

## Germany is legislating on "Bad Banks"

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### Speed read

- The German "bad bank" scheme enables German banks, financial holding companies and their subsidiaries to transfer impaired securities into several, institute-specific special purpose vehicles (**SPV**) where the risks from these assets will be ring-fenced.
- Participation in the scheme is voluntary.
- The securities are transferred to the SPV at 90 % of their book value.
- In return for the transfer of securities, the transferor institution receives bonds issued by the SPV, which are guaranteed by the governmental rescue fund (**SoFFin**). For the guarantee, SoFFin charges a fee at market rate.
- The transferor institution is required to pay to the SPV in annual instalments, out of the institutions future earnings, a compensation amount covering the difference between the transfer value of the impaired securities (90% of book value) and their (lower) fundamental value, taking future risks into account.
- When the SPV is liquidated, any profit will be paid to the transferor institution for distribution to its shareholders. If the SPV incurs a loss, the institution will be prohibited from the distribution of any annual surplus and will be required to use it for payments to SoFFin until the loss is fully covered.
- Applications for participation in the bad bank scheme can be filed within 6 months following publication of the law in the Federal Legal Gazette.

### Introduction

On 13 May 2009, the German Federal Government adopted the draft "bad bank" bill. The proposed legislation will enable Germany's institutions to rid themselves of their impaired securities. It foresees the creation of several, institute-specific bad banks where the impaired securities and their risks can be parked until the maturity of such securities. Participation in the scheme is voluntary.

Any institution that chooses to use the scheme will be able to free up regulatory capital which can be used for future lending. However, the long-term risk from the transferred impaired securities will remain with the institution.

The draft bill has been introduced into the parliamentary process and it is expected that legislation will take effect before the summer break 2009.

### The scheme at a glance

The bad bank scheme will work as follows:

- Any institution that chooses to participate in the scheme (**Transferor Institution**) may set up a special purpose vehicle (**SPV**) located in Germany.
- The SPV buys the structured securities from the Transferor Institution, in general at 90% of their book value as of 31 March 2009, i.e. the price at which the securities are currently valued on the Transferor Institution's balance sheet.
- In return, the SPV issues new debt securities to the Transferor Institution, guaranteed by the governmental rescue fund (**SoFFin**) in an

amount equal to the transfer price of the structured securities (the **Guaranteed Bonds**).

- Due to the SoFFin guarantee, the Guaranteed Bonds bear a regulatory risk weighting of 0 % and therefore do not require regulatory capital. Furthermore, the Guaranteed Bonds may be used as collateral in European Central Bank money market operations as a means for the Transferor Institution to obtain further liquidity.
- As a result of the exchange of impaired securities against Guaranteed Bonds, the impaired securities are derecognised from the balance sheet of the Transferor Institution. Therefore, any further depreciation in the value of the impaired securities will not lead to further write-downs of the value of the impaired assets on the Transferor Institution's balance sheet, thus also eliminating the need for the Transferor Institution to raise additional capital to make up for such write-down.
- Before structured securities can be transferred to the SPV, their real economic value must be determined, certified by a recognized independent expert nominated by SoFFin and validated by the Federal Authority for the Supervision of Financial Services (**BaFin**). SoFFin then applies an additional discount, to be determined in the individual case, to reflect further risks which may materialise until maturity of the securities. The value arrived at after applying such discount is called fundamental value.
- The difference between the transfer value and the fundamental value must be borne by the Transferor Institution. For the duration of the SoFFin guarantee, but no longer than 20 years, the Transferor Institution must pay, out of its future earnings, equal annual instalments to the SPV. The amount of the instalment equals the difference between transfer value and fundamental value, divided by the number of full calendar years up to the end of the SoFFin guarantee, and must equal at least one twentieth of such difference. If, in a given year, the Transferor Institution is not profitable enough to pay an annual instalment in full or in part, the amount of future instalments will increase accordingly.
- When all structured securities of the SPV have matured or have been sold, the Guaranteed Bonds may be redeemed and the SPV can be liquidated. Any liquidation surplus must be paid to the Transferor Institution for distribution to its shareholders. If the receipts from the transferred

securities are lower than the fundamental value, the noteholders of the Guaranteed Bonds may call upon the SoFFin guarantee in the amount of such shortfall. The Transferor Institution will have to use any future annual surplus to make payments to SoFFin in order to compensate SoFFin for the payments under the guarantee. In this period of time distributions to shareholders will be prohibited.

## An example

The scheme may be illustrated by an example:

Suppose that a Transferor Institution owns structured securities in the amount of 100, maturing in 10 years. These securities can be transferred to an SPV at a purchase price of 90. In exchange, the SPV will issue bonds guaranteed by SoFFin in the amount of 90 to the Transferor Institution. Suppose further that the fundamental value of the assets is 80. The difference between 90 and 80 will have to be borne by the Transferor Institution. As the securities will mature in 10 years, the Transferor Institution will have to pay 10 equal instalments in the amount of 1, provided that it has generated sufficient annual surplus.

If the SPV sells the assets for a price of 50, the SPV will be unable to make payments under the Guaranteed Bonds in full, and the SoFFin guarantee will be called upon in the amount of 30. The Transferor Institution will have to use any future annual surplus to pay 30 to SoFFin before distributions to shareholders can be made again.

## The scheme in detail

- *Which institutions may participate in the scheme?*

Banks, financial holding companies and their subsidiaries. Banks and financial holding companies must have been domiciled in Germany on or before 31 December 2008.

- *Does the SPV need a banking licence?*

No, a banking licence is not required.

- *Are there any requirements as to where the SPV can be domiciled?*

Yes, there are. The SPV must be domiciled in Germany.

- *Which securities can be transferred to the SPV?*

Only structured securities and related hedges, collateral and trusts, unless purchased by the Transferor

Institution after 31 December 2008. As explained in the legislative materials, the term structured securities means securities characterized by high complexity as they are typically issued for the securitization of a portfolio of different types of receivables. This includes asset backed securities (ABS), collateralized debt obligations (CDO), CDOs of ABS, collateralized loan obligations (CLO), residential mortgage bank securities (RMBS) and commercial mortgage backed securities (CMBS). There are European Commission guidelines on eligible assets which must also be adhered to. The longest maturity shall not be longer than the duration of the SoFFin guarantee.

- *What is the transfer price at which the securities can be transferred to the SPV?*

In general, structured assets shall be transferred to the SPV at 90 % of book value or, if higher, their real economic value. Book value is the value of the relevant securities in the most recent audited annual accounts, provided their reference date is on or after 31 March 2009. Otherwise book value is to be determined as of 31 March 2009 in accordance with the rules applicable to annual accounts, and such book value must be certified by a chartered accountant. The 10 % discount shall be applied only to the extent that the Transferor Institution will be able to maintain a core capital ratio (*Kernkapitalquote*) of at least 7 % after taking the write-down resulting from the reduced transfer price into account.

- *Which requirements must be met before SoFFin can guarantee SPV bonds?*

The guarantee must be applied for by the Transferor Institution. The application must contain the formation documentation of the SPV. The Transferor Institution must make full disclosure of the risks of the transferred securities towards SoFFin, the recognized independent expert and BaFin. The guarantee will be issued only if the Transferor Institution can show a viable business model and adequate capitalisation.

- *How does the decision-making process work?*

The decision whether or not a SoFFin guarantee will be granted is taken by the Financial Markets Stabilisation Authority in its due discretion, taking into account the relevance of the Transferor Institution for stability in the financial markets, the urgency of the matter, and the principle of the most efficient use of public funds. Applicants have no right to be supported by SoFFin.

- *Is the SoFFin guarantee available free of charge?*

No. The guarantee is available only for a fee at market terms. In principle this is an individual percentage of the maximum amount of the guarantee, the risk of loss, and a margin. Furthermore, the time value of the Transferor Institution paying instalments must be taken account of. The fee can be paid in shares of the Transferor Institution.

- *What are the terms of the guarantee?*

In general, the SoFFin guarantee can be drawn on first demand, in line with market practice in the banking industry. The guarantee covers principal, interest and all other payments owing to creditors, and will be generally issued in Euro. Currency risks from guarantees in other currencies shall be hedged by SoFFin at the expense of the Transferor Institution.

- *Will the guarantee be capped?*

Yes. The cap applies to the Transferor Institution and its subsidiaries and is determined with a view to the aggregate amount of risk-weighted assets of the Transferor Institution and the financial means of SoFFin.

- *After the transfer to the SPV, how will the impaired securities be managed?*

SoFFin may, or may not, require that the impaired securities be managed by a third party rather than the Transferor Institution. In any event, SoFFin is entitled to pass instructions on whoever is in charge of administering the impaired securities portfolio. If the Transferor Institution is in charge of administering the impaired securities portfolio, the other business of such Transferor Institution must be kept separate from a functional and organisational point of view. The draft law does not contain details on how the impaired assets should be managed and what interests SoFFin should consider before giving its instructions.

- *When all structured securities of the SPV have matured or been sold, the SPV can be liquidated. If the SPV incurs a loss, the Transferor Institution will have to use any future annual surplus to make payments to SoFFin until the loss has been covered. Is there an alternative for the Transferor Institution to compensate SoFFin and escape the prohibition on distributions?*

Yes, there is. If SoFFin and the Transferor Institution agree, SoFFin can be compensated in shares of the Transferor Institution.

- *Can a Transferor Institution issue "super senior" preferred shares which enjoy a distribution preference over payables to SoFFin?*

This is possible, provided that the nominal value of such preference shares does not exceed 50% of the Transferor Institution's share capital as of the date when the legislation on bad banks takes effect. These preferred shares may even enjoy voting rights.

- *Let's assume all structured securities of the SPV have matured or have been sold and the SPV has incurred a loss. The Transferor Institution will then have to use any future annual surplus to make payments to SoFFin until the loss has been covered. Aren't these claims subject to the statute of limitation so that they will be time barred in accordance with general principles of German civil law?*

The draft legislation expressly provides that these claims are not subject to any statute of limitation.

- *Which is the point in time when applications for a SoFFin guarantee must be filed?*

Applications for participation in the bad bank scheme can be filed within 6 months following publication of the law in the Federal Legal Gazette (*Bundesgesetzblatt*).

- *The proposed bad bank scheme only deals with the transfer of structured securities and related hedges, collateral and trusts, unless purchased*

*by the Transferor Institution after 31 December 2008. Is it possible to extend this scheme to other assets, such as non-performing loans or even assets that are not impaired but are no longer considered strategic by the Transferor Institution?*

Under the proposed regime, it is not possible to exchange such assets for Guaranteed Bonds. However, the Federal Government is working on a broader scheme involving the transfer of other impaired assets, such as loans. Furthermore, there is a discussion whether a mechanism for the transfer of entire business lines affected by the financial crisis should be included.

- *What about the state owned Landesbanken? Can they participate in the proposed scheme?*

The draft bad bank scheme is not restricted to banks from the private sector or to banks of a specific legal form of incorporation. The Federal Government is in ongoing discussions with the governments of the affected Federal States and with the owners of the *Landesbanken* with a view to finding a solution tailored to the *Landesbanken's* needs.

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