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Sovereign Debt Crisis Causes Germany to Revive and Amend its Phased-Out State Aid Legislation for Financial Institutions

I. Introduction

On **December 14, 2011** the German Federal Government passed its 'Draft Second Act for the Purpose of Implementing a Package of Measures for the Stabilization of the Financial Market' (*Entwurf eines Zweiten Gesetzes zur Umsetzung eines Maßnahmenpakets zur Stabilisierung des Finanzmarktes – Zweites Finanzmarktstabilisierungsgesetz – 2. FMStG)* ("Draft Legislation"). The Draft Legislation will require parliamentary approval from the *Bundestag* and *Bundesrat* and is expected to take effect (possibly with certain amendments) in the first quarter (earliest February) of 2012. The Draft Legislation constitutes an amended revival of legislation that was originally enacted in October 2008 in reaction to the 'subprime'-related financial crisis. The original aid package phased out (after amendments in 2009) on December 31, 2010. It is now planned to be revived and strengthened in the face of the implications of the sovereign debt crisis.

Under the regime of the revived legislation, enterprises of the (German) financial sector[1] will until December 31, 2012 again be granted access to a comprehensive package of liquidity and capital support measures with a revolving aggregate volume of EUR 400 billion for liquidity guarantee measures and EUR 80 billion credit authorization for expenses and measures under the legislation (*e.g.*, for acquisitions of shares; recapitalizations; assumption of risk positions, loss compensation measures/obligations). In addition, the Federal Financial Services Supervisory Authority (BaFin) will be granted an additional set of instruments relating to the regulatory capital situation of financial institutions. Guarantees and capital support extended under the 'old' program will count against the newly authorized amounts. As a state aid measure, the legislation will require the approval of the EU Commission.

[1] The term "enterprise of the financial sector" is a literal translation of the term "*Unternehmen des Finanzsektors*" as used in the legislation.

II. The Background of the Draft Legislation

1. The Subprime Crisis of 2008 and the First German Aid Package

When the U.S. subprime crisis evolved into a worldwide financial crisis in autumn 2008, financial institutions were suddenly confronted with dramatic liquidity and solvency issues. In mid-September 2008, these dramatic developments culminated in the collapse of Lehman Brothers and the ensuing breakdown of the interbank lending market. Financial markets and financial institutions all over the world, including in Germany, found themselves standing on the verge of an abyss that threatened the very existence of the entire financial system and ultimately the livelihood of hundreds of millions of people.

On **October 12, 2008**, the state and government heads of the Eurozone member states agreed upon the injection of (Tier 1) capital and the granting of government guarantees in order to stabilize the situation. On **October 13, 2008**, the German Federal Government presented a package of stabilization measures in reaction to the European and internationally coordinated approach. The Financial Market Stabilization Act (*Finanzmarktstabilisierungsgesetz- FMStG*) was rushed through the required parliamentary approval process and came into effect on **October 18, 2008**. After amendments in **2009** (which, *inter alia*, introduced “bad bank” elements), the original support package phased-out on **December 31, 2010** (except for a “grandfathering” of certain measures that are related to previous support measures).

2. The Sovereign Debt Crisis and the Evolution of the Second German Aid Package

The hope that financial institutions would soon recuperate from the impact of the subprime crisis and that financial stability could be sustainably re-established ultimately was jeopardized with the onset and worsening of the sovereign debt crisis as from late 2009. A first wave of downgrading of government debt of a number of European states in 2009 developed into a severe crisis in 2010 when Greece, Ireland, and Portugal virtually lost access to the financial markets as a result of doubts regarding their credit worthiness and as further states faced or were threatened with downgrading of their government bonds. In response to the sovereign debt crises, Eurozone leaders agreed upon several rescue packages with a view to ensuring liquidity access for affected states and restoring their access to the financial markets for refinancing purposes (including notably the creation and enlargement of the European Financial Stability Facility (EFSF) in 2010/2011).

The sovereign debt crisis also threatens the viability of financial institutions and the stability of the financial system. In the wake of the subprime crisis, government bonds had seemed to be zero risk or low-risk investments, the accumulation of which was actively incentivized under banking laws that exempted government bonds from regulatory capital requirements otherwise applicable to risk weighted assets held in relation to other debtors. These seemingly no-risk assets have now, in the face of the sovereign debt crisis, developed into unpredictable time bombs on the balance sheets of financial institutions. On the one hand, financial institutions need to cover losses sustained as a result of the downgrading of sovereign debt. On the other hand, like in the financial crisis of 2008, liquidity access has again become an issue for many financial institutions as a result of the widespread loss of trust amongst market participants.

In response to the dangers entailed by the current situation, the European Council resolved on **October 26, 2011** on a coordinated approach aimed at restoring confidence in, and at strengthening prudential control of, the EU banking sector and addressing the need for a temporary capital buffer as required by the European Banking Authority (EBA). This consensus also calls for a coordinated approach with respect to funding requirements of banks in order to limit deleveraging actions.

On **December 8, 2011,** the EBA published a formal Recommendation and final figures related to banks' recapitalization needs. The formal Recommendation recommends that national supervisory authorities should require the relevant banks included in a sample to build a temporary capital buffer such that the Core Tier 1 capital ratio shall reach the level of 9 percent by the end of June 2012. According to the final figures published by the EBA with respect to the capital needs of the sample banks, several banks in Germany (and the rest of Europe) will be required to meet more stringent capital adequacy requirements by the end of June 2012, among them Deutsche Bank AG (EUR 3.239 billion), Commerzbank AG (EUR 5.305 billion), Norddeutsche Landesbank-GZ (EUR 2.489 billion), and Landesbank Hessen-Thüringen-GZ (EUR 1.497 billion). By January 2012, banks shall submit plans for achieving the target capital level to their national supervisory authorities.

III. The Draft Legislation and the Re-Established German Financial Market Stabilization Program

1. Term, Volume, Legislative Framework, and Context

The Draft Legislation forms part of the coordinated approach resolved upon by the European Council. It revives the phased-out financial market stabilization legislation with the pertinent instruments becoming available until **December 31, 2012**. The Draft Legislation re-establishes a guarantee volume of EUR 400 billion and a credit authorization volume of EUR 80 billion,[2] which is meant as a strong signal of the government's resolve to ensure financial market stability. The Draft Legislation affects various areas of law, including in particular:

- The Act Regarding the Establishment of a Financial Market Stabilization Fund (*Gesetz zur Errichtung eines Finanzmarktstabilisierungsfonds – **FMStFG***)
- The Act Regarding the Acceleration and Simplification of the Acquisition of Shares as well as Risk Positions of Enterprises of the Financial Sector by the Financial Market Stabilization Fund (*Gesetz zur Beschleunigung und Vereinfachung des Erwerbs von Anteilen an sowie Risikopositionen von Unternehmen des Finanzsektors durch den Finanzmarktstabilisierungsfonds – **FMStBG***)
- The Regulation Respecting the Implementation of the Financial Market Stabilization Fund Act (*Verordnung zur Durchführung des Finanzmarkstabilisierungsfondsgesetzes – **FMStFV***)
- The German Banking Act (*Kreditwesengesetz – **KWG***)

The Draft Legislation is supplemented by the Act Regarding the Reorganization of Financial Institutions (*Kreditinstute-Reorganisationsgesetz*) and the Restructuring Fund Act (*Restrukturierungsfondsgesetz*), which came into force on **January 1, 2011/December 31, 2010**.

[2] 70 billion plus a buffer of additional 10 billion available under certain conditions with the consent of the Budget Committee of the *Bundestag*.

They are meant to facilitate a controlled restructuring or liquidation of financial institutions that are technically insolvent or on the verge of insolvency with a view to avoiding the systemic risks for financial stability that are associated with regular insolvency proceedings. The pertinent legislation allows for, *inter alia*, a possibility for the Federal Financial Services Supervisory Authority (BaFin) to order the transfer of systemically relevant parts of a financial institution to another financial institution or to a government "bridge bank". The legislation is essentially aimed at addressing specific dangers for individual financial institutions whose existence is in jeopardy and whose collapse would endanger financial market stability. The Act Regarding the Reorganization of Financial Institutions and the Restructuring Fund Act do not establish a general system of preventive measures aimed at preserving the stability of the financial system as a whole.

2. The Administrative Framework of the Revived State Aid Program - Financial Market Stabilization Fund (FMS) and Financial Market Stabilization Authority (FMSA)[3]

The administrative framework of the financial market stabilization legislation is based upon the creation of the Financial Market Stabilization Fund (*Finanzmarktstabilisierungsfonds* – ***FMS***) and the Financial Market Stabilization Authority (*Finanzmarktstabilisierungsanstalt* – ***FMSA***) in 2008.

The **FMSA** is a Federal Authority with legal capacity that is supervised by the Federal Minister of Finance and acting in the name and on behalf of the FMS. It is governed by an ordinance containing rules relating to the organization of the FMSA, its representation, cost and accounting issues. Stabilization measures are undertaken by the FMS, but the pertinent decisions respecting the granting of these measures are essentially taken by the FMSA (by way of delegation from the Federal Ministry of Finance). The FMSA does not require a license under banking laws. Its accounting follows solely German GAAP rules, and the FMSA is not obligated to apply group accounting rules (or to prepare consolidated financial statements).

The **FMS** is a Federal Special Fund without vested legal capacity but with the ability to act, sue and be sued under its own name. The German Federal State is directly liable for the liabilities of the FMS. The FMS is exempt from German merger control laws (but is subject to European merger control laws). It also enjoys preferential tax treatment and, *inter alia*, is subject neither to corporate tax nor to trade tax. Acquisitions by the FMS (but not the later divestiture of shares) are exempted from real estate transfer tax. The FMS is not an entrepreneur for purposes of the German Value Added Tax Act. As a consequence, support measures of the FMS are not subject to V.A.T., which is an essential advantage for many relevant applicants, since financial institutions are generally not comprehensively entitled to input tax deduction. Capital gains owed by or to supported enterprises in the relationship to the FMS are not subject to capital gains tax. In parallel, with respect to withholding tax requirements in double tax treaty states, the FMS is treated as a German tax resident for purposes of the double tax treaties. In addition, the financial market stabilization legislation contains provisions respecting a preferential/specific tax treatment of support measures under the legislation. FMS measures also benefit from preferential treatment in other ways, including in respect of, *inter alia*, the possibility of a challenging of pertinent transactions in

[3] *See* the English language website of the FMSA for further information regarding its organization, structure, responsibilities, etc.: http://www.fmsa.de/en/; German language: http://www.fmsa.de/de/

insolvency, exemptions from transfer restrictions, irrelevance of termination rights and other rights triggered by measures undertaken by the FMS, exemptions from data protection rules, etc.

3. Who May Apply for Stabilization Measures?

The financial market stabilization legislation is designed to deal with capital and liquidity requirements of enterprises of the German financial sector. § 2 of the FMStFG lists the relevant potential applicants, among them most prominently credit institutions (*Kreditinstitute*) and financial services institutions (*Finanzdienstleistungsinstitute*) within the meaning of the German Banking Act, insurance companies and pension funds (*Versicherungsunternehmen und Pensionsfonds*), investment companies (*Kapitalanlagegesellschaften*), as well as operators of securities and derivatives exchanges (*Betreiber von Wertpapier- und Terminbörsen*) and their respective parent companies (the latter subject to certain restrictions) ("Enterprises of the Financial Sector"). Certain measures are only available to a defined subset of these Enterprises of the Financial Sector.

While there is no firm statutory entitlement to receive support under the financial market stabilization legislation, an applicant is generally entitled to the proper exercise of the discretionary powers of the FMSA with respect to the granting and scope of the applied-for support.

4. Available Support Measures

The Draft Legislation revives and amends the original (as amended in 2009) FMS support measure instruments, which are in summary:

- Liquidity guarantees
- Recapitalizations and acquisitions of shares
- Granting of guarantees (state aid element) securing payment obligations of special purpose companies in connection with a transfer of securities to such special purpose companies ("special purpose company model")
- Assumptions of risk positions
- Establishment of public-law winding-up institutions permitting a transfer of risk positions and of business divisions into such institutions ("winding-up institution model")

The most notable changes brought about by the Draft Legislation relate to:

- a broadening of the special purpose company model, which was previously limited to guarantee-backed transfers of structured securities, and is now broadened to include all kinds of securities (including government bonds);
- a broadening of the authorization of the FMS to acquire share capital of subsidiaries with a view to supporting the parent company; and
- an alleviation of capital increases of supported enterprises for the benefit of the FMS; in case of a rights issuance that is not fully subscribed by existing shareholders, the shareholders' meeting may permit the residual shares to be issued to the FMS at a lower price.

Further changes relate to formal and organizational issues (*e.g.*, the status of the members of the FMSA's Management Committee (*Leitungsausschuss*) and the strengthening of the supervisory functions of the Federal Ministry of Finance over FMSA), and to amendments relating to the implications of the credit authorizations under the Draft Legislation for the recently introduced constitutional debt limit.

Enterprises benefitting from stabilization measures may be subjected to various obligations imposed and (*inter alia*) supervised by the FMSA in accordance with the financial market stabilization legislation. Apart from comprehensive disclosure, information, and inspection rights of the FMS/FMSA, in case of recapitalizations this should notably include obligations regarding:

- a revision of business policies and their sustainability (including cessation or reduction of certain activities);
- a revision of remuneration schemes and policies (in order to prevent undue incentives for risk incurrence and to ensure sustainability and transparency);
- the limitation of board member compensation and bonuses and the adequacy of such compensation and bonuses;
- the limitation of dividend distributions (and measures with similar effects) for the duration of the stabilization measure; and
- the prevention of distortions of competition.

(a) Liquidity Guarantees

The FMS is authorized to issue guarantees for bonds and other liabilities issued by Enterprises of the Financial Sector (or by special purpose companies having acquired their risk positions) in order to resolve liquidity shortfalls and support the capital markets refinancing. Under the Draft Legislation and upon its effectiveness, bonds and other liabilities are eligible for guarantee support issued until December 31, 2012. The term of the guaranteed liabilities and of the related guarantees was originally limited to a maximum of 60 months under the previous program and has now been extended to a maximum of 84 months for covered bonds and of 60 months for other liabilities.[4] The issuance of a guarantee on behalf of a supported enterprise is conditioned on the availability of adequate capital. In the absence of adequate capital, a combination of the guarantee issuance with capital support measures will have to be considered. The maximum amount of guarantees to be issued to an individual supported enterprise is to be based upon such enterprise's available capital. A guarantee is usually issued in euros and covers the principal amount, interest, and all other relevant amounts owed to relevant creditors. Enterprises benefiting from the guarantee issuances of the FMS are obligated to pay an adequate, market-driven consideration consisting of a percentage of the maximum amount of the guarantee plus a margin. The issuance of liquidity guarantees is the preferential stabilization measure provided it is sufficient to achieve the desired stabilization.

(b) Recapitalization Measures

The revived recapitalization measures of the financial market stabilization legislation are aimed at strengthening the equity capital of supported enterprises. Consequently, in case of credit institutions and financial institutions, a recapitalization is intended to strengthen core capital and generally aims at establishing capital adequacy within a foreseeable timeframe. A recapitalization may take the form of contributions against the issuance of share capital, contributions in the form of silent

[4] There is a slight inconsistency in the Draft Legislation, since § 2 para. 2, third sentence, no. 4 FMStFV is not amended under the Draft Legislation but still provides for a maximum term of guaranteed liabilities that should expire on December 31, 2015 (in line with the previous 60 month period and the original phase-out on December 31, 2010). This appears to be an accidental inconsistency, which will probably be adjusted in the legislative process.

participations, and the provision of other equity components by the FMS. The previously introduced authorization for management boards of stock corporations to issue jouissance rights (*Genussrechte*) to the FMS expired on December 31, 2009 and is not revived under the Draft Legislation (jouissance rights are anyway not a recognized component of the core capital and thus not adequate to satisfy EBA requirements).

The original legislation provided that a resale of shares, silent participations and other participation rights issued to the FMS should take into account considerations of market preservation and that the FMS should grant subscription rights to the shareholders of the relevant Enterprises of the Financial Sector. These provisions were vague and difficult to implement, and consequently **are abolished in the Draft Legislation**.

The details of the various recapitalization measures are provided for in the FMStBG. Its provisions relate, *inter alia*, to corporate law, securities law, and tax law, and provide for exemptions and modifications compared to the otherwise applicable general legal rules. In addition to amending certain provisions pertaining to regular capitalization measures, the Draft Legislation also provides for the formal annulment of certain recapitalization provisions that were never utilized and perceived to violate European law.

The Draft Legislation in effect is built upon the regular statutory instruments that are available for establishing equity participation, including a regular capital increase to be resolved by the shareholders' meeting, a capital increase from authorized capital, and the creation of a silent participation. With a view to achieving the desired stabilization within an adequate timeframe, the original financial market stabilization legislation provided for certain exemptions and modifications with respect to recapitalizations and also with respect to other measures taken in connection therewith. These accommodations continue to apply and include the following (for stock corporations, European stock corporations (SE), and partnerships limited by shares):

- Accommodations regarding the convocation and preparation of shareholders' meetings that effectively shorten the otherwise relevant periods;
- Accommodations regarding majority requirements in shareholders' meetings and exclusions of shareholders' subscription rights (no shareholders' approval for the establishment of a silent participation of the FMS; simple majority of the votes cast for capital increase, creation of authorized capital, creation of contingent capital for purposes of permitting a conversion of FMS silence participations into shares/convertibles (as further defined); 2/3 majority of the votes cast or of registered capital represented (simple majority if 50% representation of registered capital) for exclusions of subscription rights, capital reductions associated with recapitalization measures, and granting of conversion rights or subscription rights in relation to silent participations of the FMS[5]; exclusions of subscription rights in connection with FMS capital injections do not require further special justification);
- Accommodations regarding tax laws: Notably a newly created participation of the FMS that exceeds 25 percent of the registered capital would usually entail a partial or complete loss of loss carryforwards of the relevant entity. Recapitalization measures under the financial market stabilization legislation benefit from an exemption from such rule.

[5] The wording of the 50% representation level-rule in this case referring to "subscribed" capital.

- Accommodations regarding, *inter alia*, corporate law (*e.g.*, regarding enterprise agreements, lowered thresholds (shares representing 90% of registered capital) for squeeze-outs initiated by the FMS under corporate law), capital maintenance rules, register entries associated with capital measures (in order to minimize shareholder intervention potential), corporate governance rules, securities and exchange laws (*e.g.*, no mandatory admission of securities issued to the FMS to trading; broad exemption from mandatory tender offer rules in connection with capital injections by the FMS; modification of rules pertaining to tender offers in case of a voluntary tender offer of the FMS/Federal State in connection with recapitalization measures).[6]

The Draft Legislation also introduces **a new accommodation relating to the pricing of capital increases.** It provides that, in case of a rights issuance that is not fully subscribed by existing shareholders, the shareholders' meeting may permit the residual shares to be issued to the FMS at a lower price (majority requirements equivalent to those in case of an exclusion of subscription rights). Shareholders may not claim such preferential treatment to be an alleged incurred damage (this is meant to hamper successful shareholder suits).

(c) Acquisition of Shares

According to the original legislation as enacted in 2008, the FMS could acquire shares by participating in capital increases of a supported enterprise, but there was no explicit legal basis for the acquisition of, for instance, treasury shares or shares held by third parties (*e.g.*, in a tender offer). As it was considered desirable to enable the FMS to increase its shareholding in preparation for, or in connection with, capital support measures, an amendment of the FMStFG was enacted in 2009 authorizing the FMS to acquire shares of a (to be) supported enterprise from such enterprise or from third parties.

The Draft Legislation contains a small but nevertheless crucial amendment to this provision. Under the amended version, the FMS is also authorized to acquire shares of a direct or indirect subsidiary of an enterprise that is subject to stabilization measures of the FMS (in case of an important interest of the Federal State and in the absence of more appropriate or more efficient alternatives). Such authorization could theoretically be invoked in connection with an acquisition by the FMS of certain subsidiaries of German financing institutions, including for instance Eurohypo AG (a 100 percent subsidiary of Commerzbank AG) with a view to relieving Commerzbank AG from the capital requirements associated with Eurohypo AG.

(d) Assumption of Risk Positions

The FMS is authorized to acquire (in any adequate form) risk positions from Enterprises of the Financial Sector and related special purpose companies. Under the Draft Legislation, such risk positions must have been acquired before December 1, 2011 (the reference date under the original legislation was October 13, 2008). According to the non-exhaustive list contained in the legislation, the term "risk positions" includes receivables, securities, derivatives, rights and duties under loan commitments or warranties (*Gewährleistungen*), as well as participations. It also includes related collateral. In consideration for the transfer of the risk position, the FMS grants a bond, the maximum amount being tied to the book value of the relevant risk positions in the last interim report or annual financial report. The FMS also needs to be adequately

[6] Here as well, an additional reference date change might be required (in § 12 para. 3 no. 3 FMStBG) compared to the Draft Legislation.

compensated for the temporary risk assumption by way of interest payments. It shall generally be permitted to divest the acquired risk position (subject to the exercise of preemption rights or re-acquisitions against full compensation of the FMS for losses and adequate interest payments).

While the wording of the pertinent rules suggests the possibility of a permanent transfer of risk positions, the respective instrument in fact rather has the character of a repo transaction (mandatory re-transfer to the transferring entity within 36 months of assumption with full value compensation for FMS) due to commitments to the EU Commission undertaken by the Federal Republic in connection with the EU Commission's state aid approval. This limitation renders the instrument relatively unattractive and somewhat unnecessary in view of the other available instruments. It has in fact (seemingly) never been utilized so far.

(e) Guarantees Securing Obligations of Special Purpose Companies in Connection with a Transfer of Securities to such Special Purpose Companies

In spring 2009, the EU Commission issued its Impaired Assets Communication (2009/C72/01) ("IAC"). In response thereto, the original financial market stabilization legislation was amended to provide for a possibility for (German) credit institutions, financial holding companies and their German or foreign subsidiaries to transfer structured securities (and related hedging transactions) into a specially incorporated (German) special purpose company at a predefined price that is backed by a governmental guarantee (with a retained loss compensation obligation to be satisfied solely from future amounts to be distributed to shareholders)[7]. Only those credit institutions and financial holding companies are eligible under the guarantee concept that had a seat in Germany as of (according to the Draft Legislation) December 31, 2010 (previously: December 31, 2008).

Originally, only structured securities (like ABS, CDOs, CLOs, RMBS, and CMBS) were eligible for transfer under the guarantee-backed special purpose company model and applications for support under the model had to be submitted within the 6-month period following the enactment of the relevant amendment to the legislation (until January 22, 2010). The model thus had a quite limited area of application (and was in fact never utilized).

The Draft Legislation broadens the eligibility criteria and opens the special purpose company model for any kind of securities, notably also for government bonds. It also adjusts reference dates relating to the acquisition of these securities, the utilization of the model, and the valuation of relevant securities, and abolishes the originally short application timeframe. The model could thus now be utilized for the entire duration of the revival of the legislation (until December 31, 2012). It can now also be employed for the benefit of eligible applicants whose capital requirements are heavily determined by losses associated with government bonds. Taking into account these afore-described changes under the Draft Legislation, the concept underlying the special purpose company model can be summarized as follows:

[7] Literal translation of term used. The original term refers to a similar term used in the Stock Corporation Act (§ 174 para. 2 no. 2) in order to clarify the meaning (it does not broadly mean 'distributable profit' but more narrowly (distributable) profit as actually to be distributed to the shareholders).

- An eligible enterprise may transfer securities acquired until December 31, 2010 to a special purpose company against the granting of a bond that is guaranteed by the FMS (recourse claims under the guarantee being statutorily subordinated in order to shield the special purpose company from immediate insolvency). The FMS guarantee constitutes the crucial state aid element of the concept and is meant to shield the transferring entity from further impairment risks, thus strengthening the capital basis of the enterprise and making the bond eligible for ECB liquidity access (the bond is meant to replace the transferred assets in the balance sheet of the transferring entity). Neither the term of the bond nor the term of the guarantee is subject to the general limitations applicable to liquidity guarantees.
- The compensation for the granting of the guarantee shall be on market-driven terms and may take the form of the issuance of share capital.
- The pre-defined acquisition price for the securities, as reflected in the bond issued in consideration therefor, is meant to ensure that the assets are neither transferred below their actual current value (*tatsächlicher wirtschaftlicher Wert*) nor above the book value as of September 30, 2011. Provided that these conditions are met, the consideration shall be the higher of (i) 90 percent of the book value as of December 31, 2010, (ii) 90 percent of the book value as of September 30, 2011, and (iii) the actual current value (the book value discounts only need to be made to the extent not endangering a core capital ratio of 7%).
- The transfer is meant to effect a removal of the pertinent assets from the balance sheet of the transferring entity (in exchange for the guaranteed bond). The transferring entity will nevertheless in principle remain liable for future losses associated with the transferred securities in accordance with a defined loss compensation scheme, provided that such loss compensation, as hereinafter described, is to be made solely from (and linked to the existence of) future amounts to be distributed to shareholders of the transferring entity, if any (such that a residual risk ultimately remains with the FMS as a result of the guarantee). We understand the wording of the legislation has been drafted with a view to avoiding balance sheet recognition of the loss compensation obligations.
- The loss compensation to be paid solely from future amounts to be distributed to shareholders consists of two elements, namely **(i)** a fixed annual amount payable to the special purpose company over the term of the guarantee (max. 20 years), which is determined on the basis of the difference between the original transfer price and the so-called fundamental value (defined as the original actual current value as adjusted downwards for further risks potentially realizing until the end of the relevant term; the minimum annual amount to be 1/20 of such difference), and **(ii)** a residual amount owed to the FMS and determined by any residual losses not covered under (i) (the payment of which can be made in the form of the issuance of shares to the FMS).
- Any remaining positive balance after a complete winding-up of the transferred portfolio will be transferred to the transferring entity and be available for distribution to its shareholders (other than holders of special preference shares as explained hereinafter).

While retained loss compensation liabilities need only be paid in case of (and from) available future amounts to be distributed to shareholders, such continuing liability would still impair dividend distributions and render it unattractive to hold and acquire shares of the transferring entity. As a counter-measure, capital market access is intended to be improved by a special authorization for transferring stock corporations to issue special preference shares, including preference shares with voting rights, up to an amount representing 50 percent of the registered share capital as of the date of the enactment of the Draft Legislation. The dividend rights of the holders of these preference shares enjoy preference in relation to the retained loss compensation liabilities.

While it remains to be seen whether this concept can realistically be viably employed with respect to publicly traded companies, it certainly has the appeal of relieving the supported entity from risk weighted assets and the associated capital requirements while at the same time minimizing state aid elements as a result of the retained loss compensation obligations.

(f) Winding-up Institutions

In addition to the special purpose company model, the financial market stabilization legislation provides for a model permitting the transfer (legal or economic transfer; various methods available) of risk positions and non-strategic business divisions to public law winding-up institutions specifically established by the FMSA upon application. Like the special purpose company model, the winding-up institution model was introduced by way of an amendment to the financial market stabilization legislation in 2009. It is designed to permit a transfer and subsequent winding-up of a broad array of assets (*i.e.*, all kinds of risk positions and non-strategic business divisions) for a consideration to be determined by the FMSA, with a view to reducing capital and liquidity requirements of the transferring entity while at the same time preserving ownership responsibilities of the transferring entity. Eligible applicants are credit institutions and financial holding companies with a German seat as of and since (according to the Draft Legislation) December 31, 2010 (previous reference date: December 31, 2008) and their German and foreign subsidiaries and special purpose companies having assumed risked positions of the foregoing. The model is not intended to permanently and entirely relieve a relevant supported entity or its owners from the loss potential associated with the relevant assets. Further significant features and characteristics of the winding-up institutions model include the following:

- The winding-up institutions established for a respective supported enterprise do not require a license under banking laws, and banking laws (including supervisory rules) only apply to winding-up institutions analogously and to a limited extent.
- The refinancing of the winding-up institutions is ensured by the authorization for the FMS to issue guarantees for their bonds and other liabilities (the guarantee term being tied to the term of the bonds/liabilities; the term limitations applicable to liquidity guarantees do not apply).
- The winding-up institutions operate and are organized according to individually designed bylaws resolved upon by the FMSA; they apply German GAAP rules (which are less strict respecting the accounting for market value fluctuations of transferred assets).
- Ultimately, the principle of (direct) ownership responsibility for losses applies. A complex set of rules is meant to ensure that the indirect or direct owners of the supported entity bear the risk of losses resulting from the winding-up of the transferred assets (the exact structure of such compensation depending on the specific structure of each relevant institution). In the case of a publicly traded company (or companies with a floating shareholder base), the transferring entity shall assume a loss compensation obligation (like in the special purpose company model to be serviced from future amounts to be distributed to shareholders). The rules applicable to the pertinent obligations under the special purpose company model apply analogously. As in the case of special purpose companies, a positive balance remaining after a complete winding-up of the transferred risk positions and non-strategic business divisions is ultimately to be transferred to those persons/entities that are responsible for the loss compensation (*i.e.*, for instance the shareholders of the transferring entity or the transferring entity itself, as the case may be).
- The winding-up institutions are exempted from many otherwise applicable statutory rules or these rules are amended with respect to the special requirements of the institutions (*e.g.*, relating to enterprise agreement rules, corporate transformations).

So far, the winding-up institution model has been utilized by two government-owned entities (WestLB AG, Hypo Real Estate AG (the latter after the squeeze-out of remaining shareholders)). As these entities are ultimately government-owned, the prescribed loss participation of the direct or indirect shareholders could in these cases be easily implemented. Ultimately, the state will "take the hit".

5. Strengthening of Bank Regulatory Elements

Apart from the revival and strengthening of the financial market stabilization legislation, the Draft Legislation contains a second set of provisions relating to the strengthening of bank regulatory instruments in light of the current crisis. These instruments are designed to permit early intervention to ensure financial market stability without the requirement of a specific threat to the existence of an individual institution. Accordingly, pursuant to the Draft Legislation, for an interim period until December 31, 2012, the Federal Financial Services Supervisory Authority (BaFin) will have the right to order banks and banking groups to increase their solvency ratios beyond the levels required under the German Banking Act and the Solvency Ordinance (*Solvabilitätsverordnung*) if such a capital strengthening is necessary to prevent a disturbance to the functioning of financial markets or a threat to the stability of financial markets. For example, this could be the case if, due to extraordinary market conditions, the refinancing ability of several important financial institutions is threatened. In such case, BaFin could set minimum capital requirements different from the otherwise applicable rules and request banks and banking groups to maintain higher regulatory capital levels. The new rules also would address the situation that, as part of a coordinated effort on the EU level, a resolution by the European Council or a recommendation by the European System Risk Board or the EBA calls for higher regulatory capital ratios. Therefore, BaFin would, under the Draft Legislation, be in a position to enforce the target core capital requirement of 9% as set by EBA in the recent Recommendation.

To achieve timely compliance with the increased capital requirements, the Draft Legislation provides for the following elements:

- BaFin can request the institution to provide a plan in which the institution must outline the envisaged measures to achieve the higher capital requirements and its timing. BaFin may request changes to the plan.
- In the context of this plan, in the absence of alternatives, the relevant institution may also consider an application for stabilization measures.
- As a last resort, BaFin may appoint a special representative and entrust it with the preparation of the plan and its implementation.

Under the Draft Legislation, BaFin shall also have the power to prohibit the distribution of profits and the payment of variable remuneration elements until the institution has achieved the requested (higher) regulatory capital ratios. Conflicting resolutions would be void, and contravening third party agreements (such as employment agreements with a bonus entitlement) would be unenforceable. To facilitate capital measures to strengthen the capital ratios of the institution, the modifications and accommodations under the FMStBG shall apply *mutatis mutandis*.

IV. Conclusion

The revival and strengthening of the financial market stabilization legislation by virtue of the Draft Legislations, with its possibility to utilize support instruments until December 31, 2012, will hopefully send a strong signal to the financial markets and erect a strong fortress against the dangers of the sovereign debt crisis for financial market stability. It will certainly provide a fallback position for Enterprises of the Financial Sector to satisfy their capital and liquidity requirements in the current crisis and will thus assist in re-establishing trust into and among German market participants while at the same time fighting credit-crunch scenarios as a result of panic-type deleveraging actions. It remains to be hoped that the sovereign debt crisis triggering the need for the Draft Legislation and its underlying reasons can in fact be overcome and resolved in the near term.

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This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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