Symposium on Governmental Assistance for Industries and Businesses

Tokyo - December 16, 2009

Germany’s response to the Financial Crisis
– Governmental Assistance for Industries in Germany –

Josef Broich
Partner
Broich Bezzenberger
Berlin • Frankfurt am Main • Vienna

BROICH BEZZENBERGER

Final Version Dec. 16, 2009

Content

A.

Features and Actual Situation of Industry-Related Policies in Germany

Germany‘s Response to the Financial Crisis

2008

- On 12 August 2008, the German Parliament passed the „Act on the Limitation of Risks connected with Financial Investments (*Gesetz zur Begrenzung der mit Finanzinvestitionen verbundenen Risiken*), in particular containing rules for loan and security agreements and restricting the assignability of credit claims.
- Mid-September 2008, the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungs-aufsicht*) interdicted short sales of shares regarding eleven financial institutions (Deutsche Bank, Commerzbank, Allianz SE, Deutsche Börse, Münchener Rück, Hannover Rück, Hypo Real Estate, AMB Generali, Aareal Bank, Postbank, MLP AG) until the end of 2009.
- On 5 October 2008, the Federal Government declared to guarantee the saving deposits in Germany.
- On 17 October 2008, the SoFFin (Financial Market Stabilization Fund, *Sonderfonds Finanzmarktstabilisierung*) was founded on the basis of the new Financial Market Stabilization Act (*Finanzmarktstabilisierungsgesetz*). SoFFin‘s purpose is to stabilize and restore confidence in the financial system by the issuance of guarantees, the recapitalization of financial institutions and the assumption of risk positions.
- On 5 November 2008, the first EUR 70bn economic stimulus package (titled „protection of jobs through stabilization of the economic growth”) was passed.

2009

- On 13 February 2009, the second EUR 50bn economic stimulus package (titled „strong-willed during the crisis, strong for the next economic revival“) was passed.
- On 3 April 2009 the Financial Market Stabilization Act was supplemented in order to permit the nationalization of financial institutions for a limited time period.
- On 10 July 2009, the German Bad Bank Act was passed.
- On 25 November 2009, the maximum period for subsidies for short hours work were extended.
- On 28 November 2009, the German government announced to take additional measures to avert the credit crunch (by the acquisition of loans and the issuance of guarantees in the amount up to EUR 10bn).

Introduction: Germany‘s situation prior to financial crisis

- Similarities to Japanese situation: Aging population; savings rate much higher than US and UK; strong export; consensus driven system of aligning employee/union interests with interest of corporations led relatively late in adapting anglo-american de-regulation and shareholder value approach and reducing cross shareholdings, so called Deutschland AG or Germany Inc. model of Rhineland Capitalism abolished in late nineties.

- Due to relative late reform and deregulation attempts Germany was relatively well prepared for the financial crisis, social-democratic government had actually initiated reform, liberalization and privatization that came to fruition. Germany’s industry had to a large extent engaged in cost cutting and flexible production but kept its manufacturing base.

- Against this background the Merkel Government was reluctant to engage in patterns that Germany had just left behind like government equitiy participations, stimulus programs etc. Moreover, due to the burden of the German reunification had still a relatively high public debt exposure and the Government was looking to manage the first balanced budget without net debt since many years.

Governmental Assistance Programs

General Assistance Programs

- Assistance programs which are in place irrespective of the financial crisis are:
  - programs of the European Union;
  - programs of the Federal Republic of Germany; and
  - programs of each Federal State of Germany.

Special Programs in response to the Financial Crisis

- EUR 70bn economic stimulus package of the Federal Republic of Germany comprising:
  - EUR 50bn for investments and orders in 2009 and 2010 made by enterprises, private persons and municipalities.
  - EUR 20bn to maintain the financial resources and liquidity of enterprises.
- EUR 50bn economic stimulus package of the Federal Republic of Germany and the Federal States aiming at the protection of jobs, the stabilization of the economic growth and the modernisation of the Federal Republik of Germany.
- Special Programs of the Federal Republic of Germany for the Financial Sector:
  - Creation of the Financial Market Stabilization Fund “SoFFin” with the purpose to stabilize and restore confidence in the financial system by the issuance of guarantees, the recapitalization of financial institutions and the assumption of risk positions.
  - German Bad Bank Act.

Programs of the European Union

EU Programs

- Almost all individual budgets of the European Union ("EU") comprise funding programs for the subsidization of particular sectors of the European economy: about EUR 45.5bn (i.e. 36 percent) of the total EU budget of EUR 126.5bn is allocated to such **structural funds**.
- The structural funds are intended to grant financial assistance in order to resolve structural economic and social problems in economically underdeveloped regions of the EU. The funds aim to promote the economic and social cohesion within the EU through reduction of imbalances between its different regions.
- Enterprises located in regions with a GDP per capita of less than 75 percent of the European average are generally entitled to apply for direct financial assistance for investment. Various regions in Eastern Germany meet this criterion.
- Additional EUR 42.7bn is spent for market measures and direct subsidy payments for the European agricultural sector, further EUR 12.4bn for rural development, altogether representing 44 percent of the EU budget.
- The EU has not launched any specific assistance programs in order to meet particular challenges of the financial crisis.
- However, the EU has been involved in the development and approval of each member states' assistance program. Main focus was to prevent any violations of the European regulations on state aid and competition.

Programs of the Federal Republic

Federal Republic of Germany (KfW Programs)

- The Federal Republic of Germany grants financial assistance for industries and businesses located in Germany through the state-owned Development Loan Corporation (*Kreditanstalt für Wiederaufbau* – "KfW") based in Frankfurt am Main.
- KfW is owned by the Federal Republic of Germany (80%) and the German federal states (20%). In 2008, the total financing volume of KfW amounted to EUR 70.6 bn.
- As a promotional bank, KfW offers support to encourage sustainable improvement in economic, social, ecological living and business conditions. In particular, KfW
  - lends money to small and midsized enterprises and buys securitized loan portfolios related to small and midsized enterprises from German banks;
  - provides funds for housing, infrastructure, environmental protection and venture capital;
  - finances telecommunications, transportation and energy infrastructure projects.
- KfW covers over 90% of its borrowing needs in the national and international capital markets. In addition, KfW receives funds from the Federal Budget.
- In view of the financial crisis, the Federal Government of Germany has initiated a credit and guarantees program with a budget of EUR 115 bn. The credit assistance is administrated by KfW through its special program for small and medium-sized enterprises and its special program for larger enterprises.

Programs of the Federal States

German Federal State Programs

- Each of the 16 German Federal States maintains its own programs for economic development.
- Beneficiaries of the assistance programs are industries and businesses (in the future) located in the relevant Federal State as well as founders of a new business, institutions of education or research, universities, municipalities or private persons.
- Contents of the assistance programs are financial aid, job creation schemes, improvement of the infrastructure, stimulation of the economy (either in specific regions or in general), urban development or environmental protection.
- The state aid is granted as
  - subsidies (in particular paid by the relevant ministry or by the Federal State's development bank (*Förderbank*));
  - loans (in particular made by the relevant Federal State's development or investment bank (*Förder- oder Investitionsbank*));
  - guarantees (in particular issued by the relevant Federal State's guarantee bank (*Bürgschaftsbank*)); or
  - participations (in particular by the relevant Federal State's investment company (*Beteiligungsgesellschaft*)).

Special Programs due to the Financial Crisis

In answer to the financial crisis, the Federal Government of Germany introduced two packages of various measures for the economic stimulus (*Konjunkturpakete I und II*) in November 2008 and in March 2009.

Economic Stimulus Package I

- EUR 50bn for investments and orders in 2009 and 2010 made by enterprises, private persons and municipalities.
- EUR 20bn to maintain the financial resources and liquidity of enterprises.
- The package contains, inter alia, the following measures:
  - Accelerated depreciation for Small and Medium-Sized Enterprises ("SME");
  - Extension of subsidies for short hours work;
  - Improvement of regional economic structures;
  - Investments in the traffic infrastructure;
  - EUR 15bn KfW-funds for the maintenance of financial resources and liquidity of SME (now part of the Economic Fund Germany, *Wirtschaftsfonds Deutschland*);
  - Exemptions from motor vehicle tax for new cars

Economic Stimulus Package II

- EUR 50bn for the protection of jobs, the stabilization of the economic growth and the modernisation of the Federal Republic of Germany.
- The package contains, inter alia, the following measures:
  - About EUR 14bn public investments in infrastructure and education;
  - KfW-funds for loans to large enterprises and guarantees to improve the supply of credit in general (part of the Economic Fund Germany, *Wirtschaftsfonds Deutschland*);
  - Additional funds for the „Central Innovation Program for SME (*Zentrale Innovationsprogramm Mittelstand*)" regarding research and development projects;
  - "Cash for clunkers" (*Umweltprämie*);
  - Also: debt brake

Second Economic Stimulus Package: Economic Fund Germany (*Wirtschaftsfonds Deutschland*)

The second economic stimulus package (*Konjunkturpaket II*) contains a credit and guarantees program (Economic Fund Germany, *Wirtschaftsfonds Deutschland*) with a budget of EUR 115 bn. This program includes the EUR 15bn KfW-funds for the maintenance of financial resources and liquidity of SME as part of the first economic stimulus package (*Konjunkturpaket I*).

General Terms

- The Economic Fund consists of funds in the amount of EUR 115bn for loans and guarantees.
- Available until the end of 2010.

Elements

- KfW-special program for SME: the EUR 15bn KfW program for the maintenance of financial resources and liquidity of SME with a group turn-over of less than EUR 500m has been made more flexible and has been extended until the end of 2010.
- KfW-Special program for large enterprises: EUR 25bn KfW credit program for large enterprises guaranteed by the Federal Republic of Germany, including KfW's participation in syndicated loans.
- Guarantee program: EUR 75bn for the granting of guarantees.

Success

- Until 18 September 2009, in total 2,738 applications in the amount of EUR 13.2bn were filed with KfW.
- 1,416 application in the amount of EUR 2,64bn were approved, 394 applications (EUR 563m) were declined until that date.
- 96 % of the approvals relate to SME, only 4 % to large enterprises.

KfW-Special Program for Small and Medium-Sized Enterprises

Beneficiaries

- The program is made for small and medium-sized enterprises of the industrial economy as well as freelancers.
- Such enterprises must be privately owned (at least more than 50 %) and may either be located in German or abroad.
- The group turn-over may not exceed 500m.

Purposes

- The funds must be used for the medium- or long-term financing of capital expenditures in Germany.
- Such capital expenditures must hold prospects of a sustainable economic success.
- Alternatively, the funds may be used for the financing of the working capital or for project financings.

Other Terms and Conditions

- The application must be made with the applicant's bank that files such application with KfW.
- KfW grants an indemnification of up to 90% for the benefit of the applicant's bank.
- The maximum loan amount is EUR 50m per project (EUR 200m for project financings).

KfW-Special Program for Large Enterprises

Beneficiaries

- The program is made for large enterprises with a group turnover of more than EUR 500m.
- Such enterprises must be privately owned (at least more than 50 %) and may either be located in Germany or abroad.

Purposes

- The funds must be used for medium- or long-term financing of capital expenditures in Germany.
- Such capital expenditures must hold prospects of a sustainable economic success.
- Alternatively, the funds may be used for the financing of working capital or for project financings.
- The funds may also be used for general financial needs of an enterprise, i.e. without any specific purpose.

Other Terms and Conditions

- The application must be made with the applicant's bank that files such application with KfW.
- KfW grants an indemnification of up to 70% for the benefit of the applicant's bank (50% if the funds are used for the working capital financings).
- The maximum loan amount is EUR 300m per project.

Syndicated Loans

- KfW has been enabled to participate as lender in syndicated loans.
- The maximum commitment of KfW is EUR 200m, whereas KfW participation may not exceed 50 % of the total amount of the syndicated loan.

Guarantee Program

Background	➢ Due to the financial crisis and the current economic conditions, borrowing by enterprises has become more difficult. The guarantee program‘s purpose is therefore to facilitate such borrowing. ➢ Until the end of 2010, the Federal Republic of Germany exculpates the banks from the risk in connection with the financing of capital expenditure and working capital.
Beneficiaries	➢ The program is made for private enterprises of the industrial economy as well as freelancers. ➢ The beneficiaries must hold out the prospect of a sustainable economic success, but show a lack of acceptable assets for the collateralization of the required loan.
Three Level Guarantee Program	➢ Guarantees of up to EUR 2m serving as collateral for financings of capital expenditure and working capital of SME are granted by the relevant Federal State’s guarantee bank (*Bürgschaftsbank*). ➢ Guarantees of up to EUR 50m (newly-formed German states: EUR 10m) are generally granted by the relevant Federal State in connection with a risk participation of the Federal Republic of Germany. ➢ Guarantees of more than EUR 50m are granted by the Federal Republik of Germany together with the relevant Federal State.
Other Terms and Conditions	➢ EU-funding guidelines must be taken into consideration. ➢ The maximum coverage of guarantees is 80 % (in exceptional cases up to 90 %). The shareholders or investors must assume a significant portion of the risk.

Application Procedure (1)

General

- Applications for guarantees are considered by the guarantees committee (*Bürgschaftsausschuss*) of the Federal Republic of Germany of, as the case may be, of the relevant Federal State.
- Applications for loans are considered by KfW.
- Applications for loans exceeding EUR 150m and guarantees exceeding EUR 300m as well as applications of utmost relevance must be submitted to the Steering Council Business Financing (*Lenkungsrat Unternehmensfinanzierung,* "Steering Council").
- The Steering Council remits its recommendations to the Steering Committee Business Financing (*Lenkungsausschuss Unternehmensfinanzierung*, "Steering Council") for final decision.
- Applications exceeding EUR 300m are also presented to the Budget Committee of the German Parliament for formal acknowledgement.

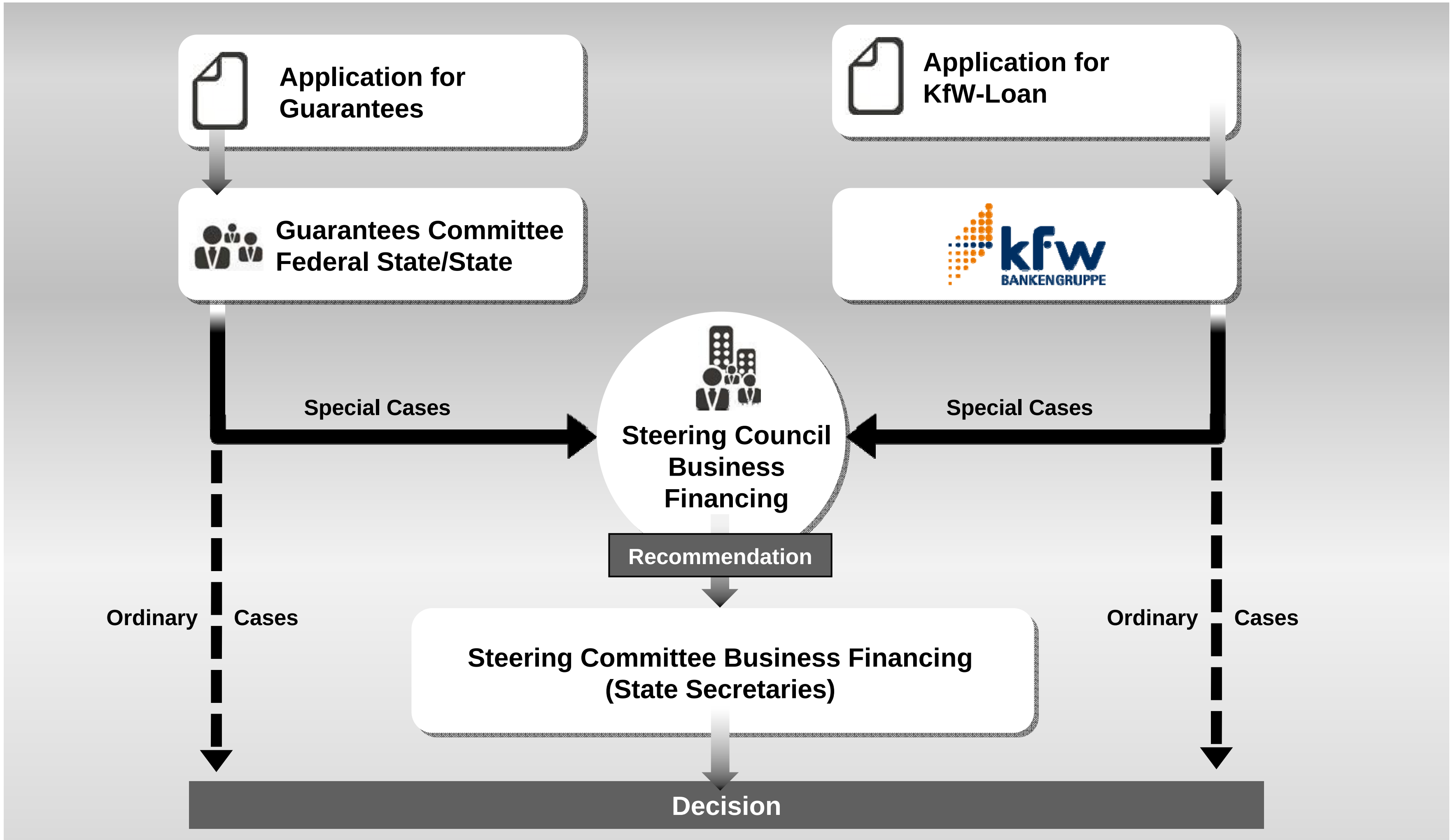
Steering Council

- Members of the Steering Council are individuals who are in command of economic and financial expertise.

Steering Committee

- Members of the Steering Committee are the secretaries of state of the Federal Ministry of Economics and Technology (*Bundesministerium für Wirtschaft und Technologie)*, the Federal Ministry of Finance (*Bundesministerium der Finanzen)* and the Federal Ministry of Justice (*Bundesministerium der Justiz*) as well as the German Chancellery (*Bundeskanzleramt*).

Application Procedure (2)



Prominent Applicants (1)

ARCANDOR

- Arcandor AG, the holding company of the German retailer Karstadt, the mail-order business Quelle and the travel firm Thomas Cook, applied for guarantees in the amount of EUR 650m and for a EUR 200m loan.
- In June 2009, Arcandor AG filed for insolvency after both applications were rejected. Arcandor AG was already distressed before 1 July 2008.

WADAN YARDS

- Wadan Yards, a Russian owned dockyard located in a structurally weak region of eastern Germany, received a syndicated loan in the amount of EUR 180m made by Deutsche Bank AG and KfW in February 2009.
- An additional 40m loan was authorized by the Federal Government in May 2009.
- Nevertheless, Wadan Yards filed for insolvency in June 2009 as the State of Mecklenburg-Western Pomerania refused to grant further credits.

PORSCHE

- In June 2009, German car manufacturer Porsche SE applied for a EUR 1.75bn loan.
- KfW requested Porsche not to utilize such loan to acquire shares and to provide a detailed redemption plan for a EUR 12.5bn loan Porsche SE had applied for with several commercial banks.
- Porsche SE waived its application after being forced by its shareholders and creditors to merge with Volkswagen AG.

Prominent Applicants (2)

Hapag-Lloyd

- In October 2009, shipping company Hapag-Lloyd AG was granted guarantees in the amount of EUR 1.2bn.
- 90 percent of the guarantees are covered by the Federal Republic of Germany and the State of Hamburg. The remaining 10 percent are covered by the commercial banks who provide Hapag-Lloyd AG with loans.
- Hapag-Lloyds AG shareholder agreed, inter alia, to increase the share capital by EUR 285m and to convert shareholder loans in the amount of EUR 353m into equity.

OPEL

- In connection with the deterioration of General Motors' financial situation, in May 2009 the US car manufacturer agreed to transfer 65 percent of the shares in its German subsidiary Adam Opel GmbH to a consortium consisting of the components supplier Magna International, the Russian Sberbank, Opel employees as well as car dealers ("Magna Consortium").
- In May 2009, the Federal Government and four Federal States with Opel production facilities granted a bridge loan of EUR 1.5bn. In addition, the Federal Government held out the prospect of additional guarantees of up to EUR 4.5bn.
- In November 2009, GM cancelled the sale of Opel to the Magna Consortium and repaid the bridge loan. It has not yet been decided whether GM will receive further state aid for Opel.

Second Economic Stimulus Package: Other Measures (1)

Enhancement of Local Infrastructure and Education

- EUR 10bn are made available by the Federal Republic of Germany for measures to improve the local infrastructure and education. The Federal States grant additional EUR 3.3bn.
- The Federal Republic invests about EUR 4bn in the federal infrastructure, the energetic building refurbishment and research programs.
- Further EUR 5.2bn were content of the first economic stimulus package in order to enhance the traffic infrastructure, to refurbish buildings and to strengthen the regional economy.
- EUR 3.5bn federal funds (plus funds provided by the Federal States) are assigned to enable cities and counties to modernize their hospitals and roads as well as to promote new urban development.
- EUR 6.5bn federal funds (plus funds provided by the Federal States) are assigned for education, i.e. for the modernization and expansion of kindergartens, schools and universities.

Second Economic Stimulus Package: Other Measures (2)

Subsidies for Short Hours Work (*Kurzarbeit*)

- If employees work less or even not at all, the loss of wages is compensated by the Federal Employment Office (*Bundesagentur für Arbeit*) that pays 60 percent of the net wages omitted due to the reduced working hours.
- Subsidies for Short Hours Work are granted in particular subject to the conditions that
  - the lack of work is material and caused by economic reasons or force majeure; and that
  - the lack of work is inevitable, but only temporarily
- The maximum period for the subsidies is 6 months. The period may be extended up to 24 month under extraordinary circumstances. Due to the financial crises, the maximum period is currently 24 months if the short hours work has commenced not later than 31 December 2009, and 18 months if the short hours work starts in 2010.
- From the beginning of the financial crisis in October 2008 until the end of August 2009, 125,000 enterprises filed for short hours work for approximately 3.3m employees.
- The Federal Employment Office expects that the costs will amount up to EUR 5bn in 2009.
- The costs for the employers which have filed for such subsidy are expected also to be up to EUR 5bn in 2009 as they still have to pay 50 % of the social insurance contributions in the first six months.
- Due to this financial burden of the employers, employees might be laid-off despite of subsidies for short hours work if the expected economic recovery fails to appear.

Second Economic Stimulus Package: Other Measures (3)

Cash for clunkers ("Umwelt-prämie")

- In order to strengthen the automotive industry, the Federal Government boosted the demand for new cars with EUR 5bn.
- Each purchaser of a new car or employee's car (*Jahreswagen*) had a right to receive EUR 2,500 "chash for clunkers" if
  - the EUR 5bn funds are still unexhausted;
  - the applicant is a private person;
  - the applicant has crapped another, at least nine years old car between 14 January 2009 and 30 June 2010;
  - the applicant was the registered keeper of that old car;
  - The applicant buys the new car or employee's car between 14 January and 31. December 2009 and gets a license not later than 30 June 2010; and
  - The new car's or employee's car's emission standard is at least „Euro 4".
- On September 2nd, 2009, the EUR 5bn fund was exhausted. In total, 1,706,839 applications have been filed until that date.
- The main beneficiaries are Volkswagen (17.68 %), Opel (10.96 %), Skoda (8.18 %), Ford (7.98 %), Fiat (7.66 %) and Toyota (5.1 %).

Second Economic Stimulus Package: Other Measures (4)

Debt Brake

- In 2009, the German Parliament and the German Federal Council enacted a constitutional amendment according to which the structural (i.e. not cyclical) net borrowing of money by the Federal Republic is limited to 0.35 % of the German GDP.
- This debt brake applies as from the financial year 2011. Not later than 2016, the Federal Republic must have reduce is structural net borrowings to 0.35 %.
- As from 2020, the Federal States are no longer entitled to take out loans at all. In return, financially week Federal States will receive certain funds from the Federal Republic and the other Federal States for budget consolidation.
- However, the Federal Republic and the Federal States may take out (additional) loans
  - in order to mitigate unusual cyclical trends, i.e. anti-cyclical borrowing is still permitted.
  - in case of natural disasters or other extraordinary emergencies (e.g. the financial crises beginning in 2007).
- Each budget of the Federal Republic and the Federal States will be supervised by a – to be created – stabilization committee (*Stabilitätsrat*).
- Contrary to the Swiss debt brake, the German debt brake's aim is not to repay outstanding loans, but (only) to reduce the maximum amount of borrowing.

Special Programs for the Financial Sector

Basically, the Federal Republic of Germany has passed two main laws in order to stabilize the German financial sector:

Financial Market Stabilization Act

- The Financial Market Stabilization Act's aim is to maintain the solvency of financial institutions located in Germany and the avoidance of a credit crunch.
- The main content of the act is the foundation of the SoFFin (Financial Market Stabilization Fund, *Sonderfonds Finanzmarktstabilisierung*). Its purpose is to stabilize and restore confidence in the financial system by several measures.

Bad Bank Act

- The (so-called) Bad Bank Act (*Gesetz zur Fortentwicklung der Finanzmarktstabilisierung*) enables banks to remove toxic assets from their balance sheets in order to gain additional core capital resources without being obliged to raise fresh equity.
- Banks may transfer their toxic assets into "bad banks", either in form of a special purpose vehicles ("SPV") or a run-off vehicles.

SoFFin - Special Fund Financial Market Stabilization

- The SoFFin was created in connection with the Financial crisis on 17 October 2008 by the German Parliament and enacted on 20 October 2008.
- It is established as an agency at the German Federal Bank (*Deutsche Bundesbank*) and is supervised by the Federal Ministry of Finance.
- The SoFFin is limited in time until 31 December 2010.

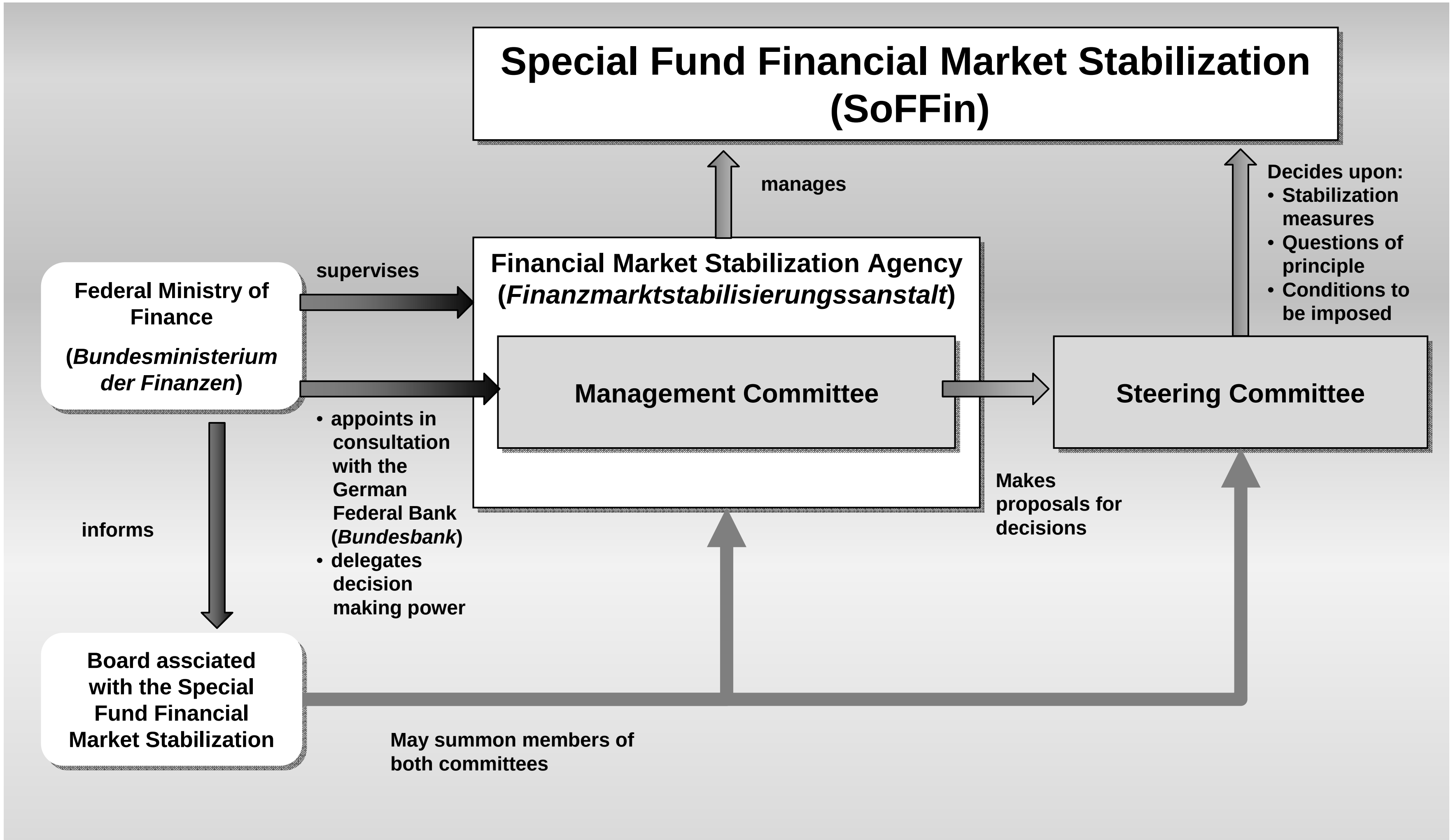
Tasks

- Guarantees: Guarantee newly issued debt securities and (founded) other liabilities of financial sector enterprises. All liabilities may have a maximum term of 60 months.
- Recapitalization: Investing in equity (recapitalization) of financial institutions in the amount of up to EUR 10bn. This may be achieved by the issuance of shares, silent participations or the acquisition of other elements of the financial institution's own funds.
- Assumption of risk positions: The Fund may assume risk positions (e.g. receivables, securities) in the amount of up to EUR 5bn from financial sector enterprises that were acquired by financial sector enterprises prior to 13 October 2008.

Financing

- The Fund may grant guarantees in an amount up to 400 billion Euros. In case a guarantee is enforced the Federal Ministry of Finance can take out credits in an amount up to 20 billion Euros as coverage.
- The Federal Ministry of Finance can take out credits in an amount of up to 70 billion Euros to provide recapitalization measures and to assume risk positions. With the consent of the budget committee of the German Parliament this credit amount can be extended by up to another 10 billion Euros.

SoFFin: Structure



Prominent Applicants (1)

COMMERZBANK

- During 2008, the second largest German bank, Commerzbank AG ("Commerzbank"), negotiated and finalized its takeover of Dresdner Bank AG.
- Due to credit risks of Dresdner Bank AG which became apparent in December 2008, Commerzbank filed for state aid with SoFFin and received EUR 16.4bn in form of a silent participation against payment of 9 % interest p.a and the suspension of dividend payments in 2009 and 2010. Commerzbank agreed to reduce the remuneration of the management board members and to provide additional EUR 2.5bn as loans for SME.
- In addition, SoFFin guaranteed debt securities issued by Commerzbank with a maximum term of 36 month with EUR 15bn. The interest rates for the guarantees range from 0.5 to 0.948 p.a., dependent on maturity and utilization.
- In May 2009, the Federal Republic of Germany purchased newly issued shares for EUR 1.77bn which represent 25 percent plus one share of Commerzbank share capital.

Prominent Applicants (2)

Hypo Real Estate GROUP

- Hypo Real Estate Holding AG ("HRE") encountered financial difficulties during the liquidity crisis of September 2008, principally due to the heavy debt burden of its subsidiary, Dublin-based Depfa Bank plc.
- On 29 September 2008, a EUR 35 bn credit line was extended to HRE from the German government and a consortium of German banks. The deal fell apart on 4 October 2008 after the banking consortium involved pulled out.
- A second proposed bailout was agreed on 6 October 2008, with German banks to contribute EUR 30 bn and the German Federal Bank (*Deutsche Bundesbank*) EUR 20 bn to a credit line.
- In February 2009, HRE was granted further framework guarantees by SoFFin, taking HRE's total state funding to EUR 52 bn.
- On 17 April 2009, SoFFin tendered an offer to take over HRE by buying and creating shares that would raise its equity stake to 90 %. On 24 April 2009, the HRE governing boards recommended that shareholders approve the offer by SoFFin. By that date, government support for the company had reached EUR 102 bn.
- With the German state (via SoFFin) already owning 90% of HRE, an extraordinary general meeting on 5 October 2009 approved a EUR 1.30 per share squeeze out of the remaining private shareholders, including J.C. Flowers (which a year earlier had held a 25 % stake). The decision resulted in the complete nationalization of HRE within a year of it having been a DAX constituent.

Prominent Applicants (3)

IKB
Deutsche Industriebank

- Small and medium-sized companies creditor IKB Deutsche Industriebank AG (“IKB”) was the first European bank to declare financial trouble due to the US subprime disaster.
- IKB announced its difficulties on Monday, 30 July 2007 by means of a profit warning.
- The weekend before such announcement, IKB’s majority shareholder KfW and Germany’s bank associations agreed to rescue IKB with EUR 3.5bn (70 % provided by KfW and 30 % by other banks).
- On 29 November 2007 received an additional guarantee in the amount of EUR 350m issued by a group of banks.
- On 7 January 2008, KfW signed a EUR 54m convertible bond issued by IKB which has been converted into share capital only few weeks later. KfW’s share in IKB thereby increased to 43,4 percent.
- In February 2008 KfW provided IKB with further EUR 1.05bn. Moreover, IKB announced a capital increase of EUR 1.5bn with KfW as firm underwriter. As a consequence, KfW’s share in IKB rose to 90.8 percent.
- In October 2008 KfW sold its shares in IKB to the US based Lone Star Funds for EUR 137m. After this takeover, SoFFin provided guarantees worth EUR 5bn in December 2008. In July 2009 SoFFin added further guarantees amounting to EUR 7bn.

Bad Banks (1)

Background

- On 23 July 2009, the German Parliament passed the Act on Further Development of Financial Markets Stabilization (*Gesetz zur Fortentwicklung der Finanzmarktstabilisierung*).
- The act enables banks to remove toxic assets from their balance sheets in order to gain additional core capital resources without being obliged to raise fresh equity.
- Banks may transfer their toxic assets into “bad banks”, either in form of a special purpose vehicles (“SPV”) or a run-off vehicles (*Abwicklungsanstalten*).

Special Purpose Vehicle

- Banks may transfer structured securities (*strukturierte Wertpapiere*) acquired not later than 31 December 2008 to an SPV against receipt of bonds issued by the SPV and guaranteed by SoFFin for a maximum term of 20 years. The bank must pay a guarantee fee to SoFFin.
- The (toxic) securities must be transferred with a deduction of 90 % on their book value. The deduction may, however, only be made to the extent the core capital ratio remains 7 percent.
- Due to such transaction, the balance sheet shows the (guaranteed) securities of the SPV and not the toxic structured securities. The bonds are eligible for refinancing with central banks.
- The bank has to use its profits to compensate the SPV for losses resulting from the transferred securities over a stretched period of time (in accordance with the term of the SoFFin guarantee).
- If – at the end of the term of the SoFFin guarantee – not all such losses have been compensated, the bank is not allowed to pay any dividends to its shareholders until the losses are covered.
- To the extent a surplus remains after the work-out and realization of the structured securities, such surplus will transferred to the bank for distribution to its shareholders.

Bad Banks (2)

Run-Off Vehicles

- In contrast, Banks may transfer whole business units – including toxic securities and other risk positions, both acquired not later than 31 December 2008, or non-strategic parts – into a run-off vehicles (*Abwicklungsanstalten*).
- Each run-off vehicle has partial legal capacity and is an economically and organizationally independent unit within the German Financial Market Stabilization Agency (*Finanzmarkt-stabilisierungsanstalt,* “FMSA”) - which also manages the SoFFin. The FMSA supervises any run-off vehicle.
- The owners of the transferring bank become also owner of the run-off vehicle and participate in its profits or liquidation proceeds and have to bear its losses.
- The required equity of the run-off vehicle has to be provided by the owners.
- The run-off vehicles are not considered as credit institutions or financial service institutions within the meaning of the German Banking Act (*Kreditwesengesetz,* “KWG”).
- As the run-off vehicle is taken off the transferring bank‘s balance sheet and as the run-off vehicle is not subject to the equity requirements of the KWG, the transferring bank may directly be unburdened from loss-generating business units and assets.

Prominent Applicants

- On 24 November 2009, the shareholders of WestLB AG ("WestLB") - the savings banks and the Federal State of North Rhine-Westphalia – and the Federal Government agreed upon an emergency response plan for WestLB.
- The emergency response plan contains the following measures:
  - WestLB will be split up into a core bank ("New WestLB") and a bad bank.
  - WestLB will transfer toxic securities in the amount of approximately EUR 85bn to the bad bank.
  - WestLB will provide the bad bank with EUR 3bn equity, WestLB's shareholders undertook to inject additional EUR 1bn equity. In order to secure the bad bank's risks, WestLB's shareholders will also provide certain guarantees.
  - The expected loss of the bad bank amounts to EUR 4bn in addition to potential EUR 8bn losses considered as unlikely. Additional EUR 5bn risks derive from a portfolio of securities which has already been collateralized.
  - SoFFin will provide EUR 3bn to the New WestLB" in form of a silent participation. Not earlier than 1 July 2010, such participation may be swapped into shares of the bank. The maximum shareholding may not exceed 49 % of the share capital. The Federal Government's intention, however, is to seek new investors for New WestLB.
- The emergency response plan is still subject to EUR approval.

Role of the Central Banks

- The European Central Bank ("ECB") loaned billions of Euros to banks to stabilize the financial system during the financial crisis.
- In addition, ECB lowered the key interest rate from 4.0 % at the beginning of 2008 in several steps to 1.0 % in May 2009.
- In December 2007 the ECB decided, in cooperation with the Federal Reserve, to improve dollar liquidity in the Eurozone (economic and monetary union of 16 European Union member states which have adopted the euro currency as their sole legal tender) and to stabilize the money market.
- Notwithstanding, ECB currently uttered that increased spending is not the cure for the ongoing financial crisis, contradicting current U.S. financial policy.

- Together with the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*), the German Central Bank (*Deutsche Bundesbank*) supervises the German financial institutions, in particular as regards solvability.
- The German Central Bank has been involved in various rescue measures, e.g. for Hypo Real Estate (participation in a syndicated liquidity line).
- The German Central Bank refinances SoFFin-guaranteed bonds issued by bad banks (in form of an SPV) which could be seen as a factual purchase of non-rediscountable toxic securities.

B.

Current German Discussion and Assessment

Subjects

Roots of the Crisis

- Many Germans regard the financial crisis as a result of a highly distorted financial market in which excessive concentration of risks, excessive leverage, dubious theories of risk management combined with greed for power and money create huge ticking time-bombs in form of toxic assets and bubbles.
- As a consequence, the financial crisis is often not regarded as some kind of catastrophe that affects everyone, but as a problem of a certain group of persons (in particular, the so-called “banksters”). In 2009, protests themed “we don’t pay for <u>your</u> crisis” took place in several major cities of Germany.

Effect of the emergency measures

- German economists and other experts warn that the emergency measures adopted to remedy the crisis may make matters even worse, “zombie-banks” have been created.
- It is seen very critical that the cheap liquidity provided by the central banks may lead to the next bubble at the financial markets.

Break Up Companies too Big to Fail

- Another major point of criticism is that most governments have resisted to split up large banks into several pieces to reduce the potential risks posed by giant institutions which are “too big to fail”.
- However, the British government decided to grant Lloyds Banking Group and Royal Bank of Scotland additional financial aid. In return, the government ordered the banks to shrink their businesses substantially. Germany’s newly elected governing coalition discussed a proposal which provides for dissolution of conglomerates.

Restrictions on Financial Aid due to EU-Laws

General

- Financial aid granted by the German government must comply with European law, i.e. financial aid and subsidies must not impede the free competition on the European market.
- Hence, the Competition Commissioner of the EU plays a decisive role: growing concerns regarding a potential distortion of competition by governmental aid already led to intervention by the competition commission.

Examples

- <u>Commerzbank AG</u>
  - The Federal Government pressed for a merger between Commerzbank and Dresdener Bank since a failure would have left both companies as valuable takeover targets especially for foreign banks.
  - Substantial financial state aid including partial nationalization remained as the only viable solution to maintain both banks as German banks.
  - The conditions for the financial aid granted by SoFFin had to be stipulated again after discussions between the Federal Government and the European Commission: the Commission considered the initially agreed terms as too advantageous for Commerzbank and therefore as unfair competition.
  - The European Commission also imposed the condition on Commerzbank to sell its real estate division Eurohypo.
- <u>Adam Opel GmbH (General Motors)</u>: the competition commission raised concerns over Germany's financial aid for Opel after Great Britain, Spain and Belgium demurred that such aid is linked with the undertaking not to shut down German production facilities.

C.

Future Perspectives for Industry-Related Policies in Germany / Measures to tackle the Crisis

Subjects

"Active" policies to enhance industries in Germany

- For the coming years, Germany expects a sharp rise in number of unemployed workers. Hence, the German people might pressure their government to expand governmental stimulus packages. However, the government does not have that much maneuver space due to the Maastricht restrictions.
- The German government and the governments of the Federal States might engage again in "active" policies to enhance industries in Germany in order to preserve jobs (as already seen in the Opel-case).
- Nevertheless, Germany will likely not be able to maintain nationalized industries or to reinvent the Germany Inc. in a globalized economy independent of national restrictions.

New Focus on New Technologies

- The new Federal Government elected in September 2009 should focus on new technologies such as alternative energies or modern information and communication technologies. Moreover, the government needs to focus on cutting red tape that burdens entrepreneurial efforts.
- Subsidies for "old" industries must fade out as such subsidies only defer market adjustment and pour national wealth down the drain.
- A fundamental reorganization of industries open to foreign investors is preferable to "national solutions".

Outlook

- Growing discussions “The worst is yet to come”.
- Federal State Banks (*Landesbanken*) and major commercial banks still have to work out the bulk of their toxic asset portfolios.
- Government considers solutions for the problems of the Federal State Banks which are without any real use in a modern banking environment, however, due to constitutional restrictions, the Federal States can delay break-ups and mergers into one or two big banks.
- Reform of the German Insolvency Act (*Insolvenzordnung*) under consideration, e.g.
  - Creditors shall become entitled to appoint the insolvency administrator (instead of the insolvency court).
  - The insolvency administrator shall no longer be responsible for the accounting. Instead, the accounting shall be made by another independent expert.
  - Revision of the compensation policy for the insolvency administrator. A major point of criticism is that insolvency administrators care more for their fees than for the creditors and the insolvent company.
  - Special receiverships for banks that are considered too big to fail.
- Treuhand II: safe haven for the German Mittelstand and the big industry?
- Fundamental Question: solving the problems by papering over or only by defaulting excess debt?

BROICH BEZZENBERGER

BERLIN
Kurfürstendamm 59-60
D-10707 Berlin
Tel.: +49 (0)30-893 664 0
Fax. +49 (0)30-893 664 10

FRANKFURT
Bockenheimer Landstraße 51-53
D-60325 Frankfurt am Main
Tel.: +49 (0)69-26 48 46 10
Fax. +49 (0)69-26 48 46 20

VIENNA
Kärntner Straße 7
A-1010 Wien
Tel.: +43 (0)1 512 216 6
Fax. +43 (0)1 512 216 669

www.broich.com

BROICH BEZZENBERGER