The German Financial Market Stabilization Program

Frankfurt
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On October 17, 2008, the German Federal Parliament (*Deutscher Bundestag*) and the German Federal Council (*Bundesrat*) completed legislative action under a fast-track procedure regarding the German Act on the Implementation of Measures to Stabilize the Financial Market (*Finanzmarktstabilisierungsgesetz*; the "**Act**"). The Act entered into force on October 18, 2008 and authorizes far-reaching measures with a view to stabilizing the German financial market, to safeguard the supply of capital for the German economy and to protect holders of savings deposits and investors. Key elements of the Act include:

- the creation of a public Financial Market Stabilization Fund (*Finanzmarkt-stabilisierungfonds*; the "**Fund**") and a Financial Market Stabilization Authority (*Finanzmarktstabilisierungsanstalt*; "**FMSA**");

- the authorization of the Federal Ministry of Finance (*Bundesministerium der Finanzen*; "**BMF**") to improve the access of financial institutions to liquidity and strengthen the confidence in the inter-bank market by issuing on behalf of the Fund credit guarantees in an amount of up to €400 billion for certain liabilities of such institutions; and

- the authorization of the Fund (i) to participate in the recapitalization of distressed financial institutions, in particular by contributing capital in exchange for certain equity or hybrid instruments issued by such institutions, and (ii) to acquire or hedge certain risk assets of financial institutions to provide relief to their capital base. This authorization is limited to an aggregate amount of €80 billion.

The provisions of the Act will be supplemented by regulations (*Rechtsverordnungen*) to be adopted by the German Government or the BMF, in which the Act vests far-reaching powers to further define the Fund's activities. On the basis of the Act, the German Government adopted on October 20, 2008 the Regulation on the Execution of the Financial Market Stabilization Fund Act (*Finanzmarktstabilisierungs-fonds-Verordnung*, the "**Regulation**").

The measures contemplated by the Act and the Regulation form part of a coordinated campaign by Western governments. They are consistent with the principles

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agreed among the European G8 member states on October 4, 2008 and reflect the decisions of the Council of European Union Finance Ministers of October 7, 2008, the meeting of the G7 finance ministers and central bank governors of October 10, 2008 as well as the consultation of the Euro Zone member states of October 12, 2008.

This memorandum summarizes key aspects of the Act and the Regulation that should be of interest to financial institutions and other market participants.

1. Status of the Fund and the FMSA

The Fund constitutes a special fund (*Sondervermögen*) of the Federal Republic of Germany, which in its own name may acquire rights and incur obligations for which the Federal Republic of Germany will be liable. Subject to supervision by the BMF, the Fund will be managed by the FMSA, which is established as an agency within the German Central Bank (*Deutsche Bundesbank*). The BMF is authorized to adopt the charter of the FMSA as well as administrative guidelines for the FMSA's operation of the Fund.

The capital required for the Fund's activities will be raised by issuing debt securities up to a budgeted amount of €100 billion, which amount will cover €80 billion for recapitalization measures as well as €20 billion for potential defaults on liabilities guaranteed by the Fund.[1]

2. Financial Institutions Eligible to Participate in the Program

Financial institutions eligible to apply for stabilization measures by the Fund include all German financial institutions in the broadest sense, *i.e.*:

- credit and financial services institutions within the meaning of the German Banking Act (*Kreditwesengesetz*) from the private, the public and the co-operative sector,
- insurance companies and pension funds within the meaning of the German Insurance Company Supervision Act (*Versicherungsaufsichtsgesetz*),
- investment companies (*Kapitalanlagegesellschaften*) within the meaning of the German Investment Act (*Investmentgesetz*),
- operators of securities and futures exchanges, as well as
- parent companies of the foregoing enterprises, provided that such enterprises have their registered seats in Germany and the parent companies (i) qualify as financial holding company (*Finanzholding-Gesellschaft*), mixed financial

[1] *See* Article 1 § 9 of the Act.

holding company (*gemischte Finanzholding-Gesellschaft*) or supervised financial conglomerate enterprise (*beaufsichtigtes Finanzkonglomerats-unternehmen*), or (ii) are private law companies that have been entrusted (*beliehen*) with the sponsorship (*Trägerschaft*) of a public *Landesbank*.

Certain measures of the Fund will also be available to special-purpose investment vehicles that have assumed risk positions from the foregoing financial institutions.

German subsidiaries of foreign financial institutions will be eligible participants in transactions with the Fund, as long as they are solvent.[2] In exceptional cases, the Fund may also salvage German subsidiaries in distress, provided that such companies are important to the functioning of the financial markets (*systemrelevant*) and there is a clear prospect of restructuring. However, the stabilization program will not be available to German branches of foreign financial institutions.

While the Fund was created to restore confidence in the financial sector, the Act explicitly states that financial institutions have no enforceable right to stabilization measures by the Fund for their benefit. Rather, the BMF is authorized to decide, in its lawful discretion, whether an eligible institution shall benefit from Fund stabilization measures. Depending on the facts and circumstances, the BMF might conclude that a bail-out would not be justified and therefore deny the application from an eligible institution.

Also, and more importantly, financial institutions in distress have no obligation under the Act to turn to the Fund for rescue, although managers of financial institutions could face substantial liability risks under German corporate law if they fail to apply for assistance from the Fund, or turn to the Fund too late to avoid insolvency or other serious damage to the financial institution as a result of the crisis.

So far, private banks have been more hesitant than the public *Landesbanken* in expressing their interest in transactions with the Fund. We believe that all financial institutions whose capital bases are currently strained should consider developing a concept for possible transactions with the Fund and possibly explore the FMSA's view on eligibility of the financial institution in order to be in a position to swiftly engage in transactions with the Fund if need be.

3. Conditions for the Availability of the Fund's Stabilization Measures

Pursuant to the provisions of the Act and the Regulation, financial institutions that enter into transactions with the Fund will be subject to restrictions concerning a wide range of management decisions and corporate measures.

The issuance of credit guarantees by the Fund requires financial institutions applying for such guarantees to re-examine their strategic focus and the sustainability of their business activities. The Fund may demand that such financial institutions reduce or

[2] *See* Press Release of the BMF of October 13, 2008 announcing the stabilization program.

eliminate certain risks, *e.g.* by abandoning particular business activities with regard to certain products or areas.

In the event of a recapitalization involving the Fund, or the acquisition or hedging of risk assets by the Fund, additional restrictions apply. In particular, the Fund may make these measures conditional upon the following prerequisites:

- ***Strict limits on executive remuneration, which shall not exceed an annual ceiling of €500,000 per board member* (Organmitglied) *or managing director* (Geschäftsleiter)**

  This ceiling applies to all payments received from the financial institution, group companies or companies that maintain significant business relationships with the recapitalized financial institution and its affiliates. Payments to be credited against (and thereby reducing) the ceiling include base salary, pension commitments and any other commitments of the foregoing companies. Financial institutions shall enforce the ceiling within the limits of German civil law, including the provisions of the German Stock Corporation Act (*Aktiengesetz*) regarding a reduction of the management board members' remuneration for cause.[3]

  The Fund may demand that the individual remuneration of executives be published in the Electronic Federal Gazette (*elektronischer Bundesanzeiger*), unless such information was provided in the notes to the financial statements of the financial institution.

- ***Ban on bonus payments and golden handshakes***

  For the duration of the stabilization measures, a financial institution shall not pay discretionary bonuses to its board members or managing directors. This limitation, however, shall not preclude an institution from making bonus payments to an executive if such bonus shall compensate the executive for a low base salary and the aggregate remuneration of such executive remains adequate (*i.e.*, the €500,000 ceiling applies).

  When entering into new service contracts with board members or managing directors, a financial institution shall not agree to severance payment clauses triggered by a change of control or an early termination of the service relationship with such executives.

- ***Review of remuneration schemes***

  The financial institution concerned shall review the adequacy of its remuneration scheme. To the extent permissible under German civil law, the

[3] *See* § 87(2) of the German Stock Corporation Act.

financial institution's remuneration scheme shall be adjusted to the effect that (i) it does not create incentives to enter into unreasonable risks, (ii) adequately reflects long-term and sustainable goals and (iii) provides for a sufficient degree of transparency.

- ***Ban on dividends and other payments***

  For the duration of the stabilization measures, the financial institution shall not distribute any dividends to its shareholders other than the Fund. Similarly, the financial institution shall not reduce its share capital (except for recapitalization purposes), buy treasury shares or make any other payments without legal obligation to its shareholders or their respective parent companies.

With regard to the implementation of the foregoing measures, the Act provides that the applicable restrictions shall become binding on a financial institution by way of agreement, unilateral commitment of the institution or an administrative order (*Verwaltungsakt*) by the BMF. The BMF is authorized to determine the legal consequences of non-compliance with the respective obligations.

From the perspective of executives of large institutions, the strict compensation limits could create significant disincentives for turning to the Fund for stabilization measures. It remains to be seen whether these limits result in counterproductive effects or whether they otherwise undermine the effectiveness of the measures contemplated by the Act (*e.g.*, because the management tends to apply for such measures too late). Obviously, given the current debate about executive pay generally and those of executives at financial institutions in particular, executives may come under tremendous pressure to accept the limit.

4. Credit Guarantees

In order to safeguard the liquidity supply of financial institutions, the BMF is authorized to issue on behalf of the Fund credit guarantees for debt instruments and liabilities of financial institutions with maturities of up to 36 months, provided that such instruments or liabilities have been issued or incurred (i) after the Act has become effective and (ii) not later than on December 31, 2009. Credit guarantees will generally be issued as guarantees upon first demand (*auf erstes Anfordern*). Institutions using such guarantees will be charged an "adequate" fee comprising a risk-specific percentage of the amount covered by the respective guarantee and a premium. Pursuant to the official annotations to the Act, such fee shall equal at least 2% of the amount covered by the respective guarantee.[4]

[4] This compares to a 75-basis point fee charged by the Federal Deposit Insurance Corporation (FDIC) to protect new debt issues of U.S. institutions under the FDIC's "Temporary Liquidity Guarantee Program" announced on October 14, 2008. A 10-basis point surcharge will be added to

Lenders should take into consideration that the Act does not provide for a statutory guarantee of all (distressed) liabilities incurred by eligible institutions within the foregoing time frame. Depending on the circumstances, the FMSA and the BMF could refuse to issue a guarantee if they conclude that the applicable prerequisites have not been met or a guarantee would not be justified for other reasons. An important prerequisite for obtaining a credit guarantee from the Fund is the "sufficiency" of the financial institution's own funds (*Eigenmittel*), which will be assessed by the FMSA and the BMF on an individual basis and limit the maximum amount of credit guarantees available to such financial institution.[5]

German covered bonds (*Pfandbriefe*) will not be guaranteed by the Fund. The German Government takes the position that these instruments are already safe under the existing statutory provisions, so that the market for German covered bonds should remain active without further support. Should the functioning of this market require additional safeguards, the German Government stated that it intends to take short-term legislative action to address these concerns.

For lenders being subject to regulatory solvability requirements and large exposure limitations (*e.g.*, banks and financial services institutions), guarantees issued by the Federal Republic of Germany on behalf of the Fund would qualify as credit risk mitigation pursuant to the provisions of the applicable regulatory regime. Such guarantees could thus reduce the lenders' regulatory capital requirements for exposures to financial institutions covered by the guarantees. This could be particularly relevant with regard to inter-bank loans that, based solely on their maturity or the debtor's rating, would not meet the prerequisites for a privileged regulatory risk-weighting.

5. *Recapitalization of Distressed Financial Institutions*

While credit guarantees focus on the liquidity supply of financial institutions, the Fund's authorization to participate in recapitalization measures aims at stabilizing the balance sheets and the regulatory capital base of institutions in distress. As a general rule, however, credit guarantees are to be treated as a preferred measure, so that the Fund shall only participate in a recapitalization of a financial institution if credit guarantees do not provide for a sufficient stabilization of such institution.[6]

a) General

Up until December 31, 2009, the Fund may make capital contributions to distressed financial institutions in exchange for (i) equity stakes, such as ordinary shares (*Stammaktien*) or preference shares (*Vorzugsaktien*), or (i) hybrid instruments, such as

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a participating institution's current insurance assessment in order to fully cover non-interest bearing deposit transaction accounts.

5 *See* § 2(2) clause 3 nos. 3 and 6 of the Regulation.

6 *See* § 2(2) clause 1 of the Regulation.

profit participation rights (*Genussrechte*) or silent partnership interests (*Vermögensein-lagen stiller Gesellschafter*).[7] As a general rule, the aggregate capital contributions to an individual entity and its respective affiliates is limited to a maximum amount of €10 billion.[8]

Capital provided to banks or financial services institutions within the meaning of the German Banking Act shall be primarily contributed in the form of core capital (*Kernkapital*) and aim at stabilizing the recipient's own funds (*Eigenmittel*) within a reasonable time frame. With regard to silent partnership interests, it should be noted that such instruments may be recognized as core capital of a bank or financial services institution, if they meet certain requirements. In particular, silent partnerships interests will only qualify as core capital for Basel II purposes if they are perpetual. In addition, the BaFin will only recognize such instruments as core capital up to a certain limit, which, depending on the facts and circumstances of the individual institution, may be approximately 25% of its aggregate core capital (including all "innovative" hybrid capital and outstanding silent partnership interests).

Recapitalization measures shall only be effected if "important" national interests require them and there is no better or more efficient means to realize the goals pursued. A recapitalization will also be subject to further conditions determined by the FMSA on an individual basis, such as:

- a compensation of the Fund's capital injection at arm's length terms;
- the seniority of the Fund's claims over the other shareholders' right to share in the profits of the recapitalized institution (*e.g.*, by way of a preferred right to profits or a right to receive interest); and
- the requirement that the financial institution's existing shareholders make additional capital contributions as part of the recapitalization.

b) Capital Increase

The Act contains specific provisions to increase transaction certainty and ensure the quick execution of recapitalizations agreed with the Fund. Most importantly, the Act creates a statutory authorized capital (*gesetzliches genehmigtes Kapital*) for financial institutions organized in the form of a stock corporation (*Aktiengesellschaft*), a European stock corporation (*Societas Europaea*) or a company limited by shares

[7] In this context, the Act explicitly provides that silent partnership agreements between a financial institution and the Fund do not qualify as company agreement (*Unternehmensvertrag*) within the meaning of the German Stock Corporation Act.

[8] Any amount in excess of €10 billion requires a decision of a Steering Committee (*Lenkungsaus-schuss*) established at the level of the German Government and comprising representatives of various Federal Ministries, the Federal States (*Bundesländer*) and the German Central Bank; *see* Article 1 § 4(3) of the Act and § 3(2) no. 3 of the Regulation.

(*Kommanditgesellschaft auf Aktien*). Pursuant to the provisions of the Act, the management board (*Vorstand*) is authorized, subject to the consent of the supervisory board (*Aufsichtsrat*), to increase the company's registered share capital (*Grundkapital*) by up to 50% of its registered share capital existing at the time the Act entered into force. Unless provided otherwise in the Act, the general provisions on capital increases set forth in §§ 185 to 191 of the German Stock Corporation Act (*Aktiengesetz*) also apply in this regard.

The new shares created out of the statutory authorized capital must be issued to the Fund, and the Act specifically excludes the statutory preemptive rights of the existing shareholders in this regard.[9] In return, the Fund shall, to the extent practicable, grant the shareholders pre-emptive rights when disposing of shares issued out of the statutory capital (*see* Section 5 c)).

In order to allow for a quick injection of capital in emergency situations, the Act further provides that the Fund may make a capital contribution even before the management board has formally decided to make use of the statutory authorized capital. The capital so contributed may then be credited against the Fund's contribution obligation relating to its subscription of the new shares issued out of the statutory authorized capital.[10]

With the supervisory board's consent, the management board is also authorized to determine the features of the new shares (*e.g.*, a preferential participation in the company's profits, voting rights) and the specific conditions of the issuance. In this context, the Act explicitly provides that the management board may issue new shares out of the statutory authorized capital at a discount from the price at which the company's shares trade at the time of the issuance. When determining the issue price, the management board is obliged to give due consideration to the legal principle of proportionality and the ownership rights of the existing shareholders. If the management board fails to exercise reasonable business judgment by agreeing to an inadequate discount from current market prices, German stock corporation law generally provides that the existing shareholders may bring an action against the company or file for injunctive relief to prevent an undue dilution of their ownership interests.[11] The Act does

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9 Existing shareholders enjoy the constitutional protection of their property interest under Article 14 of the German Constitution. Exclusion of their preemptive rights affect their property interests, and it remains to be seen whether the Act is going to be challenged in this respect. According to press reports, the first constitutional appeal has been filed against the Act, arguing that the Act violates the Constitution's budgetary principles as well as the equal treatment principle by affording the financial services industry an unfair advantage over other industries.

10 Pursuant to the general provisions of the German Stock Corporation Act, prepayments on a future capital increase only qualify as a cash contribution under very limited circumstances. Generally, prepayments on a future capital increase qualify as contribution in kind and therefore are subject to the strict statutory rules applicable thereto. The statutory authorized capital increase is thus privileged as compared to a capital increase pursuant to the general provisions of the German Stock Corporation Act.

11 *See* § 255(2) of the German Stock Corporation Act.

not specifically state whether the respective statutory provisions of the German Stock Corporation Act also apply to the issuance of shares out of the statutory authorized capital.[12] Even though there are good arguments in favor of an (analogous) application, it remains to be seen which position the courts will take in this regard.

The existence of a statutory authorized capital does not preclude financial institutions from using authorized capital resolved by their shareholders' meeting, provided, however, that the amount of share capital issued out of the statutory authorized capital under the Act will be credited against, and thus reduce, the existing amount of authorized capital resolved by the shareholders' meeting.[13] A recapitalization in which the Fund participates may also take the form of a regular capital increase resolved by the shareholders' meeting, in regard of which the Act contains further procedural provisions. In particular, a regular capital increase could become relevant if the ceilings of the (statutory and general) authorized capital available to a financial institution have already been reached.

Publicly listed financial institutions in need of equity capital will likely be considering all possible measures of raising equity, in particular through large rights offerings. Given the current market situation, in particular the high volatility of financial institutions' stocks, such rights offerings will require significant discounts to market in order to be successful, and even with substantial discounts financial institutions might find it difficult in the current market environment to obtain underwriting commitments by banking syndicates for the rights not taken up (the so-called "rump"). In such a scenario, a transaction structure that might be worth discussing with the FMSA is that the FMSA firmly commits that the Fund will acquire the shares that cannot otherwise be placed in the market. This transaction structure would, on the one hand, provide an incentive to the financial institutions' shareholder base to fully participate in the rights offering (given the perceived stigma that results from having the Fund as a shareholder), and, on the other hand, provide certainty to the financial institution that it will in fact cover its equity needs through the rights offering. While the issuance of a commitment to acquire the "rump" shares that cannot otherwise be placed in the market at the subscription price would generally be consistent with the provisions of the Act and the Regulation[14], it remains to be seen under which circumstances the Fund would actually issue such commitment in the context of a capital increase.

Finally, it should be noted that the provisions of the German Takeover Act (*Wertpapiererwerbs- und Übernahmegesetz*) regarding mandatory tender offers do not apply to the Fund, should the Fund acquire "control" within the statutory meaning (*i.e.*,

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12 The Act only refers to §§ 185 to 191 of the German Stock Corporation Act, but not to its § 255(2).

13 Conversely, the amount of capital issued out of the outstanding authorized capital resolved by the shareholders' meeting will NOT be credited against the ceiling for the statutory authorized capital.

14 *See* § 3(2) no. 3 of the Regulation, pursuant to which a capital contribution of the existing shareholders may be required as prerequisite for a capital contribution by the Fund.

at least 30% of the voting rights) of a publicly listed institution as a result of its recapitalization.

c) Exit of the Fund

The Fund is generally entitled to dispose of any financial instruments acquired in the recapitalization of an institution by transferring such instruments to a third party. Shares with preferential dividend rights issued to the Fund will thereby cease, by operation of law, to participate in the company's profits on a preferential basis. The Fund is also authorized to convert preference shares into ordinary voting shares (*stimmberechtigte Stammaktien*) upon their transfer to a third party.

To the extent practicable, the Fund shall first offer the financial instruments to the company's shareholders whose preemptive rights to such instruments were excluded in the recapitalization. With regard to publicly listed financial institutions, such an offering would be subject to the provisions of the German Securities Prospectus Act (*Wertpapier-prospektgesetz*) and thus require a securities prospectus, unless a statutory exemption is available under the circumstances of the particular offering. In the event that a securities prospectus is required for a public offering of securities by the Fund, the issue arises whether the financial institution concerned as the issuer of the securities may validly assume liability for the securities prospectus. Generally, the assumption of prospectus liability by an issuer in the context of a public secondary offering by a shareholder may constitute a prohibited repayment of capital (*Einlagenrückgewähr*) to such shareholder if the issuer does not receive adequate consideration, *e.g.* in the form of an "insurance premium" or otherwise.[15] It remains to be seen how the courts would apply this principle in the context of a secondary public offering of securities by the Fund. The Fund might argue that its participation in the recapitalization measure implicitly includes adequate consideration for the prospectus liability risk of the financial institution in the context of a public offering of the stake held by the Fund.

To the extent practicable, the Fund shall also avoid an undue negative impact on market prices when disposing of financial instruments.[16] As the successful placement of large equity stakes in a public rights offering might be difficult, the Fund may have to develop additional exit strategies. There is a substantial number of exit and monetization strategies that the Fund might consider once the financial crisis has been overcome and the institutions have regained their financial strength:

- The Fund may, for example, consider issuing mandatory exchangeable bonds on equity stakes held by the Fund.

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15 *See* the decision of the District Court (*Landgericht*) Bonn dated June 1, 2007 (AG 2007, 715) regarding a secondary offering of shares in Deutsche Telekom AG by the Kreditanstalt für Wiederaufbau (KfW).

16 *See* § 3(3) of the Regulation.

- Also, the Fund may consider disposing of these stakes through a series of block trades, which could offer financial and strategic investors attractive opportunities to acquire significant participations in the respective financial institutions.

- By contrast, exit strategies involving a share buy-back by the issuer would be less likely, as the German Stock Corporation Act contains significant limitations on such buy-back programs, which are not amended by the provisions of the Act. A share buy-back would in most cases require an authorization by the issuer's shareholders' meeting and be limited to 10% of the issuer's registered share capital. In addition, the statutory principle of equal treatment may require that all shareholders (and not only the Fund) may tender their shares into the buy-back program. If the Fund holds preference shares, it should, however, be possible to limit the buy-back program to such class of preference shares.

6. Acquisition or Hedging of Assets

The Fund is further authorized to stabilize the (regulatory) capital base of distressed financial institutions by purchasing or hedging assets held by such institutions or special-purpose investment vehicles to which these assets have been transferred[17], provided that such assets were acquired prior to October 13, 2008.

At the core of the current crisis are financial instruments for which an active market has ceased to exist:

- Institutions carrying such financial instruments at fair value in their balance sheet had to recognize significant losses or charges against shareholders' equity, even if these instruments were not impaired.

- Under IFRS, a reclassification of assets carried at fair value to an accounting category allowing for a carrying at (amortized) costs used to be practically impossible.

- In order to limit the impact on their profit and loss statement and revaluation reserves and to avoid a continuing erosion of their capital base, some financial institutions therefore transferred certain risk positions to other entities (*e.g.*, special-purpose investment vehicles refinanced by their shareholders).

[17] Risk assets held by special-purpose investment vehicles shall only be acquired or hedged by the Fund to the extent that the transferring financial institutions continue to bear a significant counterparty and/or liquidity risk with regard to such assets. The Fund shall ensure that an adequate risk participation of the respective financial institutions be maintained, *see* § 4(2) clause 2 no. 5 of the Regulation.

In this context, the Act provides that the Fund may also act as an acquirer of risk positions, which could be particularly relevant for institutions that otherwise would not be in a position to transfer their financial assets to third parties. As a general rule, the risk transfer from a financial institution and its respective affiliates is limited to a maximum amount of €5 billion[18] and requires sufficient own funds (*Eigenmittel*) on the part of the transferring financial institution.[19] The assets will be transferred or hedged at their carrying value, as reflected in the latest annual or interim financial statements of the transferring entity. The Fund shall ensure that it receives adequate compensation for the risk transfer, which shall at least equal its own refinancing costs.

When disposing of the acquired assets, the Fund shall avoid an undue negative impact on the market prices of such assets. The Fund may hedge itself against potential losses resulting from the assets by committing the transferring financial institution (i) to repurchase the assets from the Fund at a certain price or (ii) to indemnify the Fund against any such losses, provided that this commitment shall not prevent the derecognition of the assets from the transferring financial institution's balance sheet.

Meanwhile, the International Accounting Standards Board (IASB) and the European Commission have provided additional relief by amending the applicable international accounting standards on the recognition and measurement of financial instruments (IAS 39) and the related disclosures (IFRS 7). The amendments permit a reclassification of certain financial assets out of the "fair value through profit and loss" and "held for trading" categories, which imply that assets are being carried at fair value, to the "loans and receivables" and "held to maturity" categories, so that these assets will be carried at (amortized) cost and only be written down if they are impaired (*i.e.*, in the event of expected defaults or losses). However, the carrying amounts and fair values of the reclassified assets will have to be disclosed in the notes to the financial statements for each reporting period until derecognition of these assets. Financial institutions may apply this revised accounting framework as from the third quarter of 2008. Also, the amendments permit the calculation of fair value of financial instruments on the basis of DCF models, subject to certain conditions.

7. Amendment of Insolvency Law

The Act amends § 19(2) of the German Insolvency Act (*Insolvenzordnung*) to the extent that over-indebtedness (*Überschuldung*) does no longer require a company to file for insolvency, provided that the continuation of the company's business is deemed highly likely under the circumstances. Even if the company has negative assets, it may therefore continue its business, as long as it remains solvent (*zahlungsfähig*). It is

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[18] Any amount in excess of €5 billion requires a decision of the Steering Committee (*Lenkungsausschuss*) established at the level of the German Government; *see* Article 1 § 4(3) of the Act and § 4(2) clause 2 no. 6 of the Regulation.

[19] *See* § 4(2) clause 2 no. 3 of the Regulation.

noteworthy that this amendment to the German Insolvency Act applies to all companies subject thereto, and not just to financial institutions.

8. Competition Law Aspects

Measures taken by Member Sates to support their financial institutions may be subject to EU State aid rules and their compatibility with the EC Treaty assessed by the European Commission (the "**Commission**"). Over the last few days, the Commission has already examined, and approved, ad hoc individual interventions or general schemes launched in the context of the financial crisis.[20] On October 13, 2008, the Commission took a new step and released an important Communication regarding the application of its State aid rules to measures taken during the current global financial crisis to support financial institutions (the "**Communication**"). The Communication summarizes and expands on the principles under which the Commission intends to assess measures taken by Member Sates under State aid rules.

Key elements of the Communication include the following:

- the recognition by the Commission that it may not be appropriate to apply the normal rules on "rescue and restructuring aid" (in particular based on the Commission's Rescue and Restructuring Guidelines and Article 87(3)(c) of the EC Treaty) in the present market crisis, but that a more lenient approach (based on Article 87(3)(b) of the EC Treaty) should be adopted, which allows Member States to grant State aid to remedy a serious disturbance in their economy; this is the first time the Commission accepts to apply this provision in the context of a banking crisis;

- on guarantee schemes, the Communication allows these schemes to cover a wide range of liabilities, including retail and wholesale deposits/ inter-bank loans and certain short and medium-term liabilities. However, it does not cover guarantees for subordinated debt (tier 2 capital) or an indiscriminate coverage of all liabilities. Eligibility criteria for the guarantee must be objective and non-discriminatory. All financial institutions incorporated and with significant activities in the Member State concerned must be eligible to be covered by the scheme. Qualifying support schemes should be limited in time to two years at most and the scheme should be reviewed every six months. Private sector contribution should be ensured by an adequate remuneration of the guarantee, which might be postponed if necessary through a claw-back clause. Behavioral constraints such as limitation of the size of the balance-sheet, prohibition of share repurchases

[20] OJ C14-2008, April 2, 2008, *United Kingdom Restructuring aid to Northern Rock*; *State aid: Commission approves UK rescue aid package for Bradford & Bingley,* IP/08/1437, October 1 2008; *State aid: Commission approves revised Irish support scheme for financial institutions*, IP/08/1497, October 13, 2008; *State aid: Commission approves UK support scheme for financial institutions*, IP/08/1496, October 13, 2008.

or issuance of new management stock-options, may have to be imposed on institutions. If the guarantee is called upon, a restructuring or liquidation plan must follow and be submitted to the Commission;

- recapitalization schemes should be based on the same principles, in particular regarding eligibility criteria, temporal scope of the scheme, behavioral constraints, regular reports every six months;

- the same principles should again be applied in case of a controlled winding-up of financial institutions; in particular, the sale should be open and non-discriminatory and based on market terms;

- provision of liquidity assistance in principle does not constitute State aid when it is realized through general measures by Member States or central banks that are open to all participants such as open market operations or standing facilities. In addition, support to individual institutions does not constitute State aid if the financial institution is solvent, the facility is fully secured by collateral to which haircuts are applied, the central bank charges a punitive interest rate and the measure is taken at the central bank's own initiative. Liquidity schemes that do not fulfill these criteria, although they constitute State aid, may still be authorized according to the principles of the Rescue and Restructuring Guidelines and provided they are reviewed every six months.

These principles (and the Communication more generally) will be the basis for the assessment of the German scheme by the European Commission under the EU State aid rules. The Commission has put in place an organization that allows it to adopt State aid decisions linked to the financial crisis in record time (if necessary within 24 hours or over a week-end).

For a more detailed analysis of the Communication, see also our Alert Memorandum "The new Commission guidance on State aid and the financial crisis" of October 17, 2008, available on our website www.clearygottlieb.com.

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If you have any questions about the Act or the Communication, please contact any of the following lawyers in the German offices of Cleary Gottlieb:

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