# Too Big to Fail?

## An outline of global government interventions

A ULI Europe Policy and Practice Committee research paper


*Author*
**Lucy Newsum,**
Research Assistant, ULI Europe

*Edited by*
**Alexandra Notay,**
Vice President, Strategic Programmes, ULI



ULI Urban Land Institute

Shearman & Sterling LLP

Urban Land Institute
29 Gloucester Place
London
W1U 8HX
United Kingdom

Tel: +44 (0)20 7487 9577
Fax: +44 (0)20 7486 8652
Email: ulieurope@uli.org
Web: www.uli.org

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For more information on ULI Research and Publications, please contact Alexandra Notay, Vice President, Strategic Programmes, anotay@uli.org

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- **Provide Information** – ULI leadership in education and research examines key trends and issues, provides practical tools for industry professionals.
- **Share Best Practice** – ULI draws upon the knowledge and experience of its members to encourage and recognise excellence.

*ULI Europe is grateful to the support of Shearman & Sterling LLP in the production of this report.*

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# Biographies and Acknowledgements

## Author: Lucy Newsum

Lucy Newsum holds a First Class degree in Sociology from Durham University and was awarded the faculty's annual prize for the year's outstanding dissertation. Lucy joined ULI Europe as a Research Assistant in September 2009 and has worked with the European Policy and Practice Committee and Product Councils.

## Editor: Alexandra Notay

As Vice-President, Strategic Programmes Alexandra Notay leads the development of the ULI Energy Efficiency Exchange and oversees all Policy and Practice initiatives in Europe. Her role also includes the ongoing co-ordination of the Urban Investment Network research programme and support for European Product Councils, Awards, Young Leaders and the ULI Charitable Trust.

Before joining ULI in 2007, Alex worked in the UK government Department for Communities and Local Government (CLG) and prior to that, the Office of the Deputy Prime Minister. Her government experience includes roles as Business Manager and Policy Advisor for the Regional, Urban and Economic Policy Directorate, and Programme Manager for a cross-departmental Efficiency Review that saved £40million in 2 years. Alex holds a B.A. (Hons) in International Relations from the University of Sussex and is a registered Practitioner of PRINCE2 Project Management and Fellow of the Royal Society of Arts.

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| | |
|---|---|
| Andrew Baum | Professor of Land Management, Henley Business School, University of Reading, Academic Fellow, the Urban Land Institute |
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| Stephen Blank | Senior Fellow, Finance, the Urban Land Institute |
| Clare Breeze | Partner, Shearman & Sterling LLP (panelist) |
| Amanda D'Arcy | AD Design |
| Peter Denton | Managing Director, Westdeutsche Immobilien Bank AG (panelist) |
| Ivo de Wit | Global Portfolio Manager, ING Real Estate Select |
| Rosemary Feenan | International Director Global Research, Jones Lang LaSalle |
| Brian Field | Urban Planning & Development Advisor, European Investment Bank |
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| Francis P Lively | Associate, Shearman & Sterling LLP |
| Alexandra Notay | Vice President, Strategic Programmes, ULI |
| Mathieu Roland-Billecart | Real Estate Finance, Ernst & Young LLP (panelist) |

**ULI Europe Policy and Practice Committee Co-Chairs**

| | |
|---|---|
| Anne Kavanagh | Managing Director, Lazard & Co (moderator) |
| Scott Malkin | Chairman, Value Retail PLC and SD Malkin Properties |


**Please see page 32 for a full list of contributors.**

# Content

**Foreword** 4

**Introduction** 5

**Summary Table of the Interventions** 7

**United Kingdom** 8

**Ireland** 12

**Germany** 15

**Italy** 18

**The Netherlands** 20

**France** 23

**Spain** 25

**United States of America** 28

**Japan** 30

Glossary 31

Contributors 32

# Foreword

Survival was the key topic of discussion at the ULI Paris conference in 2009 and it soon became clear that key players within the industry wanted to know what government measures had been or were being put in place and what impact they may have on real estate markets.

This report was commissioned by the ULI Europe Policy and Practice Committee in September 2009 and is the result of a series of interviews with ULI members and their network around the globe.

This report provides a framework for a debate amongst ULI members about the likely impact of the interventions/key policy decisions to date and those still being implemented (i.e. the National Asset Management Agency or NAMA in Ireland); when they will be withdrawn and how it may affect values and the workings of the open market.

We started the debate at the ULI Annual Conference in Paris, 3rd February 2010, with an experienced panel and an engaged audience, after which the report was revised to reflect the most current thinking for publication on 10th March 2010. I would encourage you to participate in our future discussions.

**Anne Kavanagh**
Co-Chair, ULI Europe Policy and Practice Committee
Managing Director, Lazard & Co.

The Urban Land Institute (ULI) is proud to publish this report on global government interventions as part of our commitment to provide our European members with timely and informative programmes on the latest issues. I am grateful to the ULI Europe Policy and Practice Committee for highlighting the need for ULI to research this topic and to the five panelists who provided a lively and stimulating concurrent session entitled "Government to the Rescue?" at our annual conference in Paris on 3rd February 2010.

The production of this report exemplifies the collaboration between ULI Europe staff and our global membership. 50 leading ULI members from the 9 featured countries (UK, Ireland, Germany, Italy, The Netherlands, France, Spain, USA and Japan) agreed to be interviewed for this report, many of whom provided further data and reviewed the final text. It includes both the facts and figures as well as the expert opinions of academics, investors, policy-makers, lawyers and analysts. The unique strength of ULI is this broad network of senior property professionals who engage in the development of our policy and practice research, events and other activities.

I encourage you to contribute your insight and expertise to the Intitute's programme of work and be part of the debate on the most current issues in our industry.

**William Kistler**
President – ULI EMEA

# Introduction

The phrase, *too big to fail,* has developed a double meaning: the global financial crisis has demonstrated that not only is no financial firm too big or resilient to fail, but also that financial firms have become so big that failure would be catastrophic for the world economy and must be prevented; **the banks are not too big to fail but they are too big to be allowed to fail.**

*"The governments of the world needed to take major action – the banks had become too big to fail and needed to be saved"*

*"You get the feeling these government interventions are all the same, when in fact, they are quite different"*

Following the collapse of Lehman Brothers in September 2008, the credit crisis intensified and its effect rippled across the world causing a financial disaster on a global scale. In the subsequent weeks it became clear that no financial firm, however large or resilient, was exempt from the risk of bankruptcy. Initially manifested in subprime mortgages, the credit crisis caused traditional sources of funding for financial institutions to dry up and governments became crucial in providing support for failing banks. Government across Europe, the U.S., Asia and Africa have employed an extremely diverse range of interventions ranging from quantitative easing and capital loans to formal guarantees and public speeches of reassurance.

The schemes introduced by various countries, since September 2008, generally fall into three categories: recapitalisations, debt guarantees and asset purchase/insurance.

**Recapitalisations:** This involves governments injecting cash into the banks in return for common shares, preferred shares, warrants, subordinated debt, mandatory convertible notes or silent participations. By relieving banks' balance sheets, capital injections aim to both improve banks' capacity to absorb further losses and increase their capacity to lend.

**Debt guarantees:** Formal guarantees are provided by governments against default on bank debt. With the drying-up of traditional sources of funding, such as interbank lending, these guarantees allow banks to maintain access to medium-term funding at a reasonable cost. Debt guarantees are intended to reduce the risk on liquidity and lower overall borrowing costs.

**Asset purchase/insurance:** By purchasing or insuring assets, governments take on part or all of the risk of a portfolio of illiquid assets. By removing this risk from the banks' balance sheets, asset purchase improves liquidity and - if the purchase price is greater than the book values – provides capital relief.

The aim of this report is to provide clarification on the various government intervention schemes that have been implemented in countries across the globe. Through a combination of first-hand knowledge from the industry and ULI's independent research, this report explains how the schemes work, the level of capital invested, and the impact on the real estate sector. ULI Europe has conducted confidential, in-depth interviews with high-level executives who have a good understanding of the schemes in their county. This expert insight and opinion is hugely valuable and provides the reader with a more comprehensive understanding of the schemes and the industry's reaction to their implementation. While the contributors have been listed, quotes from the interviews are not attributed.

The countries of interest include the UK, Ireland, Germany, France, Spain, Italy, the Netherlands and the U.S. Asia will be covered in limited detail.

## Government Debt (in % of GDP)

| Country | 2008 | 2014 |
|---|---|---|
| France | 67.3 | 89.7 |
| Germany | 67.2 | 91.0 |
| Italy | 105.8 | 129.4 |
| Ireland | 44.1 | |
| Japan | 196.3 | 234.2 |
| Spain | 39.4 | 69.2 |
| The Netherlands | 58.2 | |
| United Kingdom * | 51.9 | 87.8 |
| United States of America | 70.5 | 106.7 |

*(Source: IMF, World Economic Outlook, April 2009) Source: Eurostat*

## Total Headline Support for the Financial Sector and Upfront Financing Needs (includes capital injection, purchase of assets and lending by Treasury, central bank support provided with Treasury backing, liquidity provision and other support by central bank, guarantees)

| Country | Total (in percent of 2008 GDP) |
|---|---|
| Italy | 3.3 |
| France | 19.2 |
| Germany | 22.2 |
| Japan | 22.2 |
| Spain | 22.8 |
| Ireland | 26.7 |
| The Netherlands | 40.1 |
| United States of America | 81.0 |
| United Kingdom * | 81.6 |

*(Source: IMF, Fiscal Implications of the Global Economic and Financial Crisis, 2009)*

## Investment: gross capital formation at market prices (in % of GDP)

| Country | 2007 | 2008 | 2010 |
|---|---|---|---|
| France | 22.2 | 22.2 | 19.8 |
| Germany | 18.3 | 19.2 | 15.6 |
| Italy | 21.8 | 21.2 | 17.3 |
| Japan | 24.1 | 23.5 | 21.3 |
| United Kingdom | 18.3 | 16.9 | 14.1 |
| United States of America | 19.5 | 18.2 | 14.9 |

*(Source: IMF, World Economic Outlook, October 2009)*

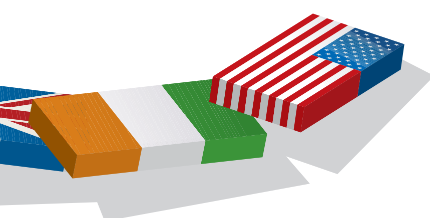
* Since the IMF data was published, the economic scenario of the United Kingdom has changed. HM Treasury now expects that overall net losses on RBS's insured assets will not exceed the £60 billion first loss amount. As a result, the direct cost to the taxpayer from the Asset Protection Scheme is expected to be nil. Therefore, the figures in tables one and two should be reduced. (HM Treasury, December 2009, Royal Bank of Scotland: details of the Asset Protection Scheme and launch of the Asset Protection Agency, www.hm-treasury.gov.uk)

# A Summary of the Government Intervention Schemes

| Country | Scheme Types, Money Invested and Life Span | | | |
|---|---|---|---|---|
| | Recapitalisations | Debt guarantees | Asset Purchase/ Insurance | Other Assistance |
| United Kingdom | £50 billion | £250 billion<br>3 years | APS (Asset Protection Scheme)<br>£282 billion, 5 years | Restructuring requirements |
| Ireland | | | NAMA (National Asset Management Agency)<br>€77 billion, 7-10 years | |
| Germany | €80 billion | €400 billion<br>Ended December 2009 | 'Bad bank scheme'<br>20 years | Restructuring requirements |
| Italy | €10-12 billion | | | 'Piano Casa', 2 years<br>Tax Amnesty |
| The Netherlands | €20 billion | €200 billion<br>1-2 years | ING - €27.7 billon | Housing Intervention<br>Restructuring requirements |
| France | SPPE (Société de prise de participation l'etat)<br>€10.5 billion | SFEF (Société de financement de l'économie)<br>€265 billion, 5 years | | |
| Spain | | €200 billion<br>Ended December 2009 | FAAF (Financial Assets Acquisition Fund)<br>€50 billion<br>No specific lifespan | FROB (Fund for Orderly Bank Restructuring)<br>€9,000 million |
| United States of America | TARP (Troubled Assets Relief Program)<br>$700 billion | | TALF (Term Asset-Backed Securities Loan Facility) $200 billion, Ends March 2010<br>MBS purchase program - $1.25 trillion | |
| Japan | 13 trillion yen | | | Purchase of commercial paper and asset-backed commercial paper – a3 trillion yen |

*"There is still a living, breathing banking market that exists today – it is just very different to the one we are used to"*

*"Success will be judge in the operation of the schemes and ultimately how much they cost the taxpayer"*



# United Kingdom

As with most of Europe, the financial crisis has impacted hugely on the UK economy. From 2008 to 2009, GDP and private consumption fell by 4.6% and 3.3%, respectively, and unemployment rose by 7.8% [1].

While the property market has remained, in a very basic sense, liquid, this is only due to a small number of minor transactions. Overall, the real estate sector has come to a near standstill. The residential property market has been the most severely hit and this has acted as the driving force behind decreased valuations across the sector. Since its peak in 2007, average prices in the residential market have fallen by 20%. While there has been some recovery in the second half of 2009, investors are concerned that this is a short term improvement and could lead to a "double-dip". Residential and commercial property values combined have fallen by 37.6% from their peak in 2007.

> *"The reduction in commercial real estate prices in the credit crunch began earlier and has gone further in the UK than in any other major market"* [2]

## Government Intervention

Even before the collapse of Lehman Brothers, the mindset of the British public was one of ever increasing caution. The bank-run on Northern Rock in 2007 played a major psychological role in creating a sense of distrust of the banking system among the public [3]. As the global financial crisis intensified, this distrust also amplified and banks quickly retracted lending to the economy because of the uncertainty surrounding huge losses from loans and where they were sitting. As a result, there was a sense of urgency from the British government to formulate a scheme that would relieve this uncertainty about banks' losses and, in doing so, aim to re-stimulate lending. In addition to the more widely employed recapitalisation and guarantee schemes, the British government introduced the Asset Protection Scheme that would impact more directly on the real estate sector.

Image courtesy of the Wikipedia Commons © 2009

### Recapitalisations and Guarantees

Recapitalisation and guarantee schemes were announced by the British government in October 2008 as part of the first package of support measures.

The government invested £50 billion in capital injections, in the form of cash that was made available to all UK banks and their foreign subsidiaries, and all UK building societies. The aim of these recapitalisations was to increase the banks' capacity to lend; therefore, in return for the government's support, the banks had to agree to continue to make available competitive credit to homeowners and small businesses over the next three years. In addition, the banks were required to limit the cash bonuses provided to senior executives in 2008, with many utilising longer term share schemes instead. RBS, HBOS and Lloyds TSB participated in the recapitalisation scheme, receiving support from the government of £20 billion, £11.5 billion and £5.5 billion respectively.

[1] The European Commission (Autumn 2009) *European Economic Forecast,* Economic & Financial Affairs Directorate

[2] Damesick, P (March 2009) *The Case for UK Property,* CB Richard Ellis, www.cbre.co.uk/research

[3] Elliot, L (September 28th, 2009) *Northern Rock Crisis hits Consumer Confidence,* www.guardian.co.uk: Northern Rock, a Newcastle-based bank, was the first run on a UK high street bank in over a century. The research group Gfk found that consumer confidence weakened significantly after the Northern Rock Crisis.

The government also made available £250 billion in guarantees for the banks. Again, this scheme was available to all UK incorporated banks and building societies. The guarantees are issued to banks with maturities of up to three years in a wide range of currencies, including British pounds, Euros, US dollars, Yen, Australian dollars, Canadian dollars and Swiss francs. In return for the government guarantees, the banks must pay a fee.

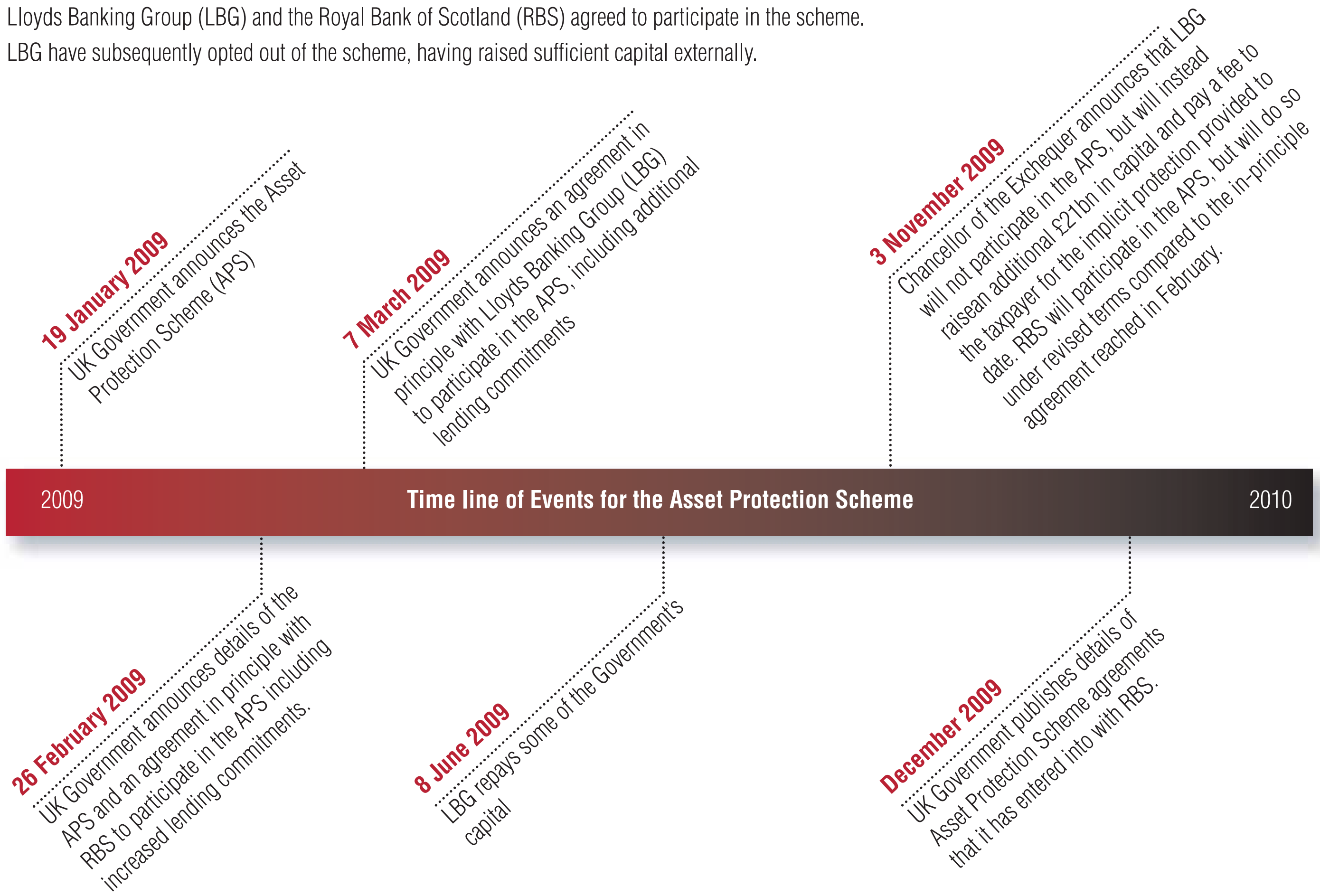
> *"An estimated £75 billion of real estate assets are covered by the APS – this is significant"*

**Asset Protection Scheme**

The Asset Protection Scheme (APS) was announced in January 2009 as part of a second package of support measures. It was designed as an asset insurance scheme whereby the government assumes ownership of the impaired assets on a bank's balance sheet, protecting the bank against any significant additional losses on those loans. Unlike the National Asset Management Agency (NAMA) in Ireland, the APS is not asset specific; it covers a range of assets that will include some real estate assets. By providing this insurance, the APS supports the banks in cleaning up their balance sheets and restoring confidence in the banking system, with the aim of creating financial stability and ultimately encouraging a return to lending.

Because the APS is an insurance scheme rather than a bad bank scheme, the illiquid assets remain on the banks' balance sheets, despite being owned by the British government. This means that, while losses from the loans are shared by the banks and the government, the management of these asset remains in the private sector.

The APS is technically open to all. However, the conditions of entry, such as the size of the debt required, means that only systemic banks can really join. When the APS was originally announced both Lloyds Banking Group (LBG) and the Royal Bank of Scotland (RBS) agreed to participate in the scheme. LBG have subsequently opted out of the scheme, having raised sufficient capital externally.



This leaves RBS as the only bank participating in the APS and its original terms of agreement with the Treasury have also changed. Initially, HM Treasury proposed to insure £325 billion worth of RBS assets, but this has been reduced to £282 billion. Once RBS has entered the APS any further losses on the insured loans are split into two tranches. The first tranche, known as the 'first loss', must be covered by RBS; this is a total of £60 billion, an increase from the £42 billion agreed at the outset.[4] Any losses on loans above this 'first loss' amount are classified as the second tranche and these are borne collectively by HM Treasury and RBS at a ratio of 9:1. Consequently, the British government covers 90% of all losses beyond £60 billion but also receives 90% of any recovery associated with the insured loans.

In return for participating in the scheme, RBS must pay an annual fee (insurance premium) to the government of £0.7 billion for the first three years, followed by £0.5 billion for the life of the scheme. This has also changed from the original agreement which outlined an up-front fee of £6.5 billion to be paid on admission to the scheme.

With Lloyds Banking Group no longer participating in the scheme and RBS's reduced pool of insured assets, the total investment in the APS has been reduced from £585 billion to £282 billion.

The APS officially began operating in December 2009. At the same time HM Treasury also launched the Asset Protection Agency (APA): a government body designed to oversee the management of the assets insured by the APS. The objective of the APA is to maximise the value of the protected assets, ensuring the minimisation of risk to the taxpayer.[5]

While the APS is a UK operated scheme, its impact is global. RBS is the largest bank in the world, ranked on total assets, and its unstable financial situation has negatively affected many economies.[6] Of the £282 billion assets that RBS is putting into the APS, £114.5 billion are located in the UK, £75.4 billion in other EU countries, £43.6 billion in the U.S and £48.4 billion in other countries. Consequently, by supporting RBS, the APS will aid the recovery of suffering economies far beyond the UK market.[7]

Steady recovery or double dip?

*"A lot of people don't realise that the APS is not free to the banks – they are paying huge amounts to take part"*

*"At the highest level, RBS and Lloyds can now be considered safe. There is enough stability not to panic the markets, but we are not at a point where government support can retract anytime soon"*

*"It remains to be seen how visible and important the APA's action will be, but it will play a critical role in determining the impact of the Asset Protection Scheme"*

4 HM Treasury (December 2009) *Royal Bank of Scotland: Details of the Asset Protection Scheme and launch of the Asset Protection Agency,* www.hm-treasury.co.uk

5 HM Treasury (December 2009) *Royal Bank of Scotland: Details of the Asset Protection Scheme and launch of the Asset Protection Agency,* www.hm-treasury.gov.uk

6 www.bankersalmanac.com (February 2010)

7 HM Treasury (December 2009) *Royal Bank of Scotland: Details of the Asset Protection Scheme and launch of the Asset Protection Agency,* www.hm-treasury.co.uk

### Restructuring Requirements

The financial crisis unveiled a moral hazard for governments across the globe and action is now being taken o prevent a disaster of this scale from occurring in the future. In collaboration with the European Commission, the British government has announced restructuring plans for a number of banks in order to promote greater competition in the UK banking market. In October 2009, plans were approved to split Northern Rock into a good bank and a bad bank; the long term proposal is to sell the good bank and gradually reduce the assets of the bad bank[8]. RBS and LBG will also undergo restructuring as they are considered to be "overlarge and overcompetitive" by the European competition commissioner, Neelie Kros[9]. In order to reduce their size, RBS and LBG will sell some of their operations in Britain over the next four years, including a significant proportion of their retail and corporate banking assets. According to HM Treasury, the assets can only be sold to small or new players in the market, to ensure that the shedding of these operations increases competition in UK banking.[11]

In addition to imposed restructuring requirements, HM Treasury is requiring financial firms to produce Resolution and Recovery Plans (RRPs), more commonly known as 'living wills'. These plans must outline how a financial firm will deal with future periods of stress without support from the taxpayer. These individual plans will help to prevent against system-wide risks, therefore providing greater financial stability in the future.[12]

*"The divestments from each bank will represent a viable stand-alone entity, together representing nearly 10% of the UK retail banking market"* [10]

### Recovery Outlook

While government support has ensured the short term stabilization of the banks, the fear now among investors and developers is that we will witness a "double dip" rather than a steady recovery; the concern is over a secondary bubble relating to the price of assets, rather than a sign of long term recovery and economic growth in the real economy. According to Cambridge Econometrics, there are various factors affecting the pattern of recovery in the short term and the long term, and the relationship between these factors will determine whether we experience a double dip. Short term factors include the recovery in investment spending, household spending and housing starts from the sharp falls that led the recession; these are helped by a recovery in asset prices. Long term factors include repairing balance sheets and returning to normal in the housing market, which relate to overall economic growth. Once the short term spending recovery ends, the long term factors are likely to weigh against economic growth for some time to come; if the short term factors peter out soon, a double dip is expected. [13]

One investor suggests that the prolonged period of relative economic inactivity combined with a lack of recovery in the long term factors could lead the UK into a Japan-like situation – an era of a lost decade. For the first time since records began in 1993, the UK borrowed money in January, a usually profitable month of income from tax receipts; "The UK's annual deficit is one of the highest. Total borrowing for the financial year to date is now running at more than £122 billion".[14] Generally, however, the mood among industry leaders is more positive; while there is a sense that we will still be "muddling through", overall consensus is that there will be improvement over the next 12 months. Whichever sentiment one subscribes to, it is agreed that the outlook for the next 3 years is almost entirely unpredictable. [15]

[8] Inman, P (October 28th, 2009) *Brussels approves plans to split Northern Rock,* www.guardian.co.uk*: Northern Rock was nationalised in Feburary 2008. In October 2009, the bank returned as a major high-street lender under agreements with the European Commission that it would splits its assets into a good bank and a bad bank.*

[9] The Economist (October 31st – November 6th 2009) *Reshaping British Banking: Rock carving,* www.economist.com, vol. 393, No. 8655, pp. 40

[10] HM Treasury, (December 2009) *Royal Bank of Scotland: details of Asset Protection Scheme and launch of the Asset Protection Agency,* www.hm-treasury.gov.uk

[11] HM Treasury (November 2009) *Implementation of Financial Stability Measures for Lloyds Banking Group and Royal Bank of Scotland,* www.hm-treasury.gov.uk

[12] HM Treasury (December 2009) *Royal Bank of Scotland: details of Asset Protection Scheme and launch of Asset Protection Agency,* www.hm-treasury.gov.uk

[13] Lewney, R (December 2009) *Conference: The Shape of Things to Come,* Cambridge Econometrics

[14] Hugh Pym, BBC Chief Economics Correspondent (18th February 2010), https:/news.bbc.co.uk/2/hi/business/8521587.stm

[15] Capital Markets Forum (November 16th, 2009), The Urban Land Institute Europe

# Ireland

Similar to the U.S. and the UK, the financial crisis in Ireland began within the property market. Following the collapse of Lehman Brothers in September 2008, it then intensified and spread to the wider economy. In 2009, GDP fell by 7.5%, private consumption fell by 7.7% and unemployment rose by 11.7%[1]. Hailed as the 'Irish Tiger', much of the Irish economic boom over the last ten years was dependant on the real estate market. As a result, the effect of the financial crisis has been significantly worse than in other countries across the globe.

> *"The health of the property sectors, both commercial and residential, has always been directly linked to the performance of the economy."* [2]
>
> *"Ireland has fallen further from a higher precipice than any other country"*

In 2006, at the peak of the property cycle, the total Irish spend on property was over €50 billion. In 2009 it was estimated to have fallen to €4.5 billion: a 90% reduction in spending. The demand for offices has decreased, investment came to a standstill in the months after the collapse of Lehman Brothers and is yet to recover, and there have been few or no sales transactions in the industrial market. The construction sector, which at the cycle peak accounted for over 13% of total employment (5% higher than the European Economic Area), is also downsizing rapidly; development demand has dropped, new home construction has come to a halt and investment in equipment and machinery is also declining.

## Government Intervention

While the Irish government has implemented a small number of recapitalisations and guarantees, it has taken longer than the US and UK to put together a significant scheme to tackle the toxic assets on banks' balance sheets. In April, 2009, the government announced the National Asset Management Agency (NAMA) which would be implemented for this purpose; the scheme was recently approved by the European Union.

### The National Asset Management Agency (NAMA)

NAMA is an asset purchase scheme, specifically created for land and development loans. Through the scheme, the Irish government purchases the toxic or illiquid assets and places them into NAMA, which effectively acts as a bad bank. This true transfer of assets removes the loans from the banks' balance sheets, creating greater balance sheet certainty with the aim of allowing banks to increase lending to households and businesses. It is expected that NAMA will ultimately become responsible for the management of these assets. There are currently five financial institutions taking part in NAMA: Anglo Irish Bank, Allied Irish Bank, Bank of Ireland, Irish Nationwide Building Society and Education Building Society. It is estimated that together these institutions will transfer 2,000 loans into NAMA at an aggregate book value of approximately €77 billion; €49 billion of which applies to land and development loans and €28 billion of associated loans[3]. Once these assets have been transferred into NAMA, it effectively has the same power as the banks with regards to the management of these assets.

A Green Party delegate taking part in the ballot on the National Asset Management Agency motion at the party's special convention in the RDS in Dublin on Saturday. Photograph: Bryan OBrien

1 The European Commission (Autumn 2009) *European Economic Forecast*, Economic & Financial Affairs Directorate

2 Henry, J (Summer 2009) *Property Outlook*, Savills Ireland

3 National Asset Management Agency (November 2009) *Presentation by Interim Managing Director to UCD law conference*, www.nama.ie. Please note: these were the official figures at the time of publication but the situation is very fluid and the figures may change.

*"The Government does not have deep pockets for continual recapitalisations. It needs participating institutions to start 'getting well', but a credible combination of re-pricing and cost reduction is required – neither of which are very politically acceptable at this time"* [5]

*"Taxi drivers can talk about NAMA – in contrast, the APS has no public profile outside the finance industry, and even then very few people know much about it"*

Participation in the scheme is not restricted to Irish real estate loans; in fact, the government expects that two thirds of the purchased property will be in Ireland, with the remaining third located in other countries, particularly the UK. Borrowers whose loans have been transferred will be required to provide NAMA with business plans for approval. It is anticipated that NAMA's requirements for the business plans will be stricter and borrowers will have to provide more detailed reporting on all levels.

The proposal for NAMA has received significant public attention and political debate. The focus of this debate has been the valuation process which determines the price at which NAMA acquires the assets. The main concern is whether the assets should be priced at the current open market value or at a more medium term valuation that allows for recovery over the next few years. The discussion turned political because over-payment for the assets would generate anger among the public who dislike the idea of simply bailing out the banks; however, underpayment for the assets would result in the banks requiring further government support in the future. NAMA has hired a number of advisors who are currently working with NAMA to produce a valuation model using "long-term economic value" (LEV) methodology. This methodology takes as its base the current open market value and allows for an upward adjustment factor of up to 25%, which is expected to reflect some improvement in the property market.[4] The planned lifespan of NAMA is 7-10 years.

### NAMA and the APS – the Key Differences

| Scheme | Scheme Type | Asset Type | Management of the Assets | Institutions eligible for the scheme | Length of the Scheme | Money Invested |
|---|---|---|---|---|---|---|
| NAMA | Asset Purchase Scheme | Toxic Real Estate Assets | NAMA (the Irish government) | Any bank can participate in the scheme | 7-10 years | €90 billion |
| APS | Asset Insurance Scheme | A range of toxic assets | The Banks | All UK banks and their foreign subsidiaries | No fixed life-span | £282 billion |

[4] Browne, A., Greenshields, F., Roland-Billecart, M (October 2009) *NAMA: opportunities and challengers for borrowers*, Ernst & Young LLP

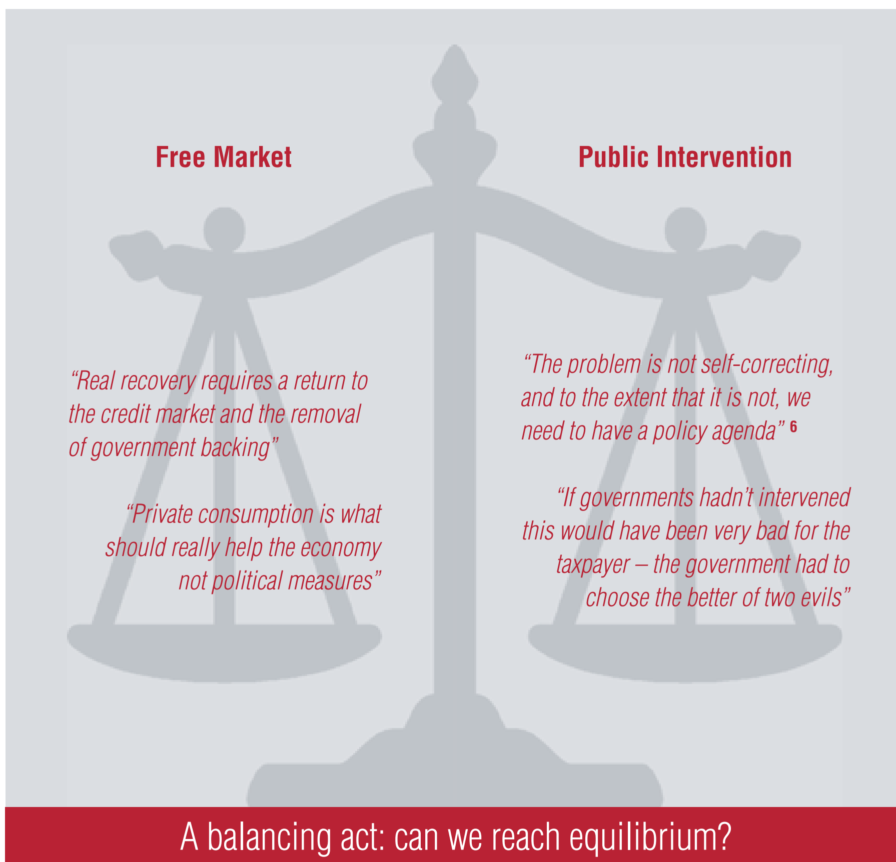
[5] Roland-Billecart, M et al (August 2009) *NAMA: Ireland's banking lifeline*, Ernst & Young LLP

## Recovery Outlook

Some investors are sceptical about the ability of NAMA to manage the assets it takes on. The scheme is sizeable for such a small country and there is a fear that the challenge of managing €77 billion worth of assets is too great for the Irish Government.

Overall, however, the scheme has received positive feedback and the focus is now on recovery – when it will be and what it will look like. One investor joked that recovery could be 'O' shaped; as we work through the irrational peaks and troughs of the market we will see a continuous cycle of recovery and collapse and the market will probably make the same mistake again but for a different reason. In order to reach equilibrium there must be a balance between government intervention and the free market; the question remains as to whether this can be achieved.

General opinion is that Ireland will start to recover when government intervention is reduced and there is a return of the credit markets. For Ireland, however, this discussion about the removal of government intervention has come before its major intervention scheme has even been implemented.




A balancing act: can we reach equilibrium?

*"NAMA's high public profile makes it difficult to find a good Manager - because they will always be in the public eye you need someone who is isolated from the political element that exists in Ireland"*

*"If the markets come back we will make a recovery. But, if the markets don't come back, then it's Armageddon"*

*"There is always risk in the market and there will always be a debate around government intervention vs the free market. Total control of either one is no good – it's about finding a balancing act."*

[6] Wolfgang Munchau (2009) *Financial Times Blog*, The Financial Times, www.ft.com

# Germany

Across the globe, countries have been hit by a reduction in exports and investment and Germany's economy is no different. However, with its large export-oriented manufacturing sector, heavy involvement in investment goods and therefore increased exposure to the global market, the financial crisis has been deeply felt in Germany. Germany's GDP fell by 5% in 2009, a greater reduction than all other European countries covered in this paper, with the exception of Ireland. As with other countries, unemployment has also risen.

While the real estate sector has also been affected by the crisis, the impact was delayed and less severe than the UK or Spain. This could be a result of a different approach by investors and the approach to market valuation employed in Germany. While most countries follow the open market valuation model (pricing property in relation to the current market conditions) Germany, on the other hand, typically subscribes to a sustainable valuation method (basing the price of property less by reference to current market evidence but more to a longer term analysis of value). Although Germany's valuation method can often lead to the under- and over-pricing of property, it does mean that the real estate sector in Germany tends to smooth away the highs and lows of the volatile market because property values remain at a more constant level.[1] As a result of this valuation process, property prices in Germany did not reflect distressed market conditions and it took longer for the financial crisis to impact on the German real estate sector.

This also explains why private consumption increased in Germany by 0.6% in 2009 despite a decrease in the majority of other European countries[2]; because the value of property remained relatively unchanged amidst the eruption of the financial crisis, consumer confidence also remained positive, and so private consumption continued as normal.

*"Germany is the birthplace of sustainable value concepts for lending valuations, and there is a suspicion that this mentality may lead to some smoothing of the peaks and troughs in market cycles"* [3]

*"The lower volume of transactions in Germany is a big concern because when assessing market improvement you want to see the big three European markets – UK, France, Germany - doing something and absolutely nothing is happening in Germany"*

## Government Intervention

In response to the global crisis, the German government established a separate body to fund and oversee the implementation of rescue schemes to stabilize the German financial system. Managed by former bankers, the 'Sonderfonds Finanzmarktstabilisierung' (SoFFin) was equipped with €480 billion which would provide support for financial institutions through recapitalisation and state guarantees. The Executive Board of SoFFin is comprised of government officials who ensure the correct operation and management of the intervention schemes.

### Recapitalisation

Of the €480 billion invested in securing the financial system, €70 billion (with an additional €10 billion in reserve) was made available for capital injections.[4] Since the scheme began in October 2008, €24.5 billion has been distributed to banks in Germany, strengthening their balance sheets and encouraging them to increase lending.[5] In return for this funding, SoFFin has taken an equity stake in the relevant banks.

[1] Crosby, N (July 2006) *Open-ended funds: liquidity and valuation issues,* Property Funds Intelligence, the Indirect Property Market, issue 01

[2] The European Commission (Autumn 2009) *European Economic Forecast,* Economic & Financial Affairs Directorate

[3] Crosby, N (July 2006) *Open-ended funds: liquidity and valuation issues,* Property Funds Intelligence, the Indirect Property Market, issue 01

[4] Mayor Brown (May 2009) *Summary of Government Interventions in Financial Markets: Germany*

[5] Shearman and Sterling LLP (2009) *Governmental Assistance to the Financial Sector: an Overview of Global Responses (v9),* Economic Stabilization Advisory Group: Client Publication

**State Guarantees**

The remaining €400 billion of SoFFin's rescue package was allocated to state guarantees. Through the scheme, SoFFin agreed to provide three year guarantees on short and medium term debt that was issued by financial institutions after October 2008 and before December 2009. The objective of this intervention was to promote inter-bank lending and aid the financial sector in overcoming the liquidity shortage. As a result, these guarantees are available to German credit institutions, insurance, pension funds, financial service providers, investment management companies and security and commodity exchanges. However, the guarantee scheme is not automatically a system-wide programme; each financial institution that applies for government assistance is considered on a case-by-case basis. Approximately twenty banks have applied for government guarantees since October 2008. The scheme ended in December 2009.

In return for both recapitalisation and state guarantees, banks were required to provide business plans detailing their transaction plans for the future, with a clear focus on actions for recovery. The plans were then independently approved by an accounting firm before the German government agrees to assist the banks through SoFFin funds.

> *"They way the government reacted to the crisis was seen as positive"*
>
> *"There are still a lot of ideas on what could be done and where the new problems will be… further changes will come – the industry needs to prepare"*

**Asset Purchase –'The Bad Bank scheme'**

In July 2009, the Gesetz zur Fortentwicklung de Finanzmarktstabilisierung (Act for the Further Development of the Financial Market Stabilisation) came into force. This Act introduced a 'bad bank' scheme that would allow banks to remove illiquid assets from their balance sheets by placing them into external units. By removing these illiquid assets, the risk associated with them is transferred away from the banks' balance sheets; without this risk, the idea is that banks will resume lending to the real economy. In addition, the 'Bad Bank Act' assists banks in reducing the size of their balance sheets, enabling them to meet European Union restructuring regulations.

The Special Purpose Vehicle model

Under the bad bank scheme, this model requires banks to set up a special purpose vehicle (SPV) into which structured securities can be transferred. The SPV will not operate as a banking business and therefore does not require a banking licence. Unlike the government guarantee scheme, this 'bad bank' model is not available to a wide variety of financial institutions. Eligible institutions include all German banks and German subsidiaries of foreign banks; but insurance companies, pension funds and investment companies are not eligible to participate in this scheme.

The eligible banks can transfer structured securities into the SPVs; these include asset backed securities, collateralised debt obligations, collateralised loan obligations, residential mortgage-backed securities and commercial mortgage-backed securities. These structured securities must have been acquired by the banks before December 2008 and can be transferred to the SPV at a value of 90% of the book value as of 30 June 2008, 90% of the book value as of 31 March 2009, or the actual economic value[6]. In exchange for these assets, the SPV issues the banks with debt securities, which replace the risk assets on the banks' balance sheet. In return for the removal of valuation risks, the banks are required to pay an annual fee; this is known as the balance payment and is the *"difference between the value for which the assets are transferred to the SPV and the so-called fundamental value, which is the expected real [current market] value of the transferred assets at maturity as set forth by an expert opinion"*[7]. In addition, the banks involved in the scheme must undergo stress tests but the results of these stress tests are not obliged to be published. Applications for the scheme closed on 22 January 2010.

*"The banking system that survived is now too big to save, not just too big to fail"* [10]

*"Legislation is working, the banks are working – put together the system for the future should survive"*

## Recovery Outlook

The assumption that the banks were too big to fail has been challenged by the credit crisis and, while the necessity of stabilizing the financial system was understood, banks' business models are now under long term scrutiny by the German government and the European Commission.

As with a number of other countries, The European Union has intervened in some of the German interventions, particularly the bailout of Commerzbank. Since November 2008, the German government has provided a total of €18.2 billion in capital injections to Commerzbank and now holds a 25% plus one share in the bank. Commerzbank has also received €15 billion in guarantees. While the European Commission agreed to this rescue package, it enforced some restructuring requirements of its own: Commerzbank must dispose of Eurohypo within the next five years[8]; reduce its balance sheets from €1,100 billion to €900 billion and, following the disposal of Eurohypo, €600 billion; divest its subsidiaries by the end of 2011; and not undertake any acquisitions for the next three years.[9]

Many German investors believe that this political scrutiny is what the industry needs; as bankers and politicians work together to find the solutions, they predict that the banking industry will need to prepare for further restructuring changes.

[6] Wolfers, B and Gleske, C.L (August 2009) *Briefing: German 'Bad Bank Act' in force*, Freshfields Bruckhaus Deringer

[7] Shearman and Sterling LLP ( 2009) *Government Assistance to the Financial Sector: an Overview of Global Responses (v9)*, Economic Stabilization Advisory Group: Client Publication

[8] Eurohypo is a leading international specialist bank for real estate and public finance. It is owned by Commerzbank. www.eurohypo.com

[9] Mayor Brown (May 2009) *Summary of Government Interventions in Financial Markets: Germany*

[10] Professor Willem Buiter, December 2009, *LSE Lecture: Global Economics Crisis*, London School of Economics

# Italy

Italy was not immediately affected by the global recession and even when the forces of this financial crisis were felt, the impact on the Italian economy was softer than elsewhere. This is largely because the Italian banks had less involvement in complex derivatives and were more strongly based in the local market.

"The government's policy response to the crisis was constrained by Italy's fragile finances, in particular its very high public debt" [1]

[1] The European Commission (Autumn 2009) *European Economic Forecast,* Economic & Financial Affairs Directorate

In reflection of the economy, the recession's impact on the Italian real estate industry has also been less severe than in other countries. In the residential market, prices have dropped more gradually and the decrease in value has been less significant, particularly in city centre or luxury housing, for which the value has hardly moved at all. In the commercial market there has been a considerable decrease in turnover and yields have decreased by 15%, but the market seems to have now stabilised at these levels.

While the effects of the global credit crisis have not been so acute in Italy, its economy had already slowed before the crisis intensified during 2008 as a result of a decrease in exports. This, combined with Italy's long-term, deep-seated structural problem of extremely high public debt, meant that the government could not spend its way out of the recession. Consequently, the Italian government has introduced a number of alternative interventions, but nothing as large or as detailed as the schemes employed by other countries.

**Recapitalisations**

With the initial intensification of the financial crisis, the Italian government perceived the risk of a run on the banks and so introduced a recapitalisation scheme. The scheme, approved by Italy's Finance Minister, Giulio Tremonti, in February 2009, was designed to strengthen banks capital reserves by underwriting so called 'Tremonti' bonds issued by the banks. The Italian government allocated €10 – 12 billion for this scheme and in return the banks agreed to continue lending to small and medium-sized businesses. Whilst the scheme was successful in preventing a run on the banking system during the initial panic, it ultimately acted as a psychological instrument because the majority of banks did not participate in the intervention. Instead they decided to strengthen their balance sheets by bond issues on the normal market and by increasing equity in the place of dividend payouts.

**'Piano Casa' – The Housing Plan**

This law was passed by the Italian Federal government in March 2009, and subsequently ratified by each region, allowing standalone and semi-detached home owners to increase the size of their property by 20%, *without* obtaining specific urban planning approvals. Many regions also allow both residential and non-residential buildings to be demolished and rebuilt with a size increase of 30-35%, on the condition that they are rebuilt in compliance with energy efficient standards.

*Source: ULI Awards for Excellence, Palazzo Tornabuoni, Italy, R.D.M Real Estate Development*

By encouraging these micro-developments, the government's objective was to restart the development market and to promote private investment in the housing industry, ensuring minimum impact on public debt. While it is too early to analyse the success of the scheme, objections have already been voiced by large construction companies who argue that this initiative will not benefit them because they are rarely contracted to carry out micro – developments.

A time-scale of two years means that home owners are using the scheme now and the effects of the government intervention should be seen soon.

**Tax Amnesty**

Many Italians have traditionally invested money in offshore assets as a method of avoiding the high taxes in Italy. It is estimated that €200 billion of Italian private money is currently held outside Italy. As a result of the recession, the Italian government has offered a tax amnesty and guaranteed anonymity to citizens who repatriate and legalize any undeclared offshore assets. In return, these citizens must pay a 5% indemnity on the amounts repatriated. There is no limit on the amount of repatriated offshore assets, but if the amount repatriated causes the citizen to enter a higher tax bracket in the following year, they will be required to pay higher tax. The objective is to increase liquidity and stimulate the Italian economy by investing these private offshore savings rather than public funding.

Italy is already witnessing successful results, with €90 billion of offshore money repatriated by the end of 2009. In light of this success, the Italian government has extended the amnesty period with a slightly higher indemnity. There are a number of economists and operators who predict that the tax amnesty will be significantly more successful than the government's initial estimate of €100 billion, perhaps even 50% - 100% more successful.

*"The vast amount of cash coming back into the country is bound to have a strong impact on the price of assets in Italy. Given the strong propensity for Italians to seek security in local real estate developments, it is not improbable that the real estate market in Italy will impact positively during 2010 and especially in 2011."*

## Recovery Outlook

While high public debt in Italy has been an ongoing structural weakness, there is, in fact, a very low amount of private debt in Italy.

### A comparison of private debt

| Country | Average family bank debt (Euro) |
|---|---|
| UK | 23,300 |
| Spain | 19,200 |
| Ireland | 32,800 |
| Italy | 8,000 |

*(Source: European Central Bank, July 2009)*

This has meant that private consumer spending has fallen less in Italy than other countries; while the state has struggled to fund rescue packages, Italian families have actually weathered the recession more comfortably than families elsewhere.

The European Commission expects debt to GDP ratio in Italy to rise by 14 points by 2011. This is significantly less than expected in the UK (+44 points), Spain (+38 points) and Ireland (+71 points)[2], indicating that although the situation will be worse in absolute terms for Italy, it will be better in relative terms. With its low private debt and the implementation of schemes which do not impact greatly on public debt, Italy's relative economic situation should remain similar to what it was before the crisis, despite its structural weaknesses.

*Source: Corti Nuove, Italy, DEA Real Estate Advisor*

[2] Developed by the Edison Foundation, a specialist think tank sponsored by many Italian industries and industrial associations, based on data from the European Commission (2009).

# The Netherlands

As one of the most open economies in Europe, the Netherlands has been highly exposed to the declining share prices around the world and therefore hard hit by the recession. In particular exports, which account for almost 80% of the Netherlands GDP, have been severely reduced by the rapid fall in world trade. Investments have also declined, largely due to the financial market becoming illiquid, but also because of a redemption request from institutional investors. While *"investors normally have deep pockets"*, the recession has reduced the amount of new capital, making it extremely difficult to acquire financing for forward acquisitions. This decrease in exports and investments has resulted in the Dutch economy contracting by 1% in the fourth quarter of 2008.

> *"People seem to understand that saving the banking system was the highest priority for the economy"*
>
> *"If the Dutch government didn't stimulate the housing sector, it would cost the taxpayer more in the future"*

The fourth quarter of 2008 also saw a drop in value in the real estate market. The fall in value from peak to trough for offices was 15%, retail was 5-8%, and residential was 5-8%. Within the residential sector, new houses have been hit harder than existing stock: before the recession, 40,000 new houses were being sold per year but this has shrunk by 50%. House prices have also fallen: while they averaged at €300,000 before the recession, the average is now €240,000. The cheaper new houses are still selling quite well, but sales of more expensive houses have almost reached a standstill.

## Government Intervention

In light of the heavy impact of the financial crisis on the Dutch economy, the government responded with a number of sizable interventions, demonstrated by the increase in national debt by nearly €100 billion between 2008 and 2009; €85 billion of which was related to government interventions.

### Housing Intervention

The Dutch government has allocated €350 million to stimulate the building of new houses. The money is assigned in phases to local governments who have responsibility for exactly how it is distributed among investors, developers and builders. A maximum of €10,000 is appointed for each new house that is built, on condition that the houses are built within a specified time period. If the houses are not built within this time period, the money must be returned to the government. The table below outlines the sum of money and the time period for each phase.

*Source: La Grand Cour, Amsterdam, Bouwfonds Ontwikkeling*

**Outline of the Housing Intervention Phases**

| Phase | Date Issued | Sum of Money (Euro) | Time Period |
|---|---|---|---|
| 1 | Already Issued | 100 million | Building must have commenced by 1st January 2010 |
| 2 | In the process of being issued | 150 million | Building must have commenced by 1st July 2010 |
| 3 | Still to be issued | 100 million | Undecided |

While this intervention helps, it is more of a symbolic act rather than a real investment strategy. The government estimates that it will lead to the building of 30-40,000 more houses. However, operators in the real estate industry believe it will only help to build approximately 10,000 new houses. This is because of the method by which new houses are developed and sold in the Netherlands: a new house is sold on its plan, which then provides developers with the money to build the house. Because the credit crisis has resulted in a reduced number of buyers, the government's offer of €10,000 is not enough for developers to start building. Builders and developers were disappointed with this intervention as they wanted a more proactive investment strategy.

*Source: Meerpad, Amsterdam, Bouwfonds Ontwikkeling*

The other schemes employed by the Dutch government have focused on ensuring the financial stability of the banks and have only had an indirect impact on the real estate industry.

**Nationalisation**

One of the first significant steps taken by the Dutch government to ensure financial stability in the Netherlands was to nationalise Fortis Bank[1], including Fortis shares in ABN AMRO. On 3 October 2008, all Fortis shares – all assets and liabilities – were acquired by the Dutch government for a total of €16.8bn, disconnecting all Dutch-based banking and insurance activities from Fortis in Belgium and Luxembourg. The government advocates that the acquisition of Fortis is a temporary measure and plans have been announced to return Fortis assets to private hands once the market conditions improve.

**Recapitalisation**

Following the nationalisation of Fortis, the Dutch government, in collaboration with the Dutch Central Bank, introduced a recapitalisation scheme worth €20 billion. Since it was introduced in October 2008, three banks have participated in the scheme: ING (€10 billion), AEGON (€3 billion) and SNS REAAL (€750 million).[2] In return for these capital injections, the banks must provide the Dutch government with securities and the government is entitled to nominate two representatives to the Supervisory Board of each bank. The objective of this capital injection is to prevent these fundamentally healthy banks from bankruptcy. So far, the scheme has been deemed successful.

**State Guarantees**

While the recapitalisation measures were employed to prevent the bankruptcy of financial institutions, the objective of the guarantee scheme is to actively encourage banks to start lending again, reintroducing liquidity into the market. The Dutch government has made available €200 billion to provide banks with guarantees on senior unsecured loans (loans without collateral). By offering this guarantee, the government is sharing the risk of the loan, giving banks the confidence to resume lending. The issuance of these guarantees closed at the end of 2009.

[1] Since May 2009, Fortis Bank has become part of BNP Paribas. BNP Paribas is the largest deposit bank in the European Economic Area. www.fortisbank.com

[2] Ministerie van Financiën (2009) *Informatieblad: National Financial Annual Report 2008*

| The following banks have received state guarantees in the Netherlands: |
| --- |
| Fortis |
| ING |
| Leaseplan |
| NIBC |
| SNS |

**Commercial Real Estate:**
In relation to commercial real estate, the Dutch government has agreed to guarantee 50% of any financing provided by banks to investors and developers. This intervention will make it easier for investors and developers to access financing for forward acquisitions and projects. The guarantees are available until the end of 2010.

**Residential Real Estate:**
As part of the state guarantee scheme, and in association with VROM (The Ministry of Housing, Spatial Planning and the Environment), the Dutch government has offered guarantees on mortgages up to €350,000. This intervention safeguards credit provision to private individuals, making mortgages for cheaper and middle income homes easier to obtain. The scheme will continue until 2011.

While the Dutch government has employed these substantial interventions, both investors and developers agree that the greatest incentive to the economy was the government's decision not to cut the normal budget and to maintain low interest rates. "It is this intervention that is giving liquidity to the market by making it possible for banks and clients to still be able to pay interest. This has probably had the biggest impact on the real estate sector – much more than the other interventions."

**Asset Insurance**
In January 2009, the Dutch government introduced an asset insurance scheme specifically for ING. This scheme, described as an 'Illiquid Asset Back-Up Facility', allows the government to take on 80% of the risk of a €27.7 billion portfolio of Alt-A mortgage securities at ING Direct USA and ING insurance Americas. While ING remains the legal owner of these securities, the Dutch government and ING will share the exposure of results on the portfolio at a ratio of 80:20. By assuming this risk, the government's aim is to improve the bank's liquidity; therefore, in return for this guarantee, ING has agreed to assign €25 billion in credit to individuals and organisations[3]. In addition, ING has suspended bonuses to the entire board of directors and any government nominated members of the ING Supervisory Board will have approval rights on certain executive appointments.

*"It is this intervention that is giving liquidity to the market by making it possible for banks and clients to still be able to pay interest. This has probably had the biggest impact on the real estate sector – much more than the other interventions."*

*"The new-normal will be back to normal"*

## Recovery Outlook

The European Commission oversees all local government interventions that are employed across Europe. As with other countries, the commission has decided to step in with an intervention of its own: the commission has forced ING to split its banking and insurance businesses, ordering it to sell the insurance part of the company within the next four years.

This forced split of ING is part of a wider plan by the European Commission to create a more fragmented market again. The aim is to break down large conglomerates so that if another crisis occurs in the future, it will be easier to manage. Investors in the Netherlands believe that the next few years are crucial for witnessing this type of action and, as we emerge from the recession, we will see a different banking environment to that we are used too.

[3] Shearman & Sterling LLP (2009) *Governmental Assistance to the Financial Sector: an Overview of Global Response (v9)*, Economic Stabilization Advisory Group: Client Publication

# France

Together with all European countries, real estate investors and operators in France have become more cautious due to the global financial crisis. Since 2007, commercial property prices have fallen by approximately 30%. The residential sector has not suffered as badly, with house prices dropping by 11.2%, and apartment prices by 8.4% from the first quarter 2008 to first quarter 2009.[1]

*"As long as the interest rates remain low there is little likelihood that an asset protection scheme will be employed"*

While the French economy has felt the effects of the financial crisis, in general, the impact has been less severe than in neighbouring European countries. This is partly due to domestic demand remaining resilient; in other countries private consumption has fallen dramatically, whereas French private consumption has slowed but remained positive with a 1.0% change in 2008 and 0.8% change in 2009.[2] In addition, the French economy has a smaller manufacturing sector and a lower degree of openness – in terms of export trade – therefore the impact from the external drop in demand has been softer compared with countries such as Germany and Italy.

## Government Intervention

During the previous economic crisis in the 1990s, the French government implemented an asset protection scheme for the bad loans on banks' balance sheets. However, while the government has acknowledged the effective use of this previous strategy, they currently have no plans to employ such a scheme. This means that although a variety of interventions have been introduced, none of them directly impact on the property industry.

### Recapitalisations

In October 2008, shortly after the collapse of Lehman Brothers, the French government announced the establishment of 'Société de prise de participation l'etat' (SPPE). This separate, government owned entity was set-up specifically to oversee the injection of capital into French banks. SPPE was equipped with a total of €10.5 billion[3] in order to support the short-term financing of banks, increasing their capacity to absorb further losses. This capital was issued in the form of common shares, preferred shares and subordinated debt to a total of six banks; these are listed below.

### A comparison of private debt

| Bank | Capital Issued (€) |
|---|---|
| Crédit Agricole | 3 billion |
| BNP Paribas | 2.25 billion |
| Société Générale | 1.7 billion |
| Crédeit Mutuel | 1.2 billion |
| Caisse d'épargne | 1.1 billion |
| Banque Populaire | 950 million |

*(Data Source: Mayor Brown (29th May 2009)Summary of Government Interventions in Financial Markets: France, Mayor Brown LLP)*

[1] CB Richard Ellis (2009) *France: Market View Residential*, www.cbre.co.uk/research

[2] The European Commission (Autumn 2009) *European Economic Forecast*, Economic Financial Affairs Directorate

[3] Mayer Brown (May 2009) *Summary of Government Interventions in Financial Markets: France*

In return for this government support, these banks had to provide subordinated debt securities without voting rights. In January 2009, a second amount of recapitalisation was approved, bringing the total capital injection by SPPE to €21.5 billion. Within this second tranche of recapitalisation, BNP Paribas was granted an additional amount of €5.1 billion, giving the French government 17% of the share capital, therefore making it the primary shareholder in BNP Paribas.[4]

**Government Guarantees**

In addition to setting up the SPPE, the French government also established the 'Société de financement de l'économie' (SFEF), a specialised company with the purpose of guaranteeing bank debts. The SFEF is jointly owned by the government and seven banks (the six banks which received capital injections and HSBC). The government objective is to remain a minority shareholder in the company, therefore two thirds of the SFEF's equity will be held by the seven banks. A total of €265 billion in funds raised by the SFEF can be loaned to banks in return for eligible collateral. Unlike recapitalisations, government guarantees aim to support banks' medium-term financing, therefore, the guarantees are available for a maximum duration of five years.

*"Somebody has to pick up the bill"*

*"The government interventions do not have a direct impact on the property industry"*

## Recovery Outlook

In general, there has been a positive reaction from the public to the French interventions. While the majority of the money invested in these interventions is the taxpayer's, as of yet, there has been no increase in tax rates. The French government is borrowing money to fund the banking interventions, and this will ultimately lead to tax increases, but this was deemed a necessary action in order to save the banking system and the public are generally accepting of this.

It is clear from the interventions employed by the French government that the property industry is not a high priority. The government has agreed to support the refinancing of banks, on the condition that banks use this support in a responsible way; lending to the corporate sector to ensure the prevention of a financial crisis there, rather than the real estate sector. With the majority of property currently still well leased, interest rates remaining low and continued financing in place, the French government is not anticipating a real estate crisis; therefore no funding has been assigned to the sector. While many commentators agree that there is no imminent real estate crisis in France, they suggest that there is a possibility of one between 2010 and 2014 and their concern is that the government will not be prepared.

[4] Shearman and Sterling LLP (2009) *Governmental Assistance to the Financial Sector: an Overview of Global Responses (v9),* Economic Stabilization Advisory Group: Client Publication

# Spain

## Spain's economy has suffered significantly from the global financial crisis. In 2009, GDP fell by 3.7%, private consumption also dropped by 5.2% and unemployment rose dramatically by 17.9%.[1]

In addition to experiencing the effects of this financial crisis, Spain has also experienced a severe real estate crisis. After a decade-long construction boom, the intensification of the credit crisis caused the Spanish property market to collapse; home sales fell by nearly 50% year-on-year in April 2009 and are predicted to fall a further 10% this year (2009) and 12% next year; there are currently more than a million new homes that remain unsold.[2] New home starts have also fallen rapidly with 100,000 in 2009, compared with 700,000 in the final years of the boom.[3] Originally manifested in the residential property market, the real estate crisis quickly spread to the commercial sector and it became clear that no operator within the industry was safe.

However, unlike other European countries, Spain's banks have remained relatively stable. This is largely due to the prudent risk policy employed by the Bank of Spain over the last nine years. In 2000, the Spanish government introduced a 'counter-cyclical' provisioning policy that required banks to set aside reserves for any hypothetical losses on loans in the future. While many banks initially resisted this regulation, they can now draw on these resources to help them weather the financial crisis more successfully. Santander, Spain's largest bank, is a good example of the success of this strategy. Santander had set aside €6 billion in provisions and, as a result, it has come out of the crisis "clearly strengthened".[4]

*"While many real estate players believed only the residential property companies would be affected, the reality is that the whole of the real estate sector has severely suffered"*

*"Spanish banks have been among the most robust and profitable in the world since the financial crisis began"[5]*

*"If Spain didn't have this provision system it would make Greece look like a party"[6]*

### Government Intervention

Although the Spanish banks entered the financial crisis in better shape, the impact of the property crash has not gone unnoticed. This 'crisis within a crisis' is having the greatest bearing on the Spanish saving banks – known as cajas. Cajas are unlisted savings and loans institutions, owned by local governments, whose profits are invested in social programs. Because they are entirely domestic focused, the cajas are heavily over-exposed to the property market and have therefore been the hardest hit by the real estate crisis. It is estimated that 70% of the cajas combined €900 billion loan portfolio is in real estate and, as a result, much of the Spanish government intervention has focused on supporting these smaller savings banks whose provisioning cushion could not withstand the property collapse.

#### The Financial Assets Acquisition Fund (FAAF)

In October 2008, the Spanish government passed a law for the establishment of the Financial Assets Acquisition Fund (FAAF). The fund acts as an asset purchase scheme and was equipped with €50 billion, with the aim of increasing banks access to funding and, therefore, stimulating banks lending to non-financial entities, companies and households. However, FAAF is different from the asset purchase schemes employed by Ireland and Germany; while these schemes acquire toxic assets from the banks' balance sheets, FAAF only acquires high quality assets. For this reason, FAAF is not a bailout plan; it is not rescuing banks and relieving them of their impaired assets, rather, it is simply stimulating liquidity in the capital market by providing medium-term credit to the banks through the purchase of top quality assets. These assets will then be traded on regulated markets.[7]

[1] The European Commission (Autumn 2009) *European Economic Forecast,* Economic & Financial Affairs Directorate

[2] Guerrero, A (September 2009) *A Tough Road Ahead: Spain's bank and savings institutions are still reeling from the collapse of the country's housing market,* Global Finance Magazine, www.gfmag.com/archives

[3] Mallet, V (March 29th, 2009) *Spain's lenders see salvation in mergers,* The Financial Times

[4] Banco Santander, S.A is a bank holding company. Santander operates principally in Spain, the United Kingdom, Portugal, other European countries, Latin America and the United States, offering a range of financial products. The Financial Times business profile, www.ft.com/marketdata.

[5] Mallet, V (March 29th, 2009) *Spain's lenders see salvation in mergers,* The Financial Times

[6] Paris Panel Session. Explanation: The deepening crisis in Greece has led to concerns about the demise of the Euro. The financial situation of Portugal, Ireland, Italy, Greece and Spain (known as the PIIGS), has this year caused the Davos group to spend a session "Rethinking the Eurozone". However, it seems unlikely that the Euro will be broken up. (Elliot, L, January 2010, Greek Crisis Show Euro is Too Big to Fail, www.theguardian.co.uk

[7] www.fondoaff.es (January 2010)

> "The Bank of Spain has played a big role in assisting the government to establish different measures"

> "The main idea is that the FROB will promote a new era for the savings banks"

The assets are purchased in both outright and repurchase orders through auctions. The aim of the auction is to encourage some competitiveness among the banks for the FAAF funds and to reinforce that FAAF is not offering a rescue package. To ensure that toxic assets are excluded from the possible assets purchased by the fund, banks are only allowed to auction assets that have been issued after 1 August 2007 for repurchase orders and after 15th October 2008 for outright orders. The two types of purchase order – outright and repurchase – represent the different transactions that FAAF can enter into. The first is a full transaction in which FAAF acquires assets from the participating institutions. The second is a purchase transaction in which the bank auctioning its assets agrees to re-purchase them at a set price, after a specified length of time. The FAAF held auctions until 31 December 2009, at which all Spanish Banks and Spanish branches of foreign credit institutions could apply for fund support.[8]

**Fund for Orderly Bank Restructuring (FROB)**

With a focus on supporting the smaller savings banks, the Spanish government introduced the Fund for Orderly Bank Restructuring (FROB). Managed by a Governing Committee appointed by the Minister for the Economy and Treasury, the FROB has two functions: firstly, to oversee the restructuring process of the savings banks; and secondly, to support and enhance their equity.[9] In contrast to other European restructuring processes, the Spanish scheme is not enforcing downsizing requirements, rather, its aim is to consolidate some of the smaller savings banks into larger entities through mergers or takeovers. This is because Spain is suffering from the opposite problem; while in other countries the financial crisis has affected the larger banks, in Spain it is the smaller banks which have suffered. The banks in Spain were not too big to fail; rather they were too small to survive.

The FROB has been equipped with €9,000million equity, of which 2,250 will be contributed by the Deposit Guarantee Funds and 6,750 will be charged to the state budget.[10] With leverage FROB can be expanded to €90billion. This capital will be used to support the savings banks mergers and to reinforce banks' equity. However, in the future, these saving banks must return the FROB capital. In addition to providing financial support, the FROB can also introduce management measures by replacing the Directors of an institution with representatives from the Bank of Spain.

[8] www.fondoaff.es (January 2010)
[9] www.frob.es (January 2010)
[10] www.frob.es (January 2010)

Before entering into any FROB managed merger, takeover, or transfer of business, the banks are encouraged to look for private agreements and solutions to their insolvency. So far, these private agreements have been successful as no bank has yet taken up government support through the FROB.

**Government Guarantees**

In December 2008, the European Commission approved the Spanish government's decision to allocate €100 billion for the guarantee of new debt issuance by Spanish Banks in the European market. The scheme was made available to all banks resident in Spain since 13th October 2008, and to subsidiaries of foreign entities so long as they had substantial operations in Spain.[11] The scheme's objective was to encourage new funding operations, therefore increasing lending in the market. To continue this encouragement, the Spanish government pumped an additional €100 billion into the guarantee scheme in 2009. In return for any government guarantee, the participating bank had to pay a fee, dependent on the type of secured obligation. The scheme closed on 31st December 2009.

*"Public intervention has caused high public deficit which will negatively affect private consumption causing the market to suffer."*

## Recovery Outlook

Overall, the Spanish public accept that government intervention was necessary and are appreciative that, as a result, Spain can now weather the credit crisis more smoothly. However, there are concerns about the long term impact of government intervention. Feelings shared by developers, investors, and a majority of the public, advocate that it is private consumption that will support long term economic recovery, not political measures. The fear is that the extremely high public deficit due to government intervention will negatively affect private consumption, stunting Spain's economic recovery in the long term; VAT and Savings Tax are expected to increase by 2-3%, resulting in reduced consumer spending, causing the market to suffer. In light of this, investors are predicting that it will be difficult to reach previous levels again in the future; "the new normal will be a low pace of recovery".

[11] Mayor Brown (May 2009) *Summary of Government Interventions in Financial Markets: Spain*

# United States of America

Initially manifested in U.S. subprime mortgages, the impact from the credit crisis hit the US economy faster than any other country. While the crisis only became global after the collapse of Lehman Brothers in 2008, American was feeling the effects from early 2007. The US government responded to the crisis incredibly swiftly, flooding the system with money and employing a vast number and range of interventions. The table below outlines a selection of these schemes, particularly the ones that relate to the real estate industry.

**Summary of a selection of US government interventions**

Special Central Bank Assistance Measures

**Public-Private Investment Program (PPIP)** On March 23, 2009, the Treasury announced a two- pronged program that is intended to deal with troubled assets on financial institution balance sheets. Treasury, in conjunction with the FDIC and the Federal Reserve, has established the PPIP, the purpose of which is to purchase the troubled assets owned by financial institutions through a combination of private and public capital, utilizing private- sector expertise and the resources of the U.S. Government. The PPIP has two parts, addressing both the legacy loans ("Legacy Loans Program") and legacy securities ("Legacy Securities Program") clogging the balance sheets of financial firms. The Legacy Securities Program consists of two related parts: (1) debt financing from the Federal Reserve under the TALF (described below) and (2) matching private capital raised for dedicated funds targeting legacy securities. It is intended to facilitate the creation of Public-Private Investment Funds("PPIFs"), which are investment funds that will invest in legacy securities. They will be managed by qualifying private sector asset managers ("Fund Managers"). The Legacy Loans Program is intended to facilitate the creation of PPIFs that will purchase pools of legacy loans. Unlike Legacy Securities PPIFs, Legacy Loan PPIFs will be formed at the time that a selling institution successfully sells a pool of loans to bidders. Treasury intends to provide approximately 50% of the equity capital in each loan PPIF, with the other 50% coming from private investors. Private investors will manage the pools of assets, with oversight from the FDIC. The loan PPIF will be financed through the issuance of second non-recourse debt guaranteed by the FDIC and collateralized by the assets purchased by the PPIF. The Legacy Loans program has been indefinitely postponed because the FDIC could not persuade enough banks to sell off their bad assets.[1]

**Term Asset-Backed Securities Loan Facility ("TALF")** Under TALF announced on November 25, 2008 the Federal Reserve Bank of New York ("FRBNY") will lend up to US$ 200 billion on a non- recourse basis to holders of certain AAA-rated Asset-Backed Securities ("ABS") backed by newly and recently originated consumer and small business loans. The FRBNY will lend an amount equal to the market value of the ABS less a haircut and will be secured at all times by the ABS. The U.S. Treasury Department—under the Troubled Assets Relief Program ("TARP") of the Emergency Economic Stabilization Act of 2008—will provide US$20 billion of credit protection to the FRBNY in connection with the TALF.12 Under TALF, the definition of "eligible borrower" has been modified to permit participation by the following entities regardless of whether they are “controlled by a foriegn government": (i) U.S. branches and agencies of international banks that maintain reserves with the Federal Reserve and (ii) U.S. FDIC-insured depository institutions. Under TALF, the FRBNY will lend up to US$200 billion to eligible owners of certain AAA- rated ABS backed by newly and recently originated auto loans, credit card loans, student loans, and SBA-guaranteed small business loans. Issuers and investors in the private sector are expected to begin arranging and marketing new securitizations of recently generated loans, and subscriptions for funding will occur on the first Tuesday of every month through December 2009 or longer if the Federal Reserve chooses to extend the facility. TALF loans against newly issued asset-backed securities has been extended to March 31, 2010 and to June 30, 2010 for newly issued CMBS.[2] Each following week, the new securitizations will be funded by TALF, creating new lending capacity for additional future loans

[1] Andrew, E (June 4th, 2009) *Plan to help banks clear their books is halted,* New York Times

[2] Federal Reserve System (August 17th, 2009) *Press Release*

## Recapitalisation Measures

On October 14, 2008, the U.S. Congress announced **The Troubled Assets Relief Program** ("TARP") Capital Purchase Program providing for direct equity investments in certain financial institutions under the Economic Emergency Stabilization Act ("EESA"). The EESA authorized the U.S. Treasury to use US$250 billion without further action. Another US$100 billion can be obtained upon the President notifying Congress. Finally, the remaining US$350 billion of the total US$700 billion can be obtained by giving notice to Congress, who then have 30 days to deny funding if they wish. The EESA has two definitions of "troubled assets", one being mortgage-related assets and the other being assets on which the Treasury believes it should spend money. It is the second definition that Treasury is using to buy stock in banks, and it has chosen to spend US$250 billion on bank securities; the first US$125 billion of which went to nine banks.13 As of December 10, 2009, the total TARP investment in banks was US$245 billion[3]. The recapitalization scheme is in the form of non-voting preferred shares that are redeemable by the issuing bank after three years. The preferred shares pay an annual dividend of 5% during the first five years and step-up to 9%. Warrants were issued to the Government based on 15% of the face value of preferred shares on issue with this halved if the preference shares are redeemed prior to the December 31, 2009. As of December 23, 2009 TARP repayments totaled approximately US$164 billion.[4]

## Other Assistance to the inter-bank market or to other money markets

**Mortgage-Backed Securities Purchase Program** The U.S. Federal Reserve will be authorized to purchase up to US$1.25 trillion of distressed mortgage-backed securities and other assets and then resell the mortgages to investors under the EESA. On November 12, 2008 the Treasury Secretary, Henry Paulson, stated "Over these past weeks we have continued to examinethe relative benefits of purchasing illiquid mortgage- related assets. Our assessment at this time is that this is not the most effective way to use TARP funds, but we will continue to examine whether targeted forms of asset purchase can play a useful role, relative to other potential uses of TARP resources, in helping to strengthen our financial system and support lending. But other strategies I will outline will help to alleviate the pressure of illiquid assets." As of November 27, 2009, total mortgage-backed securities purchases exceeded US$1 trillion.[5]

*(Source: Shearman and Sterling LLP (2009) Governmental Assistance to the Financial Sector: an Overview of Global Responses (v9), Economic Stabilization Advisory Group: Client Publication)*

## Recovery Outlook

The United States still faces a great deal of uncertainty as it emerges from the recession, making the "new normal" difficult to predict. From a microeconomic level, banks will certainly impose more restrictive commercial real estate lending standards on new loan originations going forward. These more restrictive standards will include lower leverage ratios, more simple debt structures with fewer multi-tiered financings and smaller lending syndicates. However, before confidence is fully restored to the real estate finance market, the greater uncertainties at the macroeconomic level still need to be addressed. Since the economic collapse, the U.S. government has continued to purchase U.S. treasuries in an effort to keep interest rates low, while at the same time pumping capital into struggling banks to prop up balance sheets. Lenders in the real estate market have taken advantage of the U.S. government's two-fold approach by extending non-performing loans and avoiding the undesirable prospect of writing down bad debt. However, as the U.S. enters 2010, the government's economic intervention programmes are scheduled to wind down and the U.S. Federal Reserve will be under pressure to allow interest rates to rise in order to combat inevitable inflation. Such a change in circumstances begs the question of whether the other shoe is still to drop and whether a second crash in the commercial real estate market is inevitable. Whether this perfect storm will in fact play out cannot be predicted and much depends on the course of policy makers in Washington. The answers to these questions will help to mould what the "new normal" will be for the United States when it finally turns the corner in the economic crisis.[6]

[3] Geither, T (December 2009) *Written Testimony before the Congressional Oversight Panel,* United States Department of the Treasury

[4] Crutsinger, M (December 23rd, 2009) *Citigroup's return of TARP money removes pay caps,* Daily Finance

[5] Federal Reserve System (July 2009) *Monthly report on Credit and Liquidity Programs and the Balance Sheet,* Board of the Governors of the Federal Reserve System.

[6] From a conversation with Clare Breeze, Partner, and Francis P Lively, Associate, Shearman & Sterling LLP (20 January 2010).

# Japan

**Summary of the Japanese government interventions**

### Guarantees of Bank Debt

The Government has relaxed regulations on companies buying up their own shares

### Special Central Bank Assistance Measures

On 19 December 2008, the BoJ decided to introduce outright purchases of commercial paper issued by companies to raise short-term funds.

### Recapitalization Measures

Japan, China, South Korea and other Asian countries are working to form an $80 billion reserve-pool scheme from mid- 2009 to boost liquidity in the region.

### Other Measures

On December 12, 2008, the Japanese Government announced an economic stimulus package valued at 23 trillion yen, which includes 10 trillion yen in Government spending and 13 trillion yen to stabilize the financial system (including 10 billion yen to recapitalize banks and 2 trillion yen to purchase commercial paper through the Development Bank of Japan). This brings the Japanese Government's total economic stimulus package announced to date to around 44 trillion yen. On 19 December 2008, the BoJ decided to increase its outright purchase of JGBs from 14.4 trillion yen per year to 16.8 trillion yen per year, effective immediately. The BoJ also decided to expand the range of JGBs accepted in outright purchase and to introduce purchases from specific maturity segments. On 18 March 2009, the BoJ announced that it would increase the amount of outright purchases of Japanese government bonds from 16.8 trillion yen per year to 21.6 trillion yen per year. On 19 December 2008, the BoJ also decided the terms and conditions of the new operation utilizing corporate debt, of which introduction had been decided at the Monetary Policy Meeting held on December 2, 2008. On 19 December 2008, the BoJ decided to include the Development Bank of Japan Inc. as a counterparty in operations such as commercial paper repo operations. On 22 January 2009, the BoJ decided to purchase up to 3 trillion yen of commercial paper and asset-backed commercial paper rated a-1 or higher and with the residual maturity up to 3 months, with certain restrictions. On February 3, 2009, the BoJ announced that it will resume the purchase of stocks held by financial institutions so that the financial institutions may offload some of their stocks and reduce market risks. The total purchase amount is for 1 trillion yen. The BoJ has also decided to purchase up to 1 trillion yen of corporate bonds rated single A or higher and have a remaining term of one year or less from the last date of the month in which the Bank of Japan will make such a purchase. The limit per issuer of the corporate bonds is 50 billion yen. On 22 April 2009, the Diet enacted the Industrial Revitalization Law which will enable the government-backed Japan Finance Corporation to guarantee investments by designated financial institutions such as the Development Bank of Japan. The guarantee will be limited to investments in companies that have announced a plan to improve profitability within three years. Among other requirements, eligible companies must also have at least 5,000 employees in Japan and, between October 2008 and September 2009, revenue must have decreased by at least 20% on a quarterly basis or at 15% on a semi-annual basis compared to the same periods of the previous year. The guarantee will be from 50% to 80% of investments. Elpida Memory, Inc. will be the first company to benefit from the Industrial Revitalization Law. The Japanese government decided on June 22, 2009 to guarantee 80% of the loans from the Development Bank of Japan to Japan Airlines. The loan from the Development Bank of Japan is expected to be 60 to 80 billion yen.

*(Source: Shearman and Sterling LLP (2009) Governmental Assistance to the Financial Sector: an Overview of Global Responses (v9), Economic Stabilization Advisory Group: Client Publication)*

As with other countries across the globe, lending in Japan came to a standstill when the financial crisis intensified. Loans breaching covenants became an issue as cash flow suffered from rent reduction and consolidation by tenants. However, while funds and new real estate firms have suffered, Japanese established companies with longer investment horizons are playing the group card in an attempt to hold on until times get better. "Some have swooped in to buy assets that will not come on the market for a long time, such as the AIG building. Generally, however, trades are few. The Mega Banks are strong enough to roll their senior loans at maturity while securitized properties will gradually find a market. So, Japan will muddle its way through the downturn, waiting for the U.S to turn around." [1]

[1] Mike King, Principal, King Enterprise LLC, Japan, (17th February 2010)

# Glossary

**Asset purchase/ insurance:** Governments take on part or all of the risk of a portfolio of illiquid assets by purchasing or insuring the assets.

**Common Shares:** Securities representing equity ownership in a corporation, providing voting rights, and entitling the holder to a share of the company's success through dividends and/or capital appreciation. In the event of liquidation, common shareholders have rights to a company's assets only after bondholders, other debt holders, and preferred shareholders have been satisfied.

**Debt Guarantee:** Formal guarantees provided by governments against default on bank debt.

**Deleverage:** A process undertaken by a company in an attempt to reduce its financial leverage. This involves decreasing the amount of debt that is has by paying it off

**Leverage:** The degree to which an investor or business is utilising borrowed money

**Liquidation:** To sell all of a company's assets, pay outstanding debts, and distribute the remainder to shareholders, and then go out of business.

**Liquidity:** The ability of an asset to be converted into cash quickly without any price discount

**Preferred Shares:** Capital stock which provides a specific/ fixed dividend that is paid before any dividends are paid to common stock holders, and which takes precedence over common stock in the event of liquidation. The main benefit of owning preferred shares is that the investor has a greater claim on the company's assets than common stockholders. Preferred share always receive their dividends first and, in the event of a company going bankrupt, preferred shareholders are paid off before common shareholders.

**Recapitalisation:** The injection of cash into financial institutions in return for common shares, preferred shares, warrants, subordinated debt, mandatory convertible notes or silent participations.

**Solvent:** The ability to pay all debt obligations as they become due.

**Voting Rights:** The right of a common stock shareholder to vote, in person or by proxy, for members of the board of directors and other matters of corporate policy.

# Contributors

ULI Europe is extremely grateful to the many expert contributors who agreed to be interviewed and/or reviewed the text for this paper, including those who did not wish to be named.

| | |
|---|---|
| Andrea Amadesi | Managing Director, AEW Europe S.p.A |
| Mark Batten | Partner, PricewaterhouseCoopers |
| Andrew Baum | Professor of Land Management, Henley Business School, University of Reading, Academic Fellow, the Urban Land Institute |
| Stephen Blank | Senior Fellow, Finance, the Urban Land Institute |
| Clare Breeze | Partner, Shearman & Sterling LLP |
| Greg Clark | Senior Fellow, ULI Europe/India |
| Hans Copier | Managing Director, ING Real Estate Investment Management |
| Ivo de Wit | Global Portfolio Manager, ING Real Estate Select |
| Philip Feder | Registered Foreign Lawyer, Paul Hastings |
| Rosemary Feenan | International Director Global Research, Jones Lang LaSalle |
| Brian Field | Urban Planning & Development Advisor, European Investment Bank |
| Jan Fokkema | Director, NEPROM |
| John Forbes | Partner, EMEA Real Estate Industry Leader, PricewaterhouseCoopers |
| Gerard Groener | CEO, Corio N.V. Chair, ULI Netherlands |
| Thomas Höller | Managing Director, Pramerica Real Estate Investors Europe |
| Robin Kaplan | Retail Real Estate Consulting, Western and Central Europe |
| Anne Kavanagh | Managing Director, Lazard & Co |
| Mike King | Principal, King Enterprise LLC |
| Bernd Knobloch | Director, Palatium Investment Management |
| Massy Larizadeh | Head of Investor Relations, Cushman and Wakefield Investors |
| Richard Lewney | Managing Director, Cambridge Econometrics |
| Joaquin Linares Garcia de Cossio | Head of Research, ING Real Estate Southern Europe S.L.U |
| Francis P Lively | Associate, Shearman & Sterling LLP |
| Elizabeth Malloy | Assistant Director, Real Estate Finance, Ernst & Young LLP |
| Santiago Mercadé | Chief Executive Officer, Layetana Developments |
| Alexandra Notay | Vice President, Strategic Programmes, ULI |
| Mike Owen | President, Tanspacific, Executive Director, ULI Japan |
| Reinier Pollman | Head of Strategy , Policy and International Affairs, AFM |
| Montse Rius | Senior Analyst, Corporate Finance, Grupo Financiero Riva y Garcia |
| Mathieu Roland-Billecart | Real Estate Finance, Ernst & Young LLP |
| Amanda Rowland | Partner, PricewaterhouseCoopers |
| Erik Sonden | Chair, ULI France |
| Craig Stafford | Partner, PricewaterhouseCoopers |
| Arina Straver | PA to Gerard Groener, Corio |
| Pere Viñolas | Chief Executive Officer, Inmobiliaria Colonial S.A. |

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President, ULI EMEA, **William P. Kistler**

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SHEARMAN & STERLING LLP

**Urban Land Institute**
29 Gloucester Place
London
W1U 8HX
United Kingdom

Designed and Produced by:
AD Design
Tel: 01787 237662
Email: amanda@ad-design.demon.co.uk

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