Land* for its extra risk:

> while the size of the Land's proportion of the core capital of Helaba entailed an increase in risk for the Land, it is not clear that that amounted to an advantage for which Helaba should have paid a premium.[3]

In discussing whether the *Land* would have demanded a higher rate of remuneration to compensate for its substantial commitment to Helaba, the Court took the view that the rate Helaba would have had to pay in the market was the relevant benchmark:

> the applicant does not claim that Helaba would have been unable to obtain on the market, possibly as one of a number of investors, a contribution which, in its view, has the same characteristics as the contribution at issue (size, unlimited duration, liability remuneration). In those circumstances, Helaba was able to encourage the Land to forgo any remuneration premium to take account of its significant exposure to Helaba, since Helaba could have rejected the Land's offer and obtained the funds on the market at a lower cost.[4]

Phased remuneration

The BdB also challenged the level of remuneration of the Housing and Future Investment Fund on the basis that a private investor would not have accepted a phased remuneration arrangement which involved a lower rate of remuneration on the portion of the contribution above the phased amounts.

In considering the phased nature of remuneration, the Court looked at both whether the *Land* as a private investor would have accepted the arrangement and whether Helaba gained an advantage as a result. The Court noted that whether the *Land* could have obtained higher remuneration by investing elsewhere was irrelevant, as long as the remuneration was in line with market rates. Instead, the key perspective was that of Helaba:

> the question as to what alternative investment opportunities might have been of interest to the Land is irrelevant in the present case. It is not a question of determining whether the Land could have obtained a better return on its special fund by investing it differently or in another undertaking, but whether, by investing that special fund in Helaba under the agreed conditions, the Land conferred an advantage on Helaba which it could not have obtained in any other way.[5]

In considering whether there was an advantage to Helaba, the Court noted that Helaba did not need a capital contribution for regulatory capital adequacy purposes, and that its growth needs required only around €150m in new capital per year. It therefore held that Helaba behaved reasonably in demanding a two-tier remuneration system and that an investor in the *Land*'s position, which did not want to divide its contribution, would not have been able to achieve full rates on the entire amount. Furthermore, the Court noted that the BdB had not explained how the contribution afforded any advantage to Helaba.

Assessment

As already noted, the MEIP considers two perspectives: that of the investor and that of the recipient. Is the test whether, first, the public investor behaved as a market economy investor, or, second, whether the recipient's deal was no better than could have been obtained from the market? Are the two equivalent or could different conclusions be reached depending on which perspective is adopted?

As discussed above, in the *Helaba* cases the General Court considers this question carefully. The BdB's argument is essentially that a profit-maximising investor would pursue the highest return possible, which the *Land* did not necessarily do. The Court explains that whether the *Land* could have achieved higher returns by placing its investment elsewhere is essentially immaterial. The relevant test is whether Helaba could have raised similar funding in the market (ie, whether it gained an advantage by the *Land*'s participation). It thus emphasises the MEIP as a test of evidence regarding the *recipient's advantage*.

So what is correct from an economic perspective? The MEIP is a test of economic advantage. At a fundamental level, the MEIP is therefore a question of whether a transfer is made on terms that could have been obtained in the private sector, and *not* a test of the economic rationality of the public body that transfers funds to the private sector. Even if the public body could have made better use of its funds, this does not establish that the recipient has gained an advantage. The recipient's perspective is therefore paramount.

Nonetheless, for practical reasons, the investor perspective can be useful to consider (and should in fact yield the same result). In particular, whereas a financial instrument such as the loan portfolios transferred to Helaba has an identifiable and specific rate of remuneration which may be benchmarked against options available in the private sector (such as debt issued by listed firms), the same is not true of many investment projects. For example, what would be the rate to benchmark against comparators in the case of a deal between an airport and an airline? There is no single parameter that captures the combination of commercial benefits and costs, other than the overall expected rate of return on the project. Therefore, for practical reasons many investment projects will require examination of the expected profit from the investor's perspective, which in turn can be compared with a reference rate, namely the appropriate cost of capital for the project (with the cost of capital drawn from private sector benchmarks).

This test should yield the same end result for the MEIP since, if the expected profit exceeds the cost of capital, there is a profitable opportunity for comparable private investors. This, in turn, logically implies that the recipient could have turned to other investors for the same deal. In other words, there should have been other investors prepared to make the investment on the same terms. Note that this does not necessarily mean that the public sector investor has behaved optimally if it has limited funds available, as there may have been alternative projects available to that investor where the profit opportunity was greater.[6]

In the *Helaba* cases, it appears that the *Land* as investor may have increased its risk, relative to holding a diversified portfolio, by concentrating a large amount of capital in Helaba. Thus the *Land* may have put itself into an economically sub-optimal position of excessive risk exposure to Helaba. On the other hand, the contribution did not bring particular benefit to Helaba, since it would appear, according to the evidence of the Commission, that the bank could have achieved its desired outcome by raising capital from a large number of investors, each of which may have held a diversified portfolio and thus not have exposed itself to excessive risk. The private investor of the MEIP is therefore appropriately characterised more as the financial market in general (which would not face liquidity constraints), rather than one investor in particular.

In summary, the MEIP is a test of advantage—the advantage can be measured by reference to suitable comparators, but in principle the same result should be derived if a comparison is made between the expected returns and the appropriate cost of capital. In a finely balanced case, it can make sense to use both approaches—testing both against comparators and against the cost of capital. If these tests are conducted properly, they should yield the same result. This is sound economics, but the process may fail in circumstances where financial markets have little liquidity (ie, where the pool of potential investors dries up). Such a liquidity situation arose in the recent global financial crisis, which explains why the MEIP has been exceptionally difficult to apply in the recent crisis-related state aid cases, including those involving the rescue of banks.

[1] *Bundesverband deutscher Banken v Commission*, March 3rd 2010, Case T-163/05; and *Bundesverband deutscher Banken v Commission*, March 3rd 2010, Case T-36/06.
[2] European Commission (1993), 'Commission Communication to the Member States on the 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, November 13th, p. 3, point 11.
[3] Case T-163/05, paragraph 232.
[4] Case T-36/06, paragraph 90.
[5] Case T-163/05, paragraph 58.
[6] If the investor is not capital-constrained, it should be able to pursue all projects where the return is higher than the expected cost of capital. If the investor has limited funds available, however, it would pursue only those opportunities with the highest return. Imagine that a public sector investor has two available projects, one with a net present value (NPV) of €10m and one with an NPV of €40m, and imagine that it chooses to invest in the former. This does not prove advantageous for the recipient in the legal sense, since the question of advantage is whether the project with an NPV of €10m would also be attractive to the private sector. Assuming that the NPV has been measured appropriately, the answer is by definition 'Yes', since on a risk-adjusted basis the profit opportunity is positive.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

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