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Inaugural (and hopefully last) edition

The economic fallout has created an unprecedented raft of financial regulation across the globe. This is why IFLR decided to publish the Financial crisis guide for the first time. The hope is that this inaugural edition will also be the last edition.

This Financial crisis guide is published in association with ICMA (International Capital Market Association) and Sifma (Securities Industry and Financial Markets Association). Both organisations have written perceptive and useful articles.

On page 6, David Hiscock, Senior Advisor for Regulatory Policy at ICMA, has a warning: regulatory reform still have a way to go before it is truly effective. Similarly, Sifma's Lorraine Charlton underlines the need for new regional and national regulation to be coordinated globally on page 9.

Media coverage of the regulations in the largest financial markets has been vast and deep. Tarp, Talf and P-Pip have become common terms on US networks and UK news crews have introduced quantitative easing into the vocabulary of the wider population. But what about the reforms in other countries?

In Japan, there has been an overhaul in the way that credit ratings agencies are regulated. But lawyers from Anderson Mori & Tomotsune (page 29) are concerned that that it may discourage structural innovation.

In contrast, page 49 sees Uría Menéndez lawyers applauding Spain's new bankruptcy laws that are helping to lessen the concerns coming out of the financial crisis. And on page 42, Paulo Câmara of Sérvulo & Associados praises the Portuguese government for its reaction to the effects of the fallout on banking.

This guide also contains practical advice. In Switzerland, banks refinanced Swiss assets using alternative financing sources when bank lending dried up. Lawyers from Walder Wyss & Partners highlight the lessons that can be learned from the process on page 57.

Nicholas Pettifer

How you should manage liabilities

"I'd like to see a company use cash to solve a problem like excess leverage, rather than take market discounts with a debt buyback"

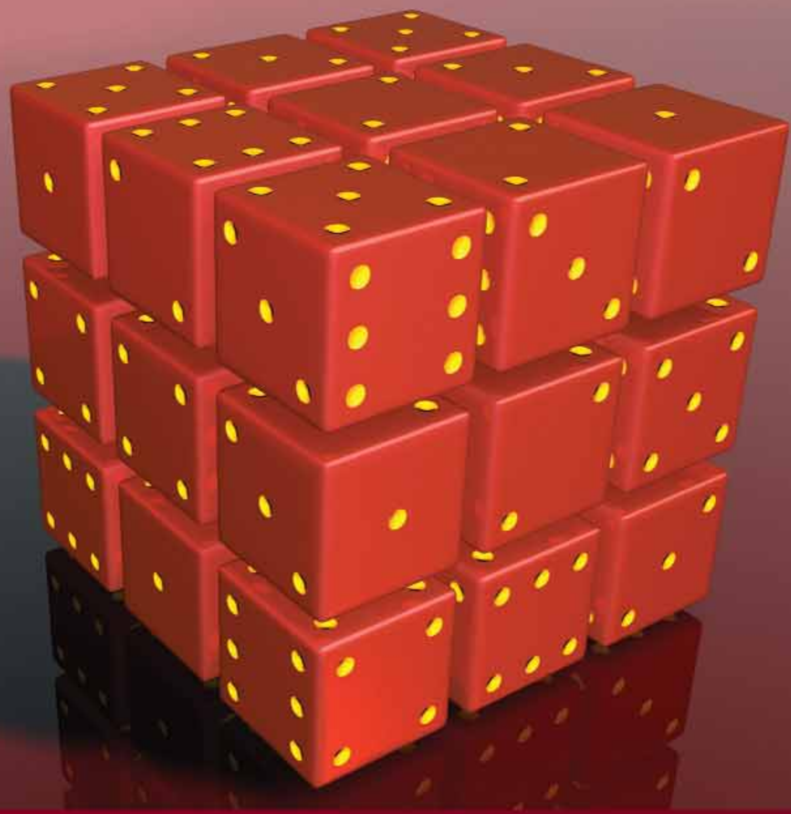
Read the recommendations of Gilbert Sanborn, chair of restructuring advisory at Barclays Capital in New York. IFLR April 2009

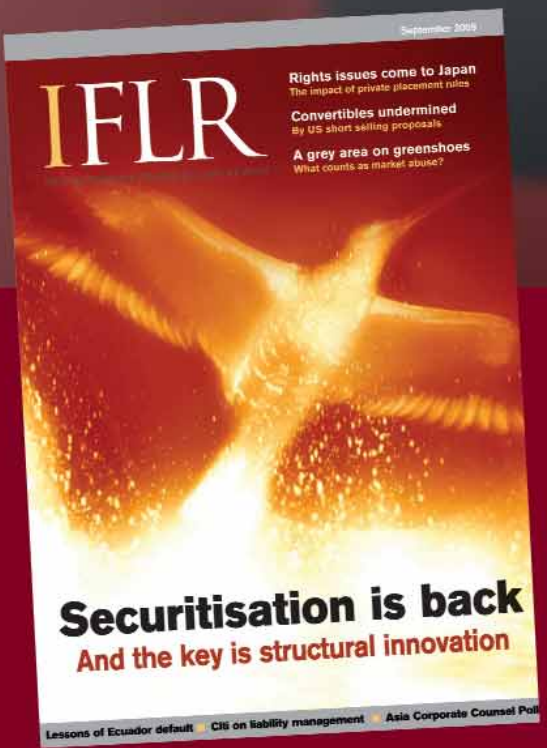
"There is no concept of rollover under Islamic law. Bonds can be repaid for a nanosecond and then immediately re-issued, but it makes other creditors nervous"

Marisa Drew, co-head of debt advisory and restructuring at Credit Suisse, explains Islamic restructuring. IFLR March 2009

"The Market Abuse Directive created a grey area that hasn't been solved on what buybacks count as market manipulation"

Read IFLR journalist Elizabeth Fournier on the problems facing European companies. IFLR February 2009





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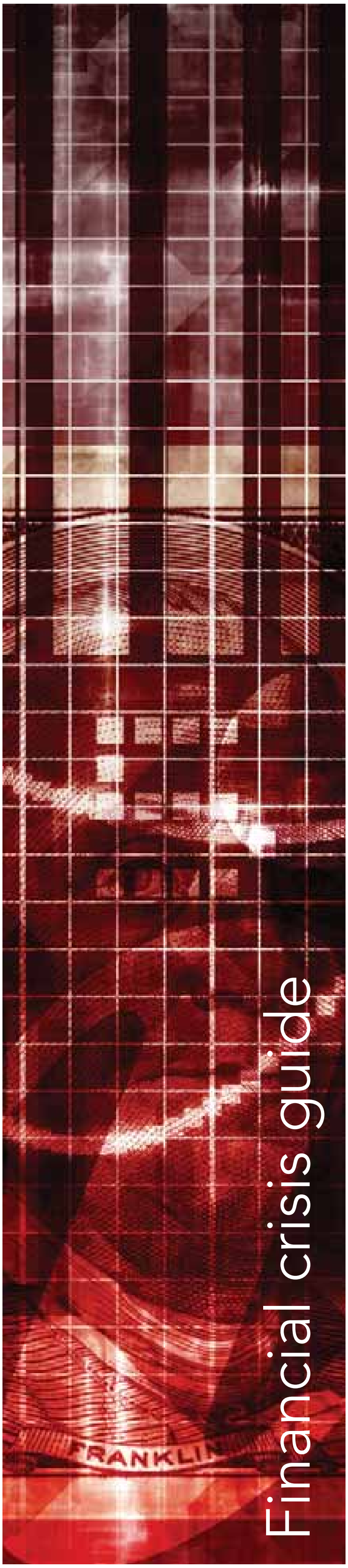

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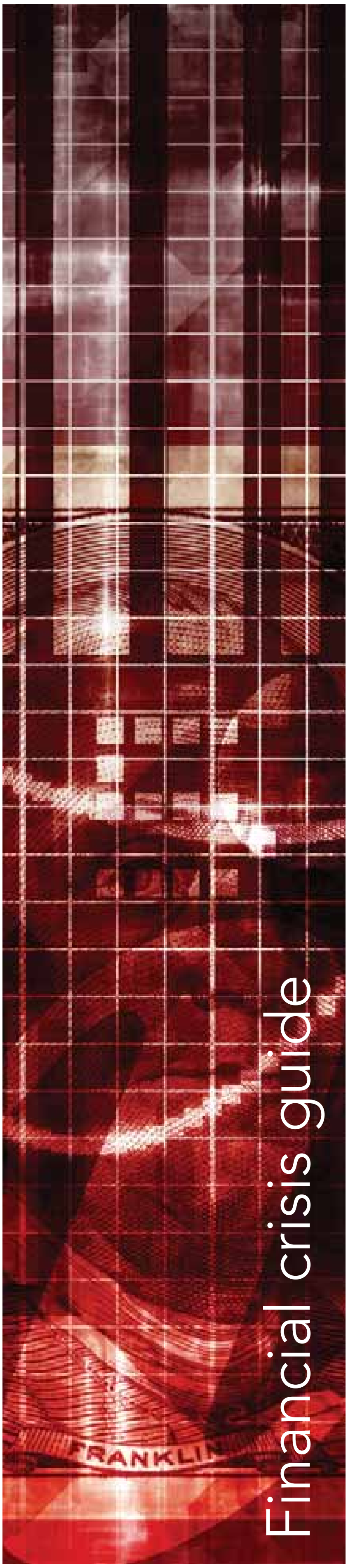

Open questions

David Hiscock, Senior Advisor for Regulatory Policy at the International Capital Market Association (ICMA), lays out questions that still need to be answered to deliver more effective financial supervision

From its beginning as a modest offshore market, the international capital market – with Europe at its heart – has grown into a broad and deep market of around €10 trillion serving the needs of governments, supranationals and corporates from all over the world. From year to year and decade to decade, the market has expanded dynamically across all geographical and product areas. This has helped the free movement of capital across borders and the integration of economies, removing obstacles and building bridges linking the different national markets together, and enhancing structural reform and monetary integration.

Onset of financial crisis and the initial response

The dynamic development of the international capital market and accelerated globalisation has led to ever-more complex markets with many new asset classes. These pose market-related, legal and practical challenges to market participants as well as to supervisory and political authorities. Added to this has been the experience of the international financial crisis of the last two years. This has highlighted many respects in which more work is needed for a robust regulatory environment, designed to meet the challenges of today's financial market place. The period of the crisis has been marked by massive intervention by the financial authorities, particularly in the US and in Europe, in an attempt to restore orderly markets – through the recapitalisation of banks; the provision of government guarantees on interbank lending; and in some cases government purchases of toxic assets, all accompanied by a dramatic easing of monetary policy and selective fiscal stimulus, country by country, but in a coordinated pattern. The critical question continues to be whether this proves to be sufficient to adequately revive bank lending to the private sector, or whether further steps will be needed.

Conjunctively, in response to the crisis, the authorities are already moving towards changes in the regulation of the financial system. Globally, their starting point was the Group of 20 (G20) Summit in Washington last November. This was accompanied at European level by the February report on the supervision of the financial system, prepared by a panel of wise men chaired by Jacques de Larosière.

Following the subsequent G20 Summit in London on April 2, the immediate priority remains to recover from the international financial crisis by restoring confidence:

- There is a consensus that monetary easing and fiscal stimulus are needed to end the global recession, though views differ about whether enough has been done already or more needs to be done.
- The second objective is to stabilise the financial system through government involvement, where necessary, in restructuring banks (by insuring or purchasing so-called legacy assets to clean up bank balance sheets) and recapitalising them (by providing sufficient equity to withstand future losses if the market is not willing to provide it), as well as by providing guarantees on future lending until confidence is restored.
- The third objective is to devise an exit strategy through the eventual sale of government-owned shares and tightening monetary and fiscal policy again when economic conditions permit.

But the longer-term issue is how to prevent another crisis on a similar scale, in which regard the G20 work plan lays out a lengthy list of tangible regulatory reforms. Progress reports affirm that these are being swiftly advanced through the ongoing efforts of various international fora, such as the IMF, and standard setting bodies, such as the Basel Committee on Banking Supervision. The September Pittsburgh G20 Summit meeting continues to build on all of this. It is equally clear, from both the de Larosière report, prepared for the European Commission, the subsequent EU communications and recommendations built thereon and the Turner review, prepared for the UK Chancellor, that there will be a new approach by the authorities in Europe – working within the global context. This will address

"How should the authorities deal with financial institutions that are too large to be rescued by the small countries in which they are based?"

each of financial regulation, the supervision of financial institutions and the stability of the financial system as a whole.

What can the market expect and what further issues need to be resolved?

What can the market expect?

Details of the main elements of the new system of financial markets regulation have not yet all been agreed, but – as things stand going into September 2009 – the proposals include the following:

- Prudential supervision will be more intrusive, in the sense that supervisors will want to know in more detail what is going on – so that they can assess the systemic implications, rather than, as in some countries in the past, relying on a light-touch regime.
- There will be much more emphasis on the effective regulation of liquidity.
- The regulation of capital adequacy will change. Banks will in due course need more capital and of higher quality, particularly against risk taking on the trading book (less leverage will be permitted than in the past); and a maximum gross leverage ratio may be imposed as a back-stop.
- A counter-cyclical capital regime is likely to be introduced, with capital buffers being built up in good times so they can be drawn down in difficult times.
- The authorities are seeking powers to collect information on all significant unregulated financial institutions to allow assessment of overall system-wide risks.
- Prudential regulation of capital and liquidity should extend to "bank-like institutions" – if they threaten financial stability.
- Host supervisors are likely to rely less on home supervisors, following the Lehman insolvency; and host supervisors are likely to insist on having more control over foreign branches, or to convert foreign branches into subsidiaries, following the Landsbanki case.
- Banks are being encouraged to tie pay to long term performance rather than short term profit – where that is not already the case.
- There is continuing pressure for more transparency – though there are many ways in which much of the financial system is reasonably transparent already.
- Financial markets will become more resilient, for example by increasing the role of central counterparty clearing houses; and reducing reliance on credit rating agencies.

"How do you marry the top-down assessment of systemic risks with the bottom-up supervision of financial institutions?"

Delivery of European micro-prudential supervision will remain the responsibility of national supervisors, but their efforts will be supported both by colleges, to face the challenges of cross-border groups, and a newly formed cohesive body, the European System of Financial Supervision (ESFS). The ESFS will draw upon the endeavours of three new European Supervisory Authorities, formed through the evolution and expansion of the three existing Level 3 committees: the Committee of European Securities Regulators (Cesr); the Committee of European Banking Supervisors (CEBS); and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). Flanking and supporting these revised institutional arrangements will also be a series of harmonisation measures, to deliver a single European rulebook; consistency of supervisory powers; and equivalent sanctions.

In addition a new European Systemic Risk Board (ESRB) will be established. The ESRB will be established as a new independent body, responsible for safeguarding financial stability by conducting macro-prudential supervision at the European level. The creation of the ESRB – to work in conjunction with the International Monetary Fund (IMF), the Financial Stability Board (FSB) and third-country counterparts – seeks to address one of the fundamental weaknesses highlighted by this crisis, which is the exposure of the financial system to interconnected, complex, sectoral and cross-sectoral systemic risks.

What further issues need to be resolved?

These proposals leave a number of important issues still to be resolved. First, what is systemically significant? Traditionally, there has always been an element of constructive ambiguity about this. But since the insolvency of Lehman Brothers, almost all significant financial institutions – and not just banks – in trouble have potentially had systemic implications: in a crisis, they are too large or too interconnected to fail. Some part of the solution lies in improved resolution frameworks, allowing for the orderly and rapid administration of failing institutions, but this is particularly challenging when faced with the complexities of cross-border entities and the associated divergence of the legal frameworks under which they operate.

Second, how should the authorities deal with financial institutions that are too large to be rescued by the small countries in which they are based? In the current crisis, as the Governor of the Bank of England has pointed out,

About the author

David Hiscock joined the International Capital Market Association (ICMA) as Senior Advisor, Regulatory Policy in November 2008. He coordinates ICMA's policy work on various initiatives undertaken on behalf of its members and the international capital market, particularly in response to current global market turbulence.

Having initially qualified as a UK Chartered Accountant, prior to this appointment Hiscock spent over 20 years at JP Morgan, where he had a variety of roles most recently that of Managing Director and European Head of Hybrid Capital Structuring.

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financial institutions which have been global in life have become national in death. This is a particularly difficult issue in the case of banks operating cross-border in the euro area, where there is a single central bank, but national ministries of finance are the effective lenders of last resort, and it is not agreed how the burden is to be shared between them. Inter-related questions, such as the valuation of legacy assets and the continued divergence in accounting standards between the EU and the US, present further complicating issues.

Third, how can effective counter-cyclical policies be devised to allow regulation of the growth of the financial system? If it does become possible to rely on counter-cyclical policy as a "third leg of the stool", alongside monetary policy and fiscal policy, then financial crises may be less likely in future and economic recessions less severe. But are the authorities in practice prepared to lean against the wind in an economic upturn? After all, some regulators and central banks warned in advance about the risk of the current crisis (though none foresaw its scale), but they were not able to agree on what action to take and might have faced political resistance had they sought to do so.

Fourth, how to marry the top-down assessment of systemic risks with the bottom-up supervision of financial institutions? This proves difficult enough between ministries of finance, central banks and regulators at national level. But national authorities cannot easily act alone, given that regulation of the EU single market derives from European rather than national level; and that the financial markets are global in nature.

Fifth, how quickly should proposed new regulations be implemented? Banks may need more capital in future, but imposing new capital requirements now is likely to limit their ability to lend and delay the recovery.

Sixth, can the market play a role by regulating itself? The de Larosière report draws attention to the opportunity for the market to play such a role, so long as it implements its own proposals and supervisors are able to verify this. The crisis has clearly highlighted questions related to the value of self-regulation, but it undoubtedly still has an important role to play – as an integral component within a broader regulatory framework.

Finally, is it sufficient to assume that all financial crises are essentially the same, or could the next one be different? That risk is not a reason for failing to do what we can to learn the lessons from this crisis in an attempt to make the next one less severe than it otherwise might be.

In closing

In its activities ICMA has very often been the frontrunner in creating the framework of cross-border issuing, trading and investing, and has constantly helped to build the relationship amongst all market participants. In its dual capacity as a self-regulatory organisation and a trade association, ICMA has initiated numerous sets of standard practices to help develop efficient and well-functioning markets. ICMA is and always was a strong voice, in the promotion of free capital flows across borders and all other efforts on the long road to integrated capital and financial markets.

"Banks may need capital in the future, but imposing new requirements now is likely to limit their ability to lend"

In this crisis, ICMA continues to play a major role, particularly due to its unmatched geographical and institutional diversity. As a cross-border association, ICMA sponsors and brings together sell and buy-side, works on the improvement of the legal framework and continues to see its mission to service the market as a whole. ICMA will continue to represent general market matters and views to those monetary and regulatory authorities vested with the responsibility to create the appropriate framework for a national and international financial system. In stressing that self-regulation can help to solve problems more efficiently, ICMA sees itself operating as a partner to these bodies.

Keep a global perspective

Sifma's Lorraine Charlton, soon to be managing director in the new AFME, says global coordination is paramount to new regional and national regulation

In the 12 months since the financial crisis first flared up, the morning headlines have lost the capacity to shock, or even surprise. While much of the drama has abated and the sense of imminent collapse has receded, global regulatory reform continues in the background. The pace of change – slower than some might prefer, faster than others deem prudent – reflects the exceedingly complex and technical nature of the project: global, regional, and national policy makers are fashioning comprehensive overhauls of individual regulatory frameworks in the middle of a global recession.

From the outset, the Securities Industry and Financial Markets Association (Sifma) has acknowledged the need for reform and supported the efforts of policy makers to address the causes of the financial crisis and has played a constructive role in the ensuing debate. The resulting framework will have profound implications not only for our members, but also for the global economy. A key to effective and durable regulatory reform will therefore be the extent to which the resulting regulatory landscape features an integrated global system with the fewest unintended consequences. This is not to say that regional variation is unnecessary or undesirable, but that global coordination is paramount to ensure that policy makers have considered the collective global impact of regional and national reform.

Against this background of regional action requiring global coordination, Sifma has embarked on a reorganisation to function more efficiently and to represent its members more effectively as the work moves forward. On November 1, the European operations of Sifma will be spun off into an independent, self-funded organisation that will merge with the London Investment Banking Association (Liba). The resulting entity, the Association for Financial Markets in Europe (AFME) will represent a broader array of global and European participants in the wholesale financial markets, bring together a group of professionals with expertise in the most important issues facing our members, and communicate the industry perspective to regulators, policy makers, and the general public. In the meantime, AFME will continue to offer traditional activities in support of the day-to-day commercial activities of our members, including promulgating market practice and industry standards.

On the global level, AFME will be a participant in a global alliance with its partners in the US (Sifma), and Asia (the Asian Securities Industry and Financial Markets Association), through their representation on the Global Financial Markets Association (GFMA). The GFMA will provide a framework for each of these organisations to stay abreast of regional developments and to consider their collective global impact. We expect that the coming year will bring us abundant opportunity to feed constructively into a debate on reform. We highlight several major themes below.

"Remember that credit is money"
Benjamin Franklin

Macro-prudential supervision

The need to focus on financial stability and systemic risks in addition to micro-prudential supervision – which focuses on the safety and soundness of individual firms – has been agreed at G20/FSB as a source of weakness in the regulatory framework. Macro prudential supervision is likely to take any one or a combination of the following forms.

Monitoring and assessment of systemic risks – at the global, regional and national level. The most appropriate level at which systemic risk might be monitored has not yet been agreed upon at global level. Global bodies (IMF, the World Bank and the FSB) are poised to take an enhanced role. At the regional and national levels the role of central banks and of new bodies (as has been proposed by the EU), is still under debate. A likely consequence of these measures is an increased burden on firms in data and information reports and an as yet uncertain effect on the day-to-day supervision of firms.

Introduction of counter-cyclical measures. To date there has been no consensus on the tools that authorities might use to dampen cyclical effects. Regulation of leverage ratios, through-the-cycle provisioning, capital buffers, and core funding ratios have all been mooted alone or in combination as possible measures. Any of the measures that might be adopted are likely to lead to increased capital requirements and restrictions on the volume of business firms can undertake. Policy makers should act not out of urgency, but calibrate these measures carefully to the needs of a well-functioning global economy.

A more focused treatment of firms that are deemed systemically important. The G20 has agreed that systemically important firms should be supervised with care. The IMF and the FSB have been asked to produce a guideline to identify these entities. There are no agreements so far on how such entities should be treated, but the recent UK Treasury White Paper suggests that higher capital requirements and more intense supervisory focus is probable. The problems with setting a boundary for systemic firms are considerable. There is difficulty with creating a clear definition, not least that contagion can spread quickly from non-systemic to systemic and render the boundary meaningless.

"The problems with setting a boundary for systemic firms are considerable"

Revisions to the prudential framework

Although some aspects of the prudential framework were due to be reviewed even prior to the financial crisis (liquidity, trading book capital requirements and definition of capital), this has given way in the EU to a more wide ranging review to strengthen the safety and soundness of banks and investment firms.

The transposition of the Capital Requirements Directive (CRD II). This will likely occur at the end of 2010. The CRD III directive proposal is going through the Council and Parliamentary processes with a view to adoption early next year and implementation at the end of 2010. (In general terms the CRD texts reflect the negotiations in Basel.) Changes to the prudential framework will increase the capital required to be held, the systems employed by the firms, and the intensity of the supervisory relationship.

Trading Book and Market Risk capital requirements (Basel and CRD III). Introduction of stressed scenario VAR in addition to the ordinary VAR calculation. Introduction of incremental risk capital charge in the trading book to capture default and migration risks for unsecuritised credit products.

Securitisation capital requirements (CRD III). Requirements in the trading book will be aligned with those of the banking book, increased capital requirements for re-securitisation transactions, complex re-securitisations, amended treatment of positions held that have unfunded support from the firm itself ("self-guarantees").

Securitisation capital requirements (CRD II). Implementation of retention and due diligence requirements, Commission review of level of retention and methodologies.

Liquidity (CRD II and FSA UK). CRD II will introduce more robust liquidity management guidelines. The FSA will finalise its domestic liquidity regime, which will introduce the Individual Liquidity Adequacy Standards framework under which each firm will have to hold a liquidity buffer.

Large exposures (CRD II). Implementation of the revised framework.

EU Systemic Risk Board

The Commission is expected to make formal proposals in late September to establish a European Systemic Risk Board (to monitor and make recommendations on systemic risk issues in the EU); and a European System of Financial Supervisors, consisting of a network of new EU authorities (developing out of the existing Cebs, Cesr, and Ceiops Level 3 committees) and existing national authorities. In our view, the authorities should proceed with ensuring that the governance and staffing of the new EU authorities enhance the quality of regulation and supervision, the allocation of tasks and powers between EU and national authorities is appropriate and clearly set out in legislation, the respects in which the new EU authorities have rule-making and adjudicatory powers are clearly and appropriately specified, the bodies do not undermine or limit firms' discretion or supervisory judgements that national authorities are specifically charged with by EU law, and EU coordination arrangements (such as for colleges of supervisors) are not so rigid or exclusive that they undermine or cut across supervisory cooperation at a global level in relation to global firms.

About the author

Lorraine Charlton will be Managing Director of the Equity Capital Markets Division and General Counsel of Sifma. She came to Sifma from the Office of the Legal Advisor in Eritrea, where she represented it before the Eritrea-Ethiopia Claims Commission in The Hague. Charlton has also practiced in the London office of Latham & Watkins LLP, and in the Brussels and New York offices of Cleary Gottlieb Steen & Hamilton. She graduated from New York University School of Law in 1995.

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OTC derivatives

In late July, the European Commission (EC) issued a consultation paper on possible reform of the OTC derivatives market in Europe, which suggests the following improvements.

Promotion of central clearing via increased standardisation.

The EC would like to see eligibility of derivatives contracts for clearing by central clearing counterparties (CCP is defined in terms of any one CCP being willing to clear it via the EC) and standardisation of the documentation and the products themselves in the majority of cases.

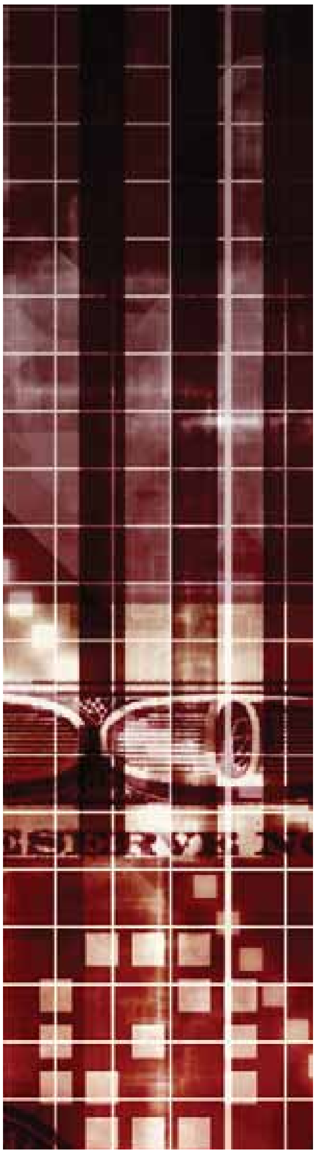
Enhance bilateral counterparty risk management techniques.

The EC recognises that some contracts will be inappropriate for clearing in CCPs, but would like to see bilateral clearing, collateral management and valuation techniques enhanced.

Increase transparency and promote use of public trading venues.

The EC would like to encourage the development and use of central data repositories. The consultation implies that new trade reporting requirements for OTC derivatives (and non-equity products generally) will be required, with trade price information made publicly available and with more reporting of derivatives positions to regulators. The EC sees trading on exchanges or e-trading platforms (MTF) as the next logical step after central clearing. It recognises that there may be a trade-off between liquidity and transparency, but argues there is a societal preference for transparent trading markets.

We (along with our sister trade association Isda) broadly support the EC's objectives. At the same time, we caution against a one size fits all approach that fails to take account of different types of derivatives and the varied practical purposes they serve, and does not provide for global consistency. We also caution against viewing standardisation as an automatic route to clearing and exchange trading. Our position on transparency is broadly supportive, but we urge the EC to avoid fragmentation of repositories, and carefully assess the impact of public dissemination of trade price information on liquidity.



Alternative investment funds regulation

We are commenting on the Alternative Investment Funds Managers Directive as it works through the EU legislative process. Member firms generally agree that fund managers should be regulated and subject to capital adequacy and conduct of business rules (as indeed they are in the UK today), but the scope of the proposal should be carefully tailored to avoid overbreadth. Members are concerned about the adverse impact on major institutional investors, such as pension funds and insurance companies, which use non-Ucits collective investment schemes routinely.

The most critical issue is the extraterritorial custodial provisions that severely restrict the class of those that can provide custody to EU credit institutions and the liability regime is also problematic. Custodians should be held to a high standard, but an absolute standard is likely to make the business very unprofitable or the cost to investors very high.

Emerging issues in 2010

Looking ahead to 2010, we have identified a number of issues that we expect will take on a higher profile and to which we intend to devote much of our attention. Many of them are natural extensions of the areas that are already under review. We expect the most important to be: the development of resolution regimes (including the concept of living wills) for banks and investment firms, the integration of post-trading systems, and a comprehensive review of EU financial services legislation (including the Market Abuse, Transparency, and the Markets in Financial Instruments Directive).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How the State succeeded

Markus Fellner and Paul Luiki of Fellner Wratzfeld & Partners analyse the government reaction to the crisis

As in many other jurisdictions, the Austrian government was forced to react quickly to the financial crisis in the autumn of 2008. Providing support to banks was a central component of the legislative measures on financial market stabilisation that were adopted in late October 2008.

After the joint declaration on the concerted European action plan on October 12 2008, the Austrian government promptly the next day announced a package of measures intended to be taken. One week later the Austrian parliament adopted the implementing legislation on financial market stabilisation which went into effect in large part on October 27 2008. The European Commission state aid approval of the Austrian financial market stabilisation measures was communicated on December 10 2008 and extended to the end of this year by a decision rendered on June 30 2009.

Even before the adoption of the financial market stabilisation package, the first bank rescue took place last year in Austria with the saving of Constantia Privatbank AG in mid-October 2008. While not one of the major banks in Austria, Constantia Privatbank AG was seen as having systemic importance in that it acted as a depositary bank for more than 200 investment funds. Five major Austrian banks (Bank Austria, RZB, Erste Bank, BAWAG and Volksbanken) stepped in and purchased all the shares in Constantia Privatbank via a jointly-held holding company for a symbolic purchase price. They also injected fresh liquidity into Constantia Privatbank. This injection of liquidity was then formally supported by a state guarantee once the legislative measures on financial market stabilisation were adopted. The Austrian National Bank also provided funds to Constantia Privatbank to ensure liquidity. This bank rescue demonstrated the need for a speedy and coordinated effort between the Austrian State and the private sector.

Shortly after the bank rescue of Constantia Privatbank, the Austrian government was tested again. By early November 2008 it became apparent that Kommunalkredit, the eighth largest bank in Austria and a leading Austrian public finance bank, was suffering from dramatic liquidity problems and transactions of foreign subsidiaries that were viewed as questionable. In early November, the Austrian State purchased more than 99% of the shares in Kommunalkredit from an Austrian and another bank for a symbolic price of €2. This was a classic bank rescue in the sense that the Austrian State stepped in to take over a bank.

While the Austrian government indeed acted quickly to support and rescue Constantia Privatbank and Kommunalkredit, the process of the major Austrian banks obtaining support in the form of state guaranteed bond issuances and recapitalisation measures has not been as swift.

Austrian banks and the CEE region

As outlined in the OECD Economic Survey of Austria 2009 (published on July 2 2009), Austria's financial system has been less affected than elsewhere, being less exposed to the most toxic international asset classes or to souring domestic credits. Most observers see the main source of risk resulting from the engagement of Austrian banks in the CEE region. Especially over the past 10 years, most Austrian banks have invested heavily in the CEE region, acquiring both target banks and expanding their existing networks.

The extent of the dependency of Austrian banks on the CEE region and the dependency of the Austrian economy on Austrian banks has received much international attention. It is indeed the case that Austrian banks' assets in CEE represent over 60% of Austrian GDP. The concerns raised by this also caused a fairly dramatic increase in basis points in early 2009 for the risk premium on Austrian government bonds. The larger question for the Austrian financial system thus is the scope of risk resulting from its banks' CEE engagement.

As the OECD pointed out in its economic survey, risks differ across the CEE countries. The CEE region is a diverse one, consisting of more than 20 independent countries. It therefore is not possible to place the entire CEE region in one risk bucket. In the end, much will depend upon the extent to which

“Over the past 10 years, most Austrian banks have invested heavily in the CEE region, acquiring both target banks and expanding their existing networks”

defaults and non-performing loans can be absorbed. This issue is also being analysed carefully by the Austrian National Bank. In July 2009, the Austrian National Bank published the results of the stress tests that it had undertaken regarding stability of Austrian banks. The National Bank came to the conclusion that even if there were another considerable deterioration in economic conditions in the CEE region, the capital ratios of all major Austrian banks would remain above the minimum legal requirements and that for this reason there currently was no need for further recapitalisations. At the same time, the National Bank recommended strong vigilance and noted that as part of a comprehensive monitoring process it was undertaking regular stress tests.

Financial market stabilisation package

The core pillars of the legislative efforts to strengthen the Austrian financial system consist of four areas: stimulation of the interbank market; providing equity support measures to individual banks; restoring depositor confidence in financial markets; and strengthening supervision of banks. Under this package, a maximum amount of €100 billion was originally foreseen to support the Austrian financial market.

This stabilisation package is broken down as follows. €66 billion is available for state guarantees for bond issues of individual banks; €15 billion can be used for recapitalising individual banks and insurance companies; €10 billion is available to support the Austrian deposit protection system; €4 billion is available for lending and borrowing activities of a newly established clearing bank; and €5 billion can be used by the clearing bank to issue itself bonds backed by state guarantees.

The overall maximum amount of €100 billion has been adjusted downward as a result of the recent adoption of the Act on Strengthening Company Liquidity (Unternehmensliquiditätsstärkungsgesetz or ULSG), which entered into effect on August 25 2009. The goal of the ULSG is to support companies via the granting of state guarantees so that they can access loans and other financing means more readily. A maximum of €10 billion is being made available pursuant to this new legislation, which thereby reduces the maximum amount of support available under the financial market stabilisation package to €90 billion (the concrete mechanism used was to reduce the amount under the Inter-Bank Market Enhancement Act (Interbankmarktstärkungsgesetz or IBSG) from €75 billion to €65 billion).

All major Austrian banks either already have taken advantage of the support measures or are in the process of negotiations with the Austrian government.

Interbank market measures

Pursuant to the IBSG passed in late October 2008 a clearing bank (Österreichische Clearingbank) was established to assist the refinancing of banks on the inter-bank market. The primary function of this new clearing bank is to borrow and to lend short-term and medium term funds to banks and insurance companies. So far only banks, and not insurance companies, have participated.

The fees and lending rates charged by the clearing bank must be in line with market conditions and must also take into account the state guarantee charge to be paid by banks utilising the clearing bank. This essentially means that borrowing and lending must take place on arm's length terms. As of mid-September 2009, the overall lending from this clearing bank was well below the amount initially anticipated. The total amount of the State guarantee for the lending and borrowing activities of the clearing bank is €4 billion. In addition, the clearing bank itself can issue bonds backed by state guarantees up to an aggregate amount of €5 billion.

State guaranteed bond issuances

Another important instrument under the IBSG is to support individual banks by having the Austrian State guarantee bond issues of individual banks. This instrument has proved to be a more popular instrument among Austrian banks than utilisation of the clearing bank. Larger amounts can also be accessed via statue guaranteed bond issues than under the clearing bank system.

The purpose of is to allow banks to refinance at favourable terms. To qualify, banks must be licensed under the Austrian Bank Act (section 1(1) para 10) to issue fixed-rate securities for the purpose of investing income therefrom in other banking transactions. These bond issuances can have a maximum maturity of five years. Bonds for banks can take the form of single bond issues, bond issues under a debt issuance programme as well as under a medium term note programme. A key component in being able to take advantage of state guarantees for bond issues is agreeing to a package of conditions with the Austrian State that also apply to recapitalisation measures.

As to the content of the State guarantees, the Republic of Austria, as guarantor, gives its unconditional and irrevocable guarantee to the benefit of note holders that payment of all amount under the notes will be made in a timely manner. These constitute direct, unsecured and unsubordinated obligations of the Republic of Austria, and rank at least *pari passu* with all other unsecured and unsubordinated obligations of the Republic of Austria, except for obligations ranking in priority pursuant to mandatory provisions of law.

As of mid-September 2009, Austrian banks have issued state guaranteed bonds in the total amount of approximately €19 billion. Major Austrian banks that have done so include Erste Bank, RZB, Volksbanken, Hypo Alpe Adria and Kommunalkredit. This amount, however, is still well below the maximum amount foreseen in the IBSG. While the support measures under the IBSG are set to expire at the end of this year, the state guarantees that were issued prior to such date will remain in place.

Strengthening the equity of individual banks

As part of the financial market stabilisation package, Austria passed the Financial Market Stabilisation Act (Finanzmarktstabilitätsgesetz or FMSA) in late October 2008 to set out the parameters for the recapitalisation of Austrian banks in need of financial assistance. For this purpose Austria established Fimbag (Finanzmarketbeteiligung AG des Bundes) in November 2008 to implement recapitalisation measures in line with the Austrian Banking Act. Fimbag is wholly-owned by the Austrian state holding company ÖIAG. Apart from its role as an acquirer of shares under the Financial Market Stability Act, other key tasks of Fimbag are to monitor compliance of the banks with the requirements imposed by the Austrian state in acquiring shares and ensuring an orderly divestment of the state's

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shares at the appropriate later point in time.

Many major Austrian banks also have lined up for and obtained state funding and support under the FMSA or a commitment that such be provided. The primary mechanism that is being used is participation capital (Partizipationskapital). Participation capital is a special category of shares under Austrian law taking a position between share capital and debt. The primary advantage for banks in issuing participation capital is that this capital form is clearly recognised as constituting core tier I capital if properly issued. This instrument therefore strengthens the capital basis of the banks at a time when risk provisions are being increased and assets of the banks devalued. It is generally recognised that while a tier 1 ratio of only 4% is required, the situation resulting from the financial crisis requires higher tier 1 ratios. It is also clear that private investor appetite for purchasing participation capital in today's market conditions is not high and therefore justifies the Austrian State stepping in to purchase such participation capital.

A key benefit for banks issuing participation capital to the Austrian State is that participation capital does not give the Austrian State any voting rights.

In order to obtain a commitment from the Austrian State to purchase participation capital (which also can be done via Fimbag), it is necessary for a bank to negotiate and agree with the Austrian State the terms and conditions of the issuance of participation capital. This can be a fairly lengthy process going over many months. Apart from the framework for terms and conditions set out in the FMSA, the Ministry of Finance promulgated on October 30 2008 a regulation further detailing terms and conditions for the purchase of participation capital.

Some of the key areas that need to be dealt with in the agreement include the following:

- Orientation of the business policy and sustainability of the business model that is being implemented;
- The use of the funds supplied;
- The remuneration paid to members of its executive bodies, employees and other agents;
- The degree to which the bank is provided with own funds;
- The distribution of dividends;
- Measures taken in order to safeguard the jobs of the employees of the bank;
- Measures for the prevention of distortions to competition; and
- The content and scope of the declaration to be provided by the board of the bank.

> **"The terms and conditions imposed on banks that are categorised as 'distressed banks' will be more stringent than those imposed on 'sound banks'"**

The FSMA and the implementing regulation, however, do not restrict the payment of dividends to shareholders during the time in which the stabilisation measure are in effect. The only requirement is that dividend payments be reasonable in light of the financial situation of the bank. One other key component of participation capital is that the Austrian State receives a dividend measured by a fixed percentage of the amount subscribed to. This normally will be 8% or 9.3%. If at least 30% of the participation capital to be subscribed to is done so by private investors (with a maximum of 10% thereof being existing shareholders), then the rate will be 8% and not 9.3%. The position paper of the Ministry of Finance also limits distributions of dividends to 17.5% of the otherwise distributable amount for the time period during which participation capital is still held by the Republic of Austria. There also is no cap on the salaries of management board members.

One issue that receives much attention is the extent to which, and if so under what circumstances, the Austrian State should be able to convert the participation capital into ordinary shares of the bank. In this case, the Austrian State would then have voting rights in the bank.

Generally, the terms and conditions imposed on banks that are categorised as 'distressed banks' will be more stringent than those imposed on 'sound banks'.

As of mid-September 2009, the amount of participation capital (including hybrid capital) that has been subscribed to or committed to be subscribed to by the Austrian State is approximately €6 billion. Since the earmarked amount is at €15 billion, there is still quite a bit of room for additional subscriptions if necessary. In addition, the FMSA contains a provision that the amount of €15 billion in any event can be exceeded to the extent measures under the IBSG remain unutilised.

Apart from the Austrian State subscribing to participation capital, the FMSA also foresees the following other instruments of recapitalisation for banks (insurance companies, though generally eligible, have not yet participated): (i) State guarantees for liabilities of the bank; (ii) State guarantees for liabilities owing to the bank; (iii) granting of loans and supplying of own funds; (iv) acquiring shares in connection with capital increases; (v) acquiring shares outright; and (vi) taking over assets by way of merger.

Outlook

The financial market stabilisation measures adopted by Austria can be generally viewed as a success. As noted by the OECD in their July 2009 report, these measures have helped alleviate the strongest sources of tension in the financial system between October 2008 and April 2009. Going forward, a watchful eye is being kept on developments in the countries of the CEE region. Even in case of a further substantial deterioration in the economies of the CEE region, the Austrian National Bank based on stress tests has reached the conclusion that no further recapitalisation is necessary. If indeed there is a dramatic deterioration and further support is required from the Austrian State, the financial market stabilisation package adopted by the Republic of Austria still has substantial room left for additional recapitalisation measures to be taken.

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Paul Luiki's areas of practice include cross-border M&A transactions with a strong focus on CEE as well as banking and finance and investment funds. Paul also has been involved in the negotiation of bank support agreements under the new financial market stability legislation. Other recent transactions he has worked on include representing an Austrian company on acquisition finance arrangements for the purchase of a Czech company.

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The EU response

Edward Greene, James Modrall and Andrew Shutter of Cleary Gottlieb Steen & Hamilton discuss the EU's regulatory response to the financial crisis in a global context

The global financial crisis has led to calls for reform from legislators across the globe. The European Commission (Commission), influenced largely by the February 25 2009 report by Jacques de Larosière (de Larosière Report), has been among the most active in proposing reforms. The Commission's proposals include new regulatory bodies at the European level, changes to the way financial institutions are regulated in the EU, and changes to the regulation of certain financial products.

Although the crisis is global, and the G20 has taken a leading role in the regulatory response, the proposals of legislators, including the Commission, do not uniformly take a global approach.

Readers of this guide will invariably be active in both the EU and US. If new regulations in the EU and US conflict or do not provide for workable mutual recognition mechanisms, the efficacy of those regulations may be diminished and financial institutions operating on a global scale will face significant challenges in continuing those operations.

From the reports assessing the causes of the crisis and proposing regulatory reform, a general consensus has emerged on two elements. First, all systemically important institutions, instruments and markets should be regulated, preferably under the umbrella of a consolidated supervisor in each jurisdiction. Second, reform will be implemented at a national, not a supranational or international, level. These two elements contain an inherent conflict, as most systemically important institutions, instruments and markets are global rather than national. In this light, if the reforms are implemented on a jurisdiction-by-jurisdiction basis, there is the risk of inconsistency (both as to approach and as to timing) between different jurisdictions and different markets. In the case of EU initiatives, there is a tension between, on the one hand, the Commission's efforts to create a more centralised and harmonised financial regulatory system in Europe with, on the other hand, the independence to which EU member states are accustomed in this sector. This is an addition to potential tensions between the reforms proposed in the EU and the US.

The Commission and the European Council have called for an enhanced European financial supervisory framework, which will be composed of two new bodies: the European Systemic Risk Council (ESRC) and the European System of Financial Supervisors (ESFS).

The ESRC will be responsible for macro-prudential oversight; specifically monitoring and assessing potential threats to financial stability that arise from macro-economic developments and from developments within the financial system as a whole. It will not have any regulatory authority over financial institutions or markets. The ESFS will consist of a network of national financial supervisors working in tandem with three new European supervisory authorities: the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities Authority. These three new bodies will replace the existing Committees of Supervisors, known as Level 3 committees, that advise the Commission under the Lamfalussy process. These proposals are designed to create a framework within which financial risk at the EU level will be supervised, and through which the actions of national supervisors may be coordinated. The new institutions will develop, in effect, a single European rulebook that will harmonise the differences in the national approaches to the transposition of existing and future community law, creating a core set of standards common to all member states. However, that rule book will be implemented at a national, not European, level.

The position in the US is complicated because of the division of responsibilities amongst various agencies. Recent US proposals would coordinate these agencies through the creation of the Financial Services Oversight Council, which would be composed of representatives from multiple agencies and chaired by the US Treasury Department. This body will also have a more formal role in the regulatory process. This approach is broadly similar to the position in the EU, in that a supervisor, comprising rep-

"The new institutions will develop a single European rulebook"

resentatives from various bodies in the sector, will monitor risk on a macro-basis and act accordingly through those bodies. The interaction between the ESRC and its US equivalent will be key to the success of both initiatives. How this will occur remains to be seen.

As regulatory oversight will remain the principal responsibility of financial institutions' home regulator, issues arise as to how those home regulators will coordinate their efforts. One problem resulting from a lack of coordination between nations may be described as regulatory territorialism. For example, as demonstrated by the collapse of the Icelandic banking system, it is important to consider the relationship between the home regulator and the regulators in jurisdictions where branches are established (host regulators). The risk is that host regulators, in an effort to protect their local markets, will (if they do not already) ring fence the assets of a foreign branch or require foreign banks to operate through subsidiaries rather than branches as a way of doing cross-border business.

Another problem arising out of insufficient international cooperation is inconsistent or incompatible regulation. Cross-border regulated entities face potentially inconsistent regulations in jurisdictions in which they do business, thereby increasing the difficulty and cost of compliance. The traditional answer to this problem has come in one of two forms. First, different jurisdictions may aim to minimise differences in their regimes. Second, a host jurisdiction may, in deference to a foreign regulated entity's home regulator, take a light-touch approach to that entity. Importantly, both approaches require coordination at a supranational level.

To this end, one approach is to appoint colleges of supervisors, such as bodies comprised of national supervisory authorities of major cross-border financial institutions to address risk and regulatory issues on a global level. For example, the Financial Stability Board (FSB), a G20 council constituted by a representative from all G20 members, Spain and the Commission, has been mandated to facilitate supervisory colleges. Thus far, the FSB has established over thirty supervisory colleges.

The FSB has also published principles of cooperation for supervisors, central banks and finance ministries in preparing for financial crises and in managing them when they happen. At this stage, however, certain matters remain unclear, such as: the role and effect of such guidelines at a national level; and the consequences, if any, of a nation's failure to implement those guidelines.

Two crucial areas for international coordination are capital adequacy and accounting standards.

In the case of capital adequacy, reforms will certainly be directed at improving the quality, quantity and international consistency of capital in the banking system, preventing excessive leverage, and creating capital buffers. In the EU, the de Larosière report noted that a key goal is consistency of approach as to what constitutes Tier 1 capital, a project in which the Committee of European Banking Supervisors has been granted a central role. On the other hand, the G20 was clear that reform to capital requirements should only be implemented once global economic recovery is assured, since it is difficult in today's markets for financial institutions to raise additional capital other than from governments. The assumption is that Basel II will be revised and then, hopefully, implemented in a more coordinated and timely fashion than the initial version. The G20, in its September 5 and 6 meeting, issued a statement on banking which identifies certain necessary action: "Rapid progress in developing stronger prudential regulation by: requiring banks to hold more and better quality capital once recovery is assured; introducing countercyclical buffers; developing a leverage ratio as an element of the Basel framework; an international set of minimum quantitative standards for high quality liquidity; continuing to improve risk capture in the Basel II framework; accelerating work to develop macro-prudential tools; and exploring the possible role of contingent capital. We call on banks to retain a greater proportion of current profits to build capital, where needed, to support lending."

In the case of the accounting standard, cross-border inconsistency and a freedom of choice in the past resulted in similar institutions following different accounting standards. This affected their apparent health as the financial crisis hit. The G20 has called for improved accounting standards which deal with cyclicality, especially when used to determine capital

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adequacy. In the EU, the Commission has called for reflection on the mark-to-market principle and, in particular, recommended that expeditious solutions be found to accounting issues such as: the treatment of complex structured products; the valuation of assets in illiquid markets where mark-to-market cannot be applied; and the pro-cyclical and short-term approach promoted by current accounting standards. Similarly, in the US, in response to Congressional pressure, the Financial Accounting Standards Board (FASB) has issued guidance on mark-to-market accounting, particularly in the areas of impairment of debt securities and estimating values in illiquid markets. The American Bankers Association has criticised FASB, amongst other things, for not going far enough toward the use of economic value, as opposed to market value, for bank balance sheet accounting. The International Accounting Standards Board (IASB) has announced that it is reviewing its standard in that respect.

The IASB, whose standards have been adopted in the EU with respect to publicly traded companies, will have to cooperate effectively with FASB in the US to achieve the goals set by the G20. In October 2008, the IASB and the FASB set up the Financial Crisis Advisory Group which recently released a report highlighting the necessity of convergence of standards between the two entities. The implementation and enforcement of any agreed standards continues to be a significant concern.

The efforts in the EU and the US to plug holes in the regulatory structure have so far focused on alternative investment funds (in particular hedge funds and private equity funds) and credit rating agencies.

An important category of financial company that has so far not been regulated on a comprehensive basis is alternative investment funds, in particular hedge funds and private equity funds. There seems to be a growing consensus among legislators that hedge funds, at least, should be regulated in some capacity, though the precise content of such proposals remains unclear. There is less consensus as to whether private equity funds should also be regulated and, if so, how the approach should differ from that for hedge funds.

The G30 proposed that, rather than directly regulating hedge funds, the advisors of hedge funds (and possibly private equity funds) be registered and licensed in the jurisdiction in which the advisors reside as opposed to where the fund is incorporated (since many of the funds are incorporated in tax havens such as the Cayman Islands). Under the proposal, information about funds and advisors would be available not only to the regulator of the advisor but also to a systemic regulator (if there is one) overseeing macro-economic developments in the market. Such information would be confidential and would pertain to, amongst other things, the fund's liquidity needs, leverage, risk concentrations and possibly counterparties.

The Commission has proposed a Directive on Alternative Investment Fund Managers (AIFM Directive) which would, with certain exceptions, create a comprehensive supervisory framework for the registration and regulation of all non-retail alternative investment funds.

The proposed AIFM Directive has been intensely criticised for imposing onerous and unworkable requirements, failing to distinguish between the types of risks posed by different types of funds, and discriminating against non-EU funds. Although the Commission's proposal provides for a mutual recognition mechanism, this mechanism would be available (at the earliest) three years after the deadline for implementation of the directive and would be subject to conditions that may be difficult, if not impossible, to satisfy. In particular, mutual recognition would be available only if the Commission finds that a non-EU fund's home regulatory system is equivalent to the directive. It would be difficult for the Commission to declare US funds eligible for mutual recognition under its own proposal, since US reforms, as discussed below, take a different approach to regulating alternative investment funds. In this light, it seems likely that the Commission's proposal will be extensively revised. The Swedish Presidency has recently acknowledged this and other problems with the Commission's approach.

The proposal in the US is less restrictive. Primarily, the approach is to widen the net of those advisors caught by registration, disclosure, compliance or conduct-of-business requirements and fiduciary responsibilities. However, in contrast to the EU proposal, US regulation would not impose capital, leverage or similar financial requirements on hedge funds or private equity funds, other than financial holding companies whose size or other factors make them systemically significant, as determined by an interagency committee.

There is also a broad consensus that credit rating agencies (CRAs) must be tightly regulated. On July 27 2009, the Council adopted a regulation establishing the legal and regulatory framework for CRAs (CRA regulation).

The CRA regulation aims to: ensure CRAs avoid and appropriately manage any conflict of interest and remain vigilant on the quality of ratings and rating methodologies; increase CRAs' transparency; and implement an efficient registration and surveillance framework to prevent forum shopping and regulatory arbitrage. The CRA regulation applies only to credit ratings issued by agencies registered within the EU and which are intended either to be disclosed publicly or distributed by subscription. Foreign CRAs and their EU affiliates will be supervised through a college of supervisors coordinated and moderated through the Committee of European Securities Regulators.

As in the EU, major policy concerns caused by CRAs in the US are the management of conflicts of interest and the transparency of ratings methodologies. Other countries are also considering reforming CRAs. As more countries go down this path, issues will arise as to the potential effects of one jurisdiction's regulation of CRAs in other jurisdictions.

It is generally agreed that derivatives (and the markets in which they are traded) must be regulated. There is a growing view that market participants should be required to use central counterparties to clear transactions as a way to reduce the systemic risk of the insolvency of an important market participant.

On July 3 2009, the European Commission released a communication entitled Ensuring efficient, safe and sound derivatives markets, accompanied by a Staff Working Paper (together, the Derivatives Communication). It is expected that the European Commission will present legislative proposals in line with the Derivatives Communication recommendations by the end of 2009.

Based largely on the de Larosière report, the Derivatives Communication surveys the derivatives market and assesses current measures to reduce risk.

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The Derivatives Communication calls for an increased use of central counterparties, particularly in relation to standardised over-the-counter (OTC) products. Major derivatives dealers committed to the European Commission to move to the central clearing of credit default swaps referencing European companies by July 31 2009. The Commission is considering other ways to encourage the use of central counterparties, thereby managing risk on the derivatives markets. The Derivatives Communication also encourages execution of trades of derivatives on an organised trading venue in order to provide increased price transparency and strengthened risk management. It proposes the promotion of standardisation of OTC derivatives to promote product fungibility, as well as to increase legal certainty and operational efficiency. Transparency in derivatives markets will be further increased in the EU by the extension of the Transaction Reporting Exchange Mechanism, the system through which European regulators exchange transaction reports under the Markets in Financial Instruments Directive, to OTC derivatives linked to instruments already caught by that reporting system.

In the US, the reforms proposed in this area are more specific. The reforms proposed would, among other modifications, require broad categories of standardised over-the-counter (OTC) derivatives to be cleared by regulated clearing houses and traded on exchanges or exchange-like trading facilities.

Certain problems require consideration in light of such proposals. For example, central clearing requires standardisation of contracts. Many OTC derivative contracts are bespoke and cannot be cleared or regulated in the same way as standardised contracts.

The collection of relevant information also plays an important role. The Derivatives Communication advocates that for trades outside the central counterparty mechanism, increased transparency should be pursued through the creation and maintenance of a central data repository, which would contain information on the number of outstanding contracts and the size of outstanding positions in a particular contract. Similarly, in the US, it has been proposed that the US Commodities Futures Trading Commission and the Securities Exchange Commission impose recordkeeping and reporting requirements on all OTC derivatives. Certain of these requirements could be satisfied by clearing or, in cases of bespoke OTC derivatives, by reporting such trades to a regulated trade repository. Central counterparties and trade repositories would then publish aggregate data regarding open positions and trading volumes and provide regulators (on a confidential basis) information regarding individual counterparties' trades and positions. In the US, the Trade Information Warehouse operated by the US Depository Trust and Clearing Corporation already acts as such a data repository for credit default swaps.

Opinions differ on reforming the regulation of the origination and sale of asset-backed securities, in particular mortgage-backed securities, to align the interests of originators and investors. Problems arose out of the originate-to-distribute model, whereby intermediaries purchased securities from the originators of those securities solely for the purpose of resale. As the intermediaries did not intend to hold the securities in their own portfolio, they lacked the incentive to ensure the integrity of the securities' underlying assets.

One response is for skin-in-the-game regulations, whereby originators must retain an interest in tranches sold to investors (between 5% and 10%), thereby motivating them to maintain the integrity of the underlying assets. The European Council has adopted a directive amending credit institutions' capital requirements, requiring the originators of asset-backed securities in the EU to retain 5% of the risk transferred or sold to investors on their own balance sheets. Similar proposals have been made in the US and by International Organization of Securities Commissions.

Both the EU and US are moving on a variety of fronts to improve their financial regulatory systems in response to the financial crisis. The Commission and the European Council have been particularly active, proposing major reforms and accelerating the implementation of measures that were already under way. There is still considerable uncertainty regarding the final shape of some of these initiatives. Some initiatives seem likely to create tension with member state governments, while others may result in difficulties for institutions active both inside and outside the EU. On both sides of the Atlantic Ocean, the key challenge will be to ensure that steps towards reform reflect a global consensus reached in the G20 and to ensure that the move to tighten regulation of the financial system does not create unintended barriers for global financial institutions.

The authors wish to thank various members of the Cleary team for their assistance with this article. For more detailed and regular updates of regulatory measures in the UK, US and around the world, please see the Financial Crisis Resource Center on the Cleary Gottlieb homepage, created to provide public and timely information relating to the distress in global financial markets.

IFLR knows how regulators will react to this crisis

"My recommendation is to decouple other voting items from the proxy access debate. There needs to be progress here"

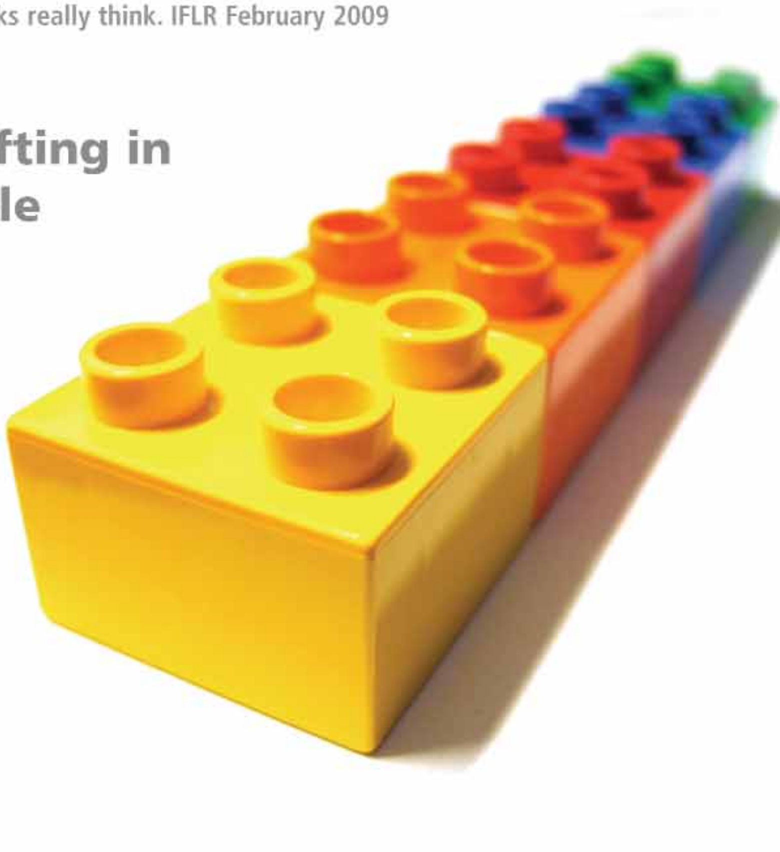
As he leaves the SEC, Director of Corporation Finance John White writes exclusively in IFLR, March 2009

"The FSA: what a complete disaster. The Bank of England should always have had control of the banks"

Editor Simon Crompton reveals what UK banks really think. IFLR February 2009

"There was great drafting in Lehman. It used simple terms to reflect the extremely limited due diligence"

Sarah Bower, of Nomura and formerly Lehman Brothers in Asia, gives the inside story on the insolvency in IFLR, April 2009



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Favourable for private workouts

Juha-Pekka Mutanen and Mika J Lehtimäki of Dittmar & Indrenius explain how to restructure distressed companies in Finland

During the first half of 2009 the number of corporate bankruptcies in Finland increased by 38% to nearly 1800. The number of statutory restructurings tripled to 289 compared to the first half of 2008. The number of distressed companies that are not formally insolvent is far higher. This means that the number of voluntary corporate restructurings is likely to increase significantly in the latter part of 2009 and throughout 2010. Furthermore, the situation will create good opportunities for distress investing in the Finnish markets.

Finnish law is favourable in terms of facilitating private workouts – management liability can be controlled, debt-equity swaps are relatively easy to carry out, divestments and creditor control can be arranged contractually, and the lender liability risk is not too high. In addition, expedited corporate restructuring procedures provide interim freezes on enforcement and enable negotiation of pre-packaged plans that can be approved by a court.

Finnish restructuring environment

There is no established manner of carrying out corporate restructurings outside the formal insolvency procedures. The only way of binding hold-out creditors is through statutory corporate restructuring. Private workouts can be achieved, but a successful private workout requires in practice 80 to 90% creditor approval if the parties wish to minimise court involvement.

The Finnish Restructuring of Enterprises Act (the Restructuring Act) was implemented in the early nineties and the latest amendments were made in 2007. Statutory restructurings have traditionally focused on debt composition, which is often inadequate for facilitating business recovery. Furthermore, restructurings were often carried out bilaterally between a bank and a borrower. There was often no need to address multi-creditor restructurings or issues arising with complex financial instruments and multi-layered debt.

During the last few years statutory restructurings have become more advanced. This is partially based on stronger presence of business recovery specialists, investment banks and the development of restructuring law.

Finnish private workouts tend to mirror the priority structure and rights of various parties in the statutory restructuring and bankruptcy because hold-out creditors holding a controlling interest in a particular debt-class can effectively block approval of the reorganisation plan, and because any large enough a creditor can file a bankruptcy petition based on a payment default of the borrower.

Statutory restructuring

General aspects

The Finnish statutory restructuring is a debtor-in-possession (Dip) procedure much like the US Chapter 11 procedure. Although the debtor retains the control of its assets throughout the procedure, management actions are substantially restricted in order to make sure that the assets are not unduly depleted and that the restructuring plan can be negotiated.

Commencement of a corporate restructuring triggers the statutory freezes to make payments, grant security for a reorganisation debt, carry out or continue debt collection measures (for example, enforcement of security) and seek interim injunctions.

The reorganisation plan is, in practice, prepared by the estate administrator in consultation with the creditors and the debtor. Although the substantive measures needed to effect the rescue are not regulated, the administrator can only submit a plan to the court that can realistically be expected to be approved by the creditors.

The creditors vote on the restructuring plan within their respective creditor groups. Generally, the

> **“The only way of binding hold-out creditors is through statutory corporate restructuring”**

plan must be accepted by more than half of the creditors representing majority of each group's claims. The terms of the restructuring debts are replaced by the terms stated in the restructuring plan. All secured debts are subject to the restructuring plan, but the composition of debts cannot be applied to their capital amount.

There are certain detailed rules for a court to 'cram down' dissenting creditor groups even if the majority vote is not reached. Furthermore, creditors that receive full payment as well as last-ranking creditors that are not entitled to any distribution under the plan are discarded in voting.

As only the debt restructuring part of the plan is specifically enforceable against the debtor, the debtor's restructuring obligations often need to be reinforced through separate contractual commitments and legal measures. This can be achieved by making creditor approval conditional on entering into other corporate restructuring measures (for example, divestments, debt-for-equity swaps, share issues and the like).

Pre-packaged deals

In cases where financing structures are not overly complex, it may be feasible to opt for an expedited pre-negotiated deal instead of a full-scale statutory restructuring. The reorganisation plan can also be prepared prior to the commencement of the reorganisation. The same applies for solicitation of creditor approvals.

As of June 2007 it has become easier to carry out an expedited reorganisation procedure. This requires that the debtor, as well as creditors representing at least 80% of the claims and any creditor representing at least 5% of all claims, give their written approval for the process. In this case, there is no need to hear various parties concerning the reorganisation plan proposal, no process for disputing restructuring claims, no division of the creditors into creditor groups and no voting procedures.

Because the expedited procedure may save a considerable amount of time, it also creates substantial pressure to prepare the pre-packaged plan with diligence.

Dip financing

The debtor is entitled to incur indebtedness and grant security interests in the ordinary course of business even after the commencement of a corporate restructuring. Dip financing is not generally considered to be within the ordinary course of business, and any such new indebtedness and granting of security interests requires the estate

“Because the expedited procedure may save a considerable amount of time, it also creates substantial pressure to prepare the pre-packaged plan with diligence”

administrator's consent. A court may on the estate administrator's application permit new super-priority financing and order that such new financing has same or better priority to the debtor's assets than existing secured debt. However, the arrangement must not considerably increase the risk of the secured creditors who hold the existing security interest. It is often advisable, in order to ensure the priority of new Dip financing, to submit to the court consents from the creditors affected by the order.

Bond buy-backs and voluntary exchange offers

The negotiation position

In a case where the company has listed bonds or other debt securities, it may be advisable either to buy back such bonds, to the extent they are traded at a discount, or, in case the company does not have the required liquidity to carry out a buy-back, to make an exchange offer for such securities.

Unlike the company's bank creditors, the debtor may not know the identity of its bond creditors or their objectives (for example, are they control investors or institutional investors looking for a secure investment?). The negotiating position of bond creditors in restucturings, debt buy-backs and exchange offers can be summarised as follows.

First, a creditor's right to receive a full payment of capital and interest on its receivable cannot be cancelled or reduced in any other manner than in bankruptcy or in statutory restructuring in which appropriate creditor majorities approve the reorganisation plan.

Second, without specific contractual provisions, creditors have no right to convert the debt into an equity interest or require owners to give up their ownership in the company. Creditors' control is based on loan covenants and negotiating power upon debtor's failure to make the agreed capital and interest payments.

Third, a creditor who in a voluntary arrangement is proposed to be treated in a less favourable manner than what would be the case in a formal insolvency process is likely to object to the proposed voluntary arrangement.

Fourth, the rule of absolute priority sets boundaries for all arrangements. It is a part of mandatory legislation and covers also ownership interests, which are always the last in priority.

Amendment of bonds terms

The terms of Finnish listed bonds vary from one case to

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another. Usually any amendments require two-thirds majority in a creditors' meeting. The same applies, for example, to covenant waivers. The meeting is usually convened by the debtor alone or together with creditors representing at least 10% of the bond capital. The quorum requirement for a first meeting is usually 50% of the bond capital and 10% for the second meeting (if the threshold cannot be reached in the first meeting). As is the case in a number of other jurisdictions, the following amendments cannot be made without all creditors giving their consent:

(i) reduction of the debt capital or interest;

(ii) extending the maturity of the bond; and

(iii) changes to the quorum and voting thresholds.

Buy-back and pre-payment

Generally, debt buy-backs and exchange offers can be carried out unless such measures have been restricted in the terms of the bond.

On the other hand, a bond has to be repaid in accordance with its terms. Therefore, a mandatory redemption or pre-payment of a bond is not possible without specific contractual provisions in the terms of the bond.

Tender offers and exchange offers

Unlike with share tender offers, the success of a bond tender offer is not as dependent on the premium offered for such securities. A bond creditor is entitled to a full repayment. Therefore, a consideration which is below the combined capital and discounted interest amounts accruing to the bonds is often not accepted.

The likelihood of success of a voluntary bond exchange offer is in practice increased if the position of the non-accepting bond creditors deteriorates as a result of the implementation of the offer. The position of the remaining bondholders can be changed in two ways:

(i) The seniority of the new bonds may be better than the ones subject to the exchange offer (through new security or subordination of the old bonds by amending its terms).

(ii) The terms of the existing bonds can be otherwise be made less advantageous for the hold-out creditors.

The majority threshold for implementing these changes in Finnish listed bonds is usually two-thirds. However, there is little case law concerning duties owed by the debtor and the majority creditors to the minority creditors.

Bondholders in private workouts

As the structure of private workouts is often influenced by the voting thresholds in a statutory restructuring, it may be easier to amend the bond terms in a private workout by using a court-approved pre-packaged plan. In such a situation, the voting threshold is 50% of the capital of the creditor class. It should be noted that in the expedited corporate restructuring procedure the thresholds are much higher.

Unlike in exchange offers in which a reduction of the capital or interest payments of the bond or extending its maturity requires unanimous bondholder consent, such changes can be implemented as a part of the reorganisation plan with a majority approval by each creditor class. Therefore, in practice all debt compositions involving bondholders need to be carried out through a court-approved restructuring plan.

Alternatively, the bondholders may be crammed down by the court even if they do not support the reorganisation plan. However, such cram-down is unlikely to be approved by a court if the reduction of the debt is excessive and the reorganisation plan does not affect the shareholder structure or require adequate participation in the restructuring by the shareholders as well. In effect, this means that a distress investor holding a control position (51%) of the creditor group often has considerable leverage in negotiation a debt-equity swap in the restructuring.

Private workouts

Example structure

The structure of a private workout depends fundamentally on the details of each particular company and situation. In a private workout, the parties must respect the priority order that would apply under the general insolvency laws. Otherwise, a creditor that has a lower priority in a contractual arrangement than in a formal procedure can effectively block the procedure. Furthermore, unlike in solvent restructurings, in private workouts, the question is primarily about to what extent each creditor participates in the sharing of financial losses and only as a secondary matter about who gets the benefits of a successful restructuring.

The following structure sets out in general terms the various phases that a Finnish private workout might consist of:

- Entering into a standstill agreement (which may also be a common understanding instead of a binding agreement): banks, other creditors and the debtor agree that debts will not be accelerated during the standstill period, and no debt enforcement measures will be taken.
- The auditors or investment bankers prepare a feasibility study concerning the recovery prospects with the assistance of the management.
- The banks and major creditors form a creditor committee and nominate a person or persons to administer the arrangement.
- The creditors enter into loss-sharing agreements.
- The parties prepare a restructuring plan concerning the company and the group.
- The restructuring plan is approved in an expedited statutory restructuring as a pre-packaged restructuring plan.
- The banks grant new secured financing in accordance with the plan.
- A part of the existing debt is converted into equity to restore the solvency of the company or the group.
- The parties start implementing the restructuring actions.

It should be noted that certain transactions which have no commercial rationale for the debtor company may be void under company legislation. Private workouts have generally a genuine commercial motive and, therefore, a financially justifiable structure will most likely not be caught by any *ultra vires* provisions.

Management liability

Liability issues may be pronounced in distressed companies. The members of the management are

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liable for damages caused to the company by deliberate or negligent violation of their duty of care. In addition, the management may be liable for damages caused to the company or a third party by breach of the explicit provisions of the Finnish Companies Act or the company's articles of association. Importantly, in these cases and in affiliated party transactions, the burden of proof is reversed. However, if the decisions of the management are based on careful evaluation of the alternatives and diligent review of the particular situation, the management will not generally be found liable.

Management's decisions may not cause undue benefit to a shareholder or another person at the expense of the company or another shareholder. This issue is encountered in a number of private workouts. Importantly, liability for damages is likely to arise if the company enters into credit transactions while its ability to make the repayments can be seriously doubted or when there is no commercial rationale to continue the financing. Failure to take action or continuance of trading when the grounds of insolvency are apparent, increase the monetary liability of the management.

In practice, in order to mitigate the above risks, it is recommended to engage specialists to carry out a feasibility study or a restructuring analysis prior to making actual decisions on the restructuring. Another way is to sign an indemnity with the management so that they are able to take the restructuring decisions with controlled liability.

Risks with avoidance of transactions

In private workouts, the transactions that are most likely to be challenged, should the debtor become insolvent are: premature payments made, for example, to trade creditors, bond repurchases, sales of assets to entities affiliated with the creditors or shareholders, and granting of new security. On a general level, Finnish law on voidable transactions is more extensive than, for example, the corresponding English law.

The preference rule and gift-like transactions

A transaction may be avoided under the general preference rule if it inappropriately prefers a creditor, results in transfer of property outside the reach of the creditors, or increases debts at the other creditors' expense. The rule may not be invoked unless the debtor was insolvent at the time of the transaction or became insolvent due to the transaction. However, a duly structured reorganisation plan or a workout arrangement that respects the statutory priorities of the creditors and treats similar creditors equally is unlikely to be caught by this provision.

The rule may apply also if the transaction is based on pressure exerted by a creditor. This means that, for example, the integrity of the restructuring valuation will be of the utmost importance. It should, among other things, be ensured that there is no financially more advantageous way of divesting a part of the business (bids have been solicited from other potential purchasers) and that the divestment produces a better overall result than a hypothetical insolvency sale would do. These measures often provide protection against avoidance of gift-like transactions as well.

Avoidance of certain payments

A payment that is premature, excessive or made with uncommon consideration may be avoided in the debtor's insolvency. "Uncommon consideration" in effect refers to something else than money, unless such payment has been agreed on when making the initial agreement. A payment is usually deemed considerable if it exceeds 15% of the assets of the insolvency estate.

Payments that are made in the ordinary course of business or based on long-term practice are generally not voidable. It is considered that 'payment' of indebtedness by conversion of debt into equity cannot be voidable as it does not deplete the company's assets – it merely dilutes the existing share ownership.

Security interests

Granting of security interests may be set aside if the perfection of the security has not taken place without undue delay after the parties had agreed on the security, or if the parties had not agreed on security when the debt was incurred. This risk is usually avoided in restructurings if granting of security is a precondition for the new financing.

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Modifying the rules

Hungarian insolvency law has been amended to deal with the impact of the economic downturn. Csilla Andrékó and Gábor Antal of Kinstellar look at how the changes work

By early October 2008, following the collapse of Lehman Brothers, all constituents of the Hungarian financial system experienced unprecedented turbulence. In response, the government and the National Bank of Hungary (NBH) introduced several measures in order to protect the financial sector from collapse and to minimise the impact of the economic recession.

These measures fall into the following categories:

- Guarantees of bank debt by the state (introduced by Act CIV of 2008 on the strengthening of the financial intermediary system (bank bailout law));
- Deposit guarantees by the state;
- Special (monetary) assistance measures by the NBH;
- Recapitalisation measures by the state (under the bank bailout law);
- Financial support by international organisations (IMF, EU and World Bank);
- Various economic stimulus packages by the state;
- Development of legislation in critical areas (most prominently in the field of insolvency); and
- Development (typically tightening) of regulations in the financial sector.

Bank bailout law

In December 2008 the Hungarian Parliament enacted the bank bailout law, which introduces a debt guarantee scheme and a recapitalisation scheme, together requiring the designation of HUF 600 billion (approximately €2 billion). These measures are available to Hungarian banks organised as corporations. This means that retail bank branches are not eligible to participate in the schemes under the bank bailout law.

The debt guarantee scheme is applied upon the request of an eligible bank and guarantees obligations based on loans and debt securities that are denominated in Euros, Hungarian forints or Swiss francs. Banks participating in the scheme are required to issue a special voting preference share in favour of the state. The preference share entitles the state to veto all major decisions put forward at the general meeting of the bank.

The recapitalisation scheme makes it possible for the state to inject capital into eligible banks (upon request) in consideration for a special voting preference share (offering identical rights to the share issued in the context of the debt guarantee scheme) and non-voting dividend preference shares. In the event of a recapitalisation transaction, the state appoints at least one person to both the board of directors and the supervisory board of the applicant bank.

Changes to insolvency proceedings

Act 51 of 2009 on the amendment of Act 49 of 1991 on bankruptcy and liquidation proceedings (Bankruptcy Act) and other related laws (Amending Act) were adopted by the Hungarian Parliament on June 8 2009. The Amending Act substantially modified the rules regulating bankruptcy and liquidation proceedings.

With some exceptions, the new provisions of the Amending Act came into force on September 1 2009, and apply to those insolvency proceedings that start after that date.

The Amending Act changed several deadlines in the course of bankruptcy and liquidation proceedings, which has resulted in a shortening of the length of the proceedings. In most (but not all) instances the time limits set out in calendar days have been converted to business days.

With one important exception, the intention to shorten the deadlines is actually not expected to result in any significant reduction of the relevant period (so the time limit of eight business days in practice may become two to three days shorter than the previously used time limit of 15 calendar days). The exception,

> "The Amending Act changed several deadlines in the course of bankruptcy and liquidation proceedings, which has resulted in a shortening of the length of the proceedings"

where the reduction was significant, is the reduction of the deadline available in liquidation proceedings for the lodgement of creditors' claims from one year to 180 days.

As a significant procedural development, since September 1 2009 the county (metropolitan) court with competence on the basis of the registered seat of the debtor has exclusive jurisdiction over bankruptcy and liquidation proceedings. In addition, according to the Amending Act, as of July 1 2010 all communications between the court and the parties (other than individuals) will be conducted electronically.

Changes to bankruptcy proceedings

The most important objective of the recent amendment to the Bankruptcy Act was to harmonise the law with the demands of proceedings in practice and increase its ability to provide real bankruptcy protection for companies in distressed situations. The overhaul of the moratorium rules is the most significant tool and probably the most important change introduced by the Amending Act. As of September 1 2009, the court can order the immediate (and temporary) moratorium in its decree within one working day on the basis of the application of the debtor. By way of the immediate nature of the moratorium, its protective nature is ensured.

Following the ordering of the immediate and temporary moratorium, the court assesses the application. If the application is complete (or in the case of incomplete applications the missing documents have been supplemented), the court orders the normal moratorium. In principle, this moratorium ceases on the 0th hour of the business day following the 90th day from the publication of the respective court decree.

In the course of the negotiations with creditors, upon the request of the debtor the moratorium may be extended, but only with the consent of the creditors. With a view to protect the interests of the creditors, the aggregate duration of the moratorium (including any extension) may not exceed 365 days from the commencement date of the bankruptcy proceedings.

Except for certain payment obligations exhaustively set out by the Amending Act (taxes, salaries, health insurance fund contributions and so on), as a general principle from the commencement date of the bankruptcy proceedings the enforcement of monetary claims against the debtor is suspended and the debtor is not permitted to make any payments under any existing claims. Consequently, save for a limited number of exceptions as set out below, no security

"The overhaul of the moratorium rules is the most significant tool and probably the most important change introduced by the Amending Act"

interests can be enforced during a moratorium. In addition, no set-off may be applied vis-a-vis debtors during a moratorium.

From the perspective of banks and financial institutions, there is a important new rule that provides that regarding the bank accounts of debtors, prompt collection orders cannot be submitted or enforced. Furthermore, money claims cannot be executed by the bank from the date when the debtor notifies the bank that it has submitted an application for bankruptcy proceedings.

The Amending Act introduced a provision whereby the contracts of the debtor cannot be rescinded or terminated by claiming that the debtor does not meet its payment obligations due to the moratorium. The debtor may only assume new obligations with the consent of the administrator and payments from the assets of the debtor may only be made with the countersignature of the administrator.

Enforcing a security deposit during moratorium

As described above, a general prohibition against enforcing security interests over the assets of the debtor applies during a moratorium. However, the Amending Act sets out limited instances when security deposits are enforceable and those exceptions correspond to the minimal requirements set out in Directive 2002/47/EC of the European Parliament and of the Council on financial collateral arrangements. For example, if both the depositor and the depositee are qualified as investment undertakings or credit institutions domiciled in an EEA Member State, the enforcement of the security deposit is possible during a moratorium.

Prohibition of payments during moratorium

Even before the effective date of the Amending Act, market players and commentators have raised serious concerns regarding the prohibition of payments during a moratorium.

It is regarded as problematic that the enforcement of close-out netting for financial arrangements (in particular derivatives developed on the basis of the International Swaps and Derivatives Association master agreement) is not regulated satisfactorily. The gist of the problem is that unlike the exception available for close-out netting arrangements in liquidation proceedings, no carve-out for close-out netting is provided among the exceptions to the general moratorium rules in bankruptcy proceedings.

Therefore, certain market participants are believed to be actively lobbying with the government for the inclusion of

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a specific exception benefiting close-out netting arrangements in bankruptcy proceedings.

Creditors' committee

The creditors may establish creditors' committees in the course of both bankruptcy and liquidation proceedings. Compared to the previously applicable rules, the Amending Act has retained the basic tasks and legal status of creditors' committees but introduced more detailed regulations.

The rules of formation differ in the event of bankruptcy and liquidation proceedings. However, the participation of one-third of all creditors (measured by the number of creditors) is required in both proceedings. In the context of bankruptcy proceedings, the creditors' committee may only be established if the creditors represented in the committee also hold at least half of the total votes that can be cast. Pursuant to the Amending Act, creditors have one vote for each HUF 100,000 of debt registered as acknowledged or undisputed. By contrast, in the event of liquidation proceedings, the creditors' committee may only be established if its members represent one-third of the claims of those creditors that are entitled to enter into a settlement agreement.

The Amending Act also allows for the committees to be comprised of at least three but not more than seven members. Pursuant to a newly introduced conflict of interests rule, the debtor or any person personally or organisationally linked to the owners or executives of the debtor, as well as any person whose claim arose within 180 days prior to the launch of the bankruptcy proceedings may not be a member of the creditors' committee.

Role of the administrator

The most important new task of an administrator is to register and classify the creditors' claims.

The Amending Act clarified that the administrator is required to approve the new commitments of the debtor (i.e. commitments made subsequently to the launch of the bankruptcy proceedings). In that context, the administrator may only approve commitments aiming to maintain the day-to-day operation of the debtor, reduce its losses or those that are made in preparation for the settlement agreement. The approval of the administrator to the granting of any additional security is also subject to the consent of the majority of the creditors with voting right.

While the book value of the debtor's assets has remained the basis for the administrator's fee, the Amending Act introduced a new method for calculating the fee. In addition, if a settlement is reached in bankruptcy proceedings, the administrator may also be entitled to a success fee.

Settlement in bankruptcy proceedings

The Amending Act has maintained the concept that the purpose of bankruptcy proceedings is to reach a settlement between the debtor and its creditors. In the framework of the settlement, the debtor enters into an agreement with its creditors on the conditions of the settlement of its debts. In addition, depending on the circumstances of the case, a settlement agreement may provide for the forgiveness of debt, restructuring, the granting of new securities or the conversion of debt to equity.

A settlement agreement may be agreed if the debtor receives the majority of the votes of the creditors with voting rights both in the secured and unsecured classes of creditors.

The agreed settlement agreement also applies to those creditors entitled to make an agreement who have not given their consent to entering into the agreement, or despite their notification, they did not participate in the negotiation or execution of the agreement. In addition, the settlement agreement also applies to creditors whose claims are disputed and in the case of disputed claims, the court may order that a provision be established in order to cover the claims once the disputes have been resolved. It is important to ensure that the settlement agreement does not differentiate within a particular class of creditors on the basis of whether a particular creditor approved or rejected the settlement.

Bankruptcy vs liquidation

Under the new rules, liquidation proceedings may only have priority over bankruptcy proceedings if the liquidation has already been ordered by a court decree of the first instance when the application for bankruptcy proceedings is received. In the absence of a court decree of the first instance ordering liquidation, the applications for liquidation do not prevent the launch and conduct of the bankruptcy proceedings. This is because the applications for liquidation are suspended by the court until the ordering of the bankruptcy proceedings (the normal moratorium) or such applications may be rejected or terminated by the court, as the case may be.

If no settlement is reached in the course of the bankruptcy proceedings or the settlement does not meet the requirements set out in the Bankruptcy Act, the court automatically turns the proceedings into liquidation proceedings without considering the existence or appropriateness of any applications for liquidation proceedings.

Changes to liquidation proceedings

In addition to the significant reduction of the period available for the lodgement of creditors' claims from one year to 180 days, the Amending Act introduced several changes to the procedural rules of the management of the claims as well.

The date of the lodgement of the creditors' claims affects the satisfaction of the claims, even if the lodgement has been made within the new limitation period of 180 days. Pursuant to the Amending Act, a pledgee, chargee or mortgagee (pledgee) may only enforce its claim prior to other creditors, under the terms of the pledge, charge or mortgage, if the pledgee lodged its claim within the notification period of 40 days and paid up the registration fee.

Importantly, while the pledged, charged or mortgaged asset may also be sold if the pledgee lodged its claim after the expiry of the period of 40 days (but, obviously, within the limitation period of 180 days), in such circumstances the proceeds from the sale of the asset must be held separately and the claim of the pledgee may only be satisfied under the general provisions. In other words, pledgees that miss the 40 days lodgement period will only be satisfied if there is sufficient coverage following the satisfaction of the statutorily defined preferred claims.

Enforcing security interests

The Amending Act kept the general rule whereby secured creditors rank ahead of the unsecured creditors in liquidation proceedings. Furthermore, with minor changes, the previously applicable mandatory order of satisfaction among secured creditors remains effective as well.

Accordingly, under the Amending Act the satisfaction of claims secured by a mortgage, a pledge or any

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charge other than a floating charge (the mortgages) enjoys priority over the satisfaction of (i) claims secured by floating charges; and (ii) unsecured claims, provided that such secured claims are duly registered by the liquidator.

The Amending Act created a new category for pending claims. Since September 1 2009, special payment mechanisms are applicable to such pending claims among claims secured by mortgages. Pursuant to the Amending Act, the term pending claims means claims where the creditor undertook conditional payment obligations in favour of the debtor, but those payment obligations have not yet materialised or become due.

So as of September 1 2009 the so-called hundred-percent rule is only applicable if the claim secured by mortgage does not qualify as a pending claim. The hundred-percent rule provides that (save for the reduction of the costs of purchase of the encumbered asset and the liquidation fee as set out by law) the total revenues arising from the sale of the asset over which a mortgage was established have to be exclusively used for the satisfaction of claims, provided that the mortgage was established over the charged asset prior to the commencement of the liquidation proceedings.

In the context of pending claims (save for the reduction of the costs of purchase of the encumbered asset and the liquidation fee as set out by law), the total revenues arising from the sale of the asset over which the mortgage was established have to be deposited at the court, provided that the mortgage was established over the charged asset prior to the commencement of the liquidation proceedings.

Liability of executive officers

In comparison to the previously applicable legislation, the rules pertaining to the liability of executives of companies subject to liquidation have become stricter under the Amending Act. The amount of the fine that can be imposed on executives increased to HUF 2 million when the executive fails to meet its obligations, meets its obligations late, gives incorrect information or does not cooperate with the liquidator.

The Amending Act extended the scope of the rule on the basis of which the court may oblige the executive to bear the costs incurred due to the failure to comply with his or her obligations, including the cost of involving an expert. Consequently, the debtor's member with majority control will be liable as a guarantor in relation to the payment of the fine and the costs.

Under the new sanction of disqualification, which is incorporated in the Companies Act, a former executive whose liability is established by the court on the basis of the above rule but who failed to comply with his or her payment obligation may not be an executive of any business association. The disqualification will cease after five years following the unsuccessful execution proceedings vis-a-vis the executive.

The related amendments of the Companies Act enable the company register to indicate whether the respective executive has been disqualified, including the commencement and termination date of the sanction. As of September 1 2009, in the course of the establishment of companies, executives have to declare whether they have been disqualified under the above sanction.

Duties of the liquidator

The liquidator has to notify its appointment to the financial institutions holding the accounts of the debtor without delay under the provisions of the Amending Act. The liquidator registers and classifies the claims already lodged in the bankruptcy proceedings immediately before the commencement of the liquidation proceedings. In addition, the Amending Act set out a more clear description of, *inter alia,* the accounting and taxation-related duties of the liquidator in connection with settlements during liquidation proceedings.

Positive development

The Amending Act signals a generally positive development and can be regarded as a milestone towards a more viable bankruptcy regime. This new regime appears to be more debtor-friendly than its predecessor. As a consequence, certain resentment can be expected on the creditors' side mostly on account of conflicting interests regarding the enforceability of security arrangements.

Nevertheless, the Hungarian economy may still be approaching a significant wave of insolvencies. It remains to be seen how the existing uncertainties can be eliminated by developing best practices. The reactions of courts to particular arrangements in an insolvency context may also substantially modify the practices of the various interested parties.

Benefit or burden?

Taro Tsunoda and Ayako Kuyama of Anderson Mori & Tomotsune discuss regulation of credit ratings agencies, and warn it may discourage structural innovation

Like many other jurisdictions, Japan has implemented various measures in response to the global financial crisis. These measures include strengthening regulation of short sales by prohibiting naked short selling (i.e. short sales conducted without borrowing the subject securities), relaxing restrictions on the acquisition of the treasury stock of listed companies by increasing the upper limit on the daily purchase volume and lifting the restriction on the timing of purchases, and allowing the flexible application of capital adequacy requirements for banks under the Basel II regime. Tokyo Stock Exchange and Tokyo Financial Exchange are each considering establishing a central clearing system for OTC derivative transactions, and the Financial Services Agency of Japan may require credit default swaps to be settled through such a system.

One measure directed at remedying a key contributing factor to the crisis is the regulation of the credit rating business. In Japan this is dealt with under the Act for Partial Amendment to the Financial Instruments and Exchange Act enacted on June 17 2009 and promulgated on June 24 2009 (Act No. 58 of 2009) amending the Financial Instruments and Exchange Act (the FIEA, Act No. 25 of 1948). The legislation introduces regulations on the credit rating business in Japan for the first time and is expected to become effective no later than June 23 2010.

The new regulations

The sub-prime mortgage crisis revealed several flaws in credit rating practices in the context of structured finance transactions: conflicts of interest between credit rating agencies, originators or issuers of structured products, other interested parties and investors in such products; scepticism regarding the quality and integrity of rating practice; insufficient disclosure of rating standards and processes; and the unexamined reliance of investors on credit ratings to the exclusion of duly considering the inherent risks of structured products. Attention on these issues worldwide has ultimately led to the introduction of regulation on credit rating agencies in major financial markets, including Japan.

The Amended FIEA introduces a non-mandatory registration system of credit rating agencies and requires registered credit rating agencies to comply with certain obligations in order to ensure their independence and to prevent conflicts of interest. The Amended FIEA also implements certain measures to maintain the quality, integrity and transparency of the rating process. In order to avoid over-regulation, no regulation of the substance of credit rating opinions is provided in the Amended FIEA.

Due to the global nature of the rating business, the new regulations are designed to be consistent with similar regulations implemented in other countries. More specifically, the new regulations are designed to conform to the Code of Conduct Fundamentals for Credit Rating Agencies published by the International Organization of Securities Commissions (Iosco).

The two key terms that determine the scope of the new regulations are credit rating and credit rating business.

Key definitions

The term credit rating is defined in the Amended FIEA as "grades expressed in codes or scores (and those items analogous thereto as defined under the relevant cabinet office ordinance) that reflect the results of assessments of the credit standing of financial instruments or juridical persons (and other entities similar to juridical persons as defined in the relevant cabinet office ordinance); provided that those grades that are determined primarily in reference to factors unrelated to credit assessment will be excluded from the definition of credit rating under the relevant cabinet ordinance".

Market risk rating and investment fund rating (where the rating is substantially affected by currency risk or skills and the competency of fund managers and thus is not generally considered to be a

> "The Amended FIEA introduces a non-mandatory registration system of credit rating agencies and requires them to comply with certain obligations to ensure their independence and to prevent conflicts of interest"

credit rating in current practice) are expected to be excluded in the as-yet-unpublished ordinance.

"Credit standing of a juridical person" is generally understood to mean the degree of likelihood of the occurrence of credit events in respect of the relevant juridical person (e.g. bankruptcy and default on payment, and acceleration of due date of debts). Likewise, the "credit standing of a financial instrument" is generally understood to mean the degree of likelihood of the occurrence of credit events of the relevant financial instrument (e.g. default on payment, suffering a loss of principal and acceleration of due date, and restructuring of such financial instrument).

Credit rating business is defined in the Amended FIEA as "the business of assigning credit ratings and providing or making publicly available such credit ratings". Certain activities that would otherwise fall within the scope of credit rating business will expressly be excluded from the definition under the relevant cabinet office ordinance if it is determined that non-regulation of these activities would not weaken investor protection.

One of the principal reasons for regulating the credit rating business is that investors use credit ratings to make investment decisions; therefore, the credit rating business is not subject to the new regulations in circumstances where the credit rating is not so used. It is expected that, similarly, the relevant cabinet office ordinance will provide that if the intended scope of recipients of a credit rating is limited to issuers (and certain other parties related to the issuers) of the subject financial instrument, provision of such credit rating will not be regulated as a credit rating business because non-regulation in such case is unlikely to weaken investor protection.

Registration of credit rating agencies

A credit rating agency that satisfies certain requirements provided for in the Amended FIEA may, but is not required to, register (individuals are not eligible for registration). Most credit rating agencies are expected to apply for registration primarily because certain restrictions will be imposed on the sale of financial products that are rated by an unregistered credit rating agency. In addition, Japan-based credit rating agencies that engage in the rating business in the US and EU countries may benefit from registering in the event the US and EU countries require foreign rating agencies conducting the rating business in their respective jurisdictions to be regulated in their home jurisdictions.

Foreign juridical persons applying to register must, in principle, have an office in Japan; but (i) certain foreign juridical persons that are appropriately supervised in their home countries may be exempt from such domestic office requirement if so provided for in the relevant cabinet office ordinance, and (ii) if rejection of an applicant on the grounds that it has no office in Japan would hinder execution of a treaty or other international agreement to which Japan is a party, the application cannot be rejected solely on the grounds that the applicant has no office in Japan.

For registered agencies

Registered credit rating agencies are subject, in relevant part, to the following regulations under the Amended FIEA:

1. Operating standard. A registered credit rating agency must perform its business fairly, faithfully and independently without being influenced by the party seeking a credit rating for its financial product or other interested parties. A registered credit rating agency is also required to conduct its business in compliance with its rating policies.

2. Management and administration systems. To ensure the quality of its business operations and to prevent conflicts of interest between the credit rating agency, interested parties and investors, a registered credit rating agency must establish appropriate management and administration systems. The details of such requisite systems will be provided for in the relevant cabinet office ordinance and are expected to be in conformity with the Code of Conduct Fundamentals for Credit Rating Agencies published by Iosco.

3. Documentation. A registered credit rating agency must establish and publish its rating policies, prepare and keep books and records, submit business reports to the regulators, and make explanatory documents available for public inspection.

4. Restrictions on providing ratings. If there exists a close relationship (as defined in the relevant cabinet office ordinance) between a registered credit rating agency (including its directors, officers or employees) and certain persons that have interests in the credit rating of the subject matter in question (so-called interested parties), the registered credit rating agency is prohibited from providing a credit rating or making a credit rating available to the public with regard to matters specified in the relevant cabinet office ordinance. The relevant cabinet office ordi-

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In 1992, Mr Tsunoda obtained an LLB from Waseda University. He also received LLM degrees from the University of Michigan Law School (2001) and the University of Chicago Law School (2002). He was admitted to the Japanese Bar in 1996 and the New York Bar in 2003.

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nance, as yet unpublished, is expected to define close relationship to include circumstances where the analyst in charge of the credit rating of a security owns that security; such an analyst would be prohibited from providing the credit rating.

A registered credit rating agency that has advised interested parties on certain matters (which are to be provided in the relevant cabinet office ordinance) that would materially affect the credit rating of the interested parties is prohibited from providing a credit rating or making a credit rating available to the public in respect of such matters (i.e. a credit rating agency is prohibited from concurrently rating and advising with respect to the same subject matter). Certain types of conduct – such as explaining rating policies upon the request of the issuer of securities – are exempt from the prohibition. The relevant cabinet office ordinance is also expected to exempt other types of conduct that are considered not to weaken investor protection taking into consideration the nature of the advice given by the registered credit rating agency in question.

5. Supervisory power of the regulators. A registered credit rating agency (and its related entities) will be subject to the supervisory power of, and inspection by, regulators, including the Securities and Exchange Surveillance Commission of Japan. The term related entities is defined as the registered credit rating agency's subsidiaries, its parent company, and sister/brother companies that engage in the business of providing credit ratings, or giving or making available such credit ratings. Accordingly, the headquarters of foreign credit rating agencies may be subject to inspection by Japanese regulators in the event that their Japanese subsidiaries that are registered credit rating agencies are subject to inspection in Japan.

6. Treatment of ratings by unregistered credit rating agencies. Unregistered credit rating agencies are not prohibited from engaging in the credit rating business. However, financial instruments traders (e.g. securities firms) and registered financial institutions (e.g. banks and other deposit taking institutions that are authorised to engage in certain securities business under the FIEA) that solicit the purchase of financial products rated by unregistered credit rating agencies must (a) notify customers that the credit rating of the financial instrument being offered was provided by an unregistered credit rating agency and (b) provide customers with the outlines of the regulations that would have been imposed if such credit rating agency had been registered and certain other matters provided for in the relevant cabinet office ordinance (this requirement is expected to become effective no later than December 23 2010).

> **"Drawing a line between permitted and prohibited consulting services might not be easy as it would likely entail a fact-specific enquiry and thus would require careful analysis of each specific transaction"**

Practical implications for structured finance

Business model

As explained above, in order to ensure the independence and the fairness of the credit rating process, a registered credit rating agency is prohibited from rating a financial product with respect to which it has consulted on matters that would materially affect the credit rating of such financial product, and, as a result, ratings agencies may no longer be able to provide certain structuring consultation under the Amended FIEA. Although the scope of the prohibition on concurrently providing consulting and rating services is not yet determined (it will be provided for in an as-yet-unpublished cabinet ordinance), it is expected that rating agencies will be prohibited or restricted to some extent from consulting on the composition of the assets underlying structured products on the assumption that such advice would be provided with a view to obtaining a higher credit rating on the structured products.

Such restriction would likely have a substantial impact on structured finance transactions for which credit rating typically requires an evaluation of non-public information provided by the originator or the issuer of the subject securities. It is also the nature of these transactions for the credit rating to enhance the grade of the structured products. As a result, the originator or issuer of the subject securities communicates closely with the credit rating agency during the course of credit rating process in order to obtain a desired credit rating for a given tranche of the structured product (this is unlike the credit rating process of traditional debt securities of corporate issuers in which the credit rating can be determined by evaluating (in most cases) publicly available information of the issuer and thus does not require the issuer to consult with the credit rating agency on the rating of the subject securities).

Although provision of certain consulting services is expected to be exempt from the scope of such prohibited activities under the relevant cabinet office ordinance, drawing a line between permitted and prohibited consulting services might not be easy as it would likely entail a fact-specific enquiry and thus would require careful analysis of each specific transaction.

Amending rating policies

In addition, the new regulations on rating policies may hinder the timely execution of certain structured finance transactions – particularly those

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involving innovative structures. Under the Amended FIEA, a registered credit rating agency is required to conduct its business in compliance with its rating policies, and any amendments of the rating policies must be published in a timely manner. Because unprecedented issues affecting credit rating are likely to arise with innovative structured products, credit rating agencies assessing such innovative products may be required to revise their rating policies so that they can assign and provide credit rating in compliance with their rating policies, which may delay the issuance of the subject structured products.

"It would be unfortunate if the new regulations impeded the sound development of structured finance transactions"

Explanation requirements

The Amended FIEA could also have an impact on the way structured products are marketed. As noted above, under the Amended FIEA, financial instruments traders (and registered financial institutions), when soliciting the purchase of structured products that have credit rating assigned by an unregistered credit rating agency, will be required to provide certain explanations to their customers. In order to satisfy such requirement, it will first be necessary to ascertain whether the subject financial products were rated by an unregistered or a registered credit rating agency. This may not be as easy as it may first seem because the definition of credit rating is not clear enough to allow every rating to be definitively identified as a credit rating within the meaning of the Amended FIEA. Moreover, it is not unusual for a structured product to have underlying assets that are also structured products. In such case, the layers of structured products (with each layer of structured products rated by a different credit rating agency) would make it difficult or burdensome to comply with the explanation requirements.

The extent of the burden of the explanation requirements will not be clear until the details are provided in the relevant cabinet office ordinance, but it is possible that the requirements will be so complicated as to effectively prohibit the marketing of structured products that are rated by an unregistered credit rating agency.

The introduction of regulations on the credit rating business is a significant step toward enhancing investor protection. At the same time, however, it would be unfortunate if the new regulations impeded the sound development of structured finance transactions. Practitioners and market participants must pay close attention to the further development of the new regulations by reviewing, in particular, the forthcoming relevant cabinet office ordinances which will complete the outline of the regulations provided in the Amended FIEA.


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Guarantees of bank deposits

Alejandro Sainz and Diego Martínez Rueda-Chapital of Cervantes Aguilar-Alvarez y Sainz chart the legislative changes in Mexican banking

Before the nineties, the banks in Mexico were owned by the government and banking deposits, as well as any liabilities arising from them, were fully and unlimitedly guaranteed. In 1991 and 1992, the Mexican government initiated the privatisation process of the Mexican banking institutions. As a result of the Mexican Government's intent on attracting potential buyers for the banks, there was a lack of due oversight of the banks' transactions by the financial authorities, which allowed unlimited insurance of deposits These were guaranteed by the Mexican Government through the Banking Deposits Savings Protection Trust (Fondo Bancario de Protección al Ahorro), a government owned trust specifically formed for such purposes.

However, the disastrous implications of the 1994 banking crisis – caused, in part, as a result of the government's lax regulation and poor supervision of the banks – forced the Mexican government to implement extreme economic measures. They wanted to prevent the total demise of the banking sector and avoid systemic risk. Hence, important amendments to the regulatory framework governing the banking and financial sectors were enacted.

The Banking Deposits and Savings Protection Act (Ley de Protección al Ahorro Bancario or LPAB) was published in the Official Gazette of the Federation on January 19 1999, becoming effective the next day. The LPAB regulates, among other matters, the insurance coverage of insured deposits maintained in banks by individuals and entities, as well as the financial support granted to banks aimed to protecting depositors' savings.

Since the enactment of the LPAB, funds placed in banks are mandatorily insured and guaranteed, on a limited basis, by an independent agency of the Mexican Government, the Mexican Institute for the Protection of Savings and Banking Deposits (Instituto para la Protección al Ahorro Bancario or IPAB). The IPAB has the authority to (i) provide Depositary Insured Institutions with limited Deposit Insurance in favor of banking depositors, and (ii) suggest and oversee any capital restoration plans (programas de saneamiento financiero) to financially assist banks for the benefit of depositors.

In addition to the limited deposit coverage granted by the IPAB, during 2004 certain regulations specifically intended to early identify financial problems of banks were enacted. This regulation is based on a 'prompt corrective actions system based on the capitalisation index of the Banks.

As a result of the foregoing, banking deposits' coverage is comprised of two main elements: (i) the Prompt Corrective Regulation, as a preventive mechanism, and (ii) the limited deposit insurance provided and managed by the IPAB.

Limited deposit insurance

Deposit insurance

Quote of the insured depositary institutions. The IPAB manages a trust fund to which State-insured Depositary Institutions contribute for the constitution of deposit insurance. Each Bank usually contributes, on a monthly basis, an amount equal to 0.4% of its total liabilities.

Insured and uninsured deposits

Not all banking deposits are insured or covered by the deposit insurance. In accordance with article 6 of the LPAB, only funds deposited on saving accounts, checking accounts, deposit certificates, promissory notes accruing interest payable at maturity, and credits derived from credit and debit cards are guaranteed by the deposit insurance. The insurance does not cover any investments in insurance companies, stock brokerage firms, development banks, investment companies, savings entibies and savings and lending companies.

"The conditioned regime allows shareholders to recapitalise the bank without risking their ownership interests"

Automatic deposit insurance coverage

Insured deposits of banking depositors are automatically insured by the deposit insurance, so there is no need for any such depositor to apply it.

Limited protection of the deposit insurance

Upon creation of the IPAB, a seven stage transition program was instituted, allowing for a gradual decrease of the deposit insurance coverage. Limitations on this insurance were imposed not only on the total amount of insured deposits, but also on the kind of the deposits to be protected, as stated above. Therefore, starting in 2005 and as per the provisions of article 11 of the LPAB, deposit insurance coverage of insured deposits is limited to a maximum of 400,000 investment units or udis (unidades de inversión), per bank, and per depositor (the deposit insurance limit). In light of this, any amount in charge of an insured depositary institution in excess of the deposit insurance limit will depend on the financial ability of the corresponding Bank to honour such liability.

Prompt corrective action regulation

The IPAB has authority to intervene an insured depositary institution as a protection mechanism of depositors' interests. In that regard, the IPAB, together with the CNBV, are constantly monitoring the financial standing of each Mexican banking institution. They base their supervision on the Prompt Corrective Action Regulation enacted in 2004. Furthermore, the Mexican Banking Institutions Act (Ley de Instituciones de Crédito) was amended in 2004 to allow the CNBV to identify, during the supervision process, any problem evidencing the poor financial health of insured depositary institutions. It also provides the authority to preventively and promptly take any actions deemed necessary for the benefit of depositors.

As a consequence of the Prompt Corrective Action Regulation, the CNBV is entitled to classify each insured depositary institution in accordance with its fulfillment of the mandatory capital requirements. The CNBV may classify banks within any of five levels, which classification is determined in consideration of the banks' capitalisation standard (índice de capitalización or ICAP), which is the relevant benchmark for the measurement of said insured depositary institutions' capital.

Conditioned operations regime

Notwithstanding the prompt corrective action regime, in the event insured depositary institutions are in extreme financial distress, resulting from their failure to achieve the necessary capital standards, the financial authorities are entitled to perform certain actions. These result in either allowing banks to operate under a conditioned regime, pursuant to article 29-Bis-2 of the Banking Act, or even to liquidate the insured depositary institution concerned.

In July 2006, the Banking Act was further amended in order to facilitate financial authorities to promptly implement the aforementioned corrective actions in the event that a bank's capital standard is below 8%, in line with the provisions of article 28 of the Banking Act. In such a case, a bank will be allowed to continue operating as on-going business, but will be subject to the regime. Under the conditioned regime, the operations of the insured depositary institution will be closely monitored by the financial authorities.

In that scenario, the bank shall be bound to comply with capital restoration plans that will be periodically reviewed by the authorities. Any restrictions imposed and applicable requirements to the undercapitalised insured deposit institution will also be periodically reviewed in order to determine whether the plan, restrictions and requirements are resulting in an increase of the capital standard. The conditioned regime also allows shareholders to recapitalise the bank without risking their ownership interests.

Receivership and liquidation of the bank

When an insured depositary institution fails to exercise its right to operate under the conditioned regime or its capital standard is less than 8% but greater than 4%, the CNBV must carry out immediate actions to intervene the operations of the bank. In accordance with article 138 of the Banking Act, if the CNBV determines that intervention is necessary, the IPAB shall appoint a receiver to act as the sole administrator of the Bank. It will be vested with full powers and authority otherwise granted to the shareholders' meeting and the board of directors, to perform all of the bank's operations. The receiver may be assisted by an advisory board.

The advisory board shall be constituted by three to five members and appointed by the IPAB. The role of the receiver is to preventively manage the bank. The receiver must explain in detail every action taken during the performance of its duty, determine the actual assets and liabilities of the bank, and prepare an inventory. It must provide the IPAB with a report on the financial, accounting, legal, economic and administrative status of the insured depositary institution, in order for the IPAB to determine whether or not the bank should be liquidated.

If the capitalisation standard falls below 4%, the bank will be automatically liquidated. When an insured depositary institution has a negative capital standard, it becomes essential to protect the interests of the depositors. It is important to bear in mind that the current Mexican Bankruptcy Act (the Concursos Law) provides special regulations in the event an insured depositary institution is declared insolvent.

Insolvency matters

On May 12 2000, the Concursos Law replaced the previous Mexican Bankruptcy and Suspension of Payments Law. Under the Concursos Law there is a single insolvency proceeding known as Concurso Mercantil (Concurso procedure). The Concurso Procedure consists of two main stages; the concilia-

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Alejandro Sainz is the co-managing partner of the firm, Chairman of the insolvency & restructurings practice group and co-chair of the mergers & acquisitions practice group. He represents national and multinational clients in a broad range of transactional matters, providing legal advice in the areas of corporate, finance and commercial law. This work includes reorganisations, restructurings, work-outs, bankruptcy and cross-border insolvency procedures, project and corporate finance, M&A, foreign investment, joint ventures, infrastructure, real estate, gaming and telecommunications transactions.

In the restructuring and insolvency arena, he represented: (i) the ad-hoc committee of foreign secured creditors in the $800 million cross-border restructuring of the debt of Satmex; (ii) Grupo Iusacell in its $650 million cross-border restructuring of its debt, and; (iii) the ad-hoc committee of creditors in the Mexican legal aspects of the US insolvency procedure of Tower Automotive.

Among other restructuring and insolvency matters, Mr. Sainz is representing: (i) the ad-hoc committee of noteholders in the cross-border insolvency procedure of Corporacion Durango; (ii) the ad-hoc committee of noteholders in the cross-border insolvency procedure of Comercial Mexicana; (iii) Grupo Iusacell Celular in the cross-border restructuring procedure of its new debt; (iv) an important creditor in the bankruptcy procedure of the Mexican airline Alma, and; (v) certain creditors in the cross-border insolvency procedure of Majapara, a Mexican foreign exchange broker.

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tion stage, and the bankruptcy stage. Both of these stages are supervised by the Federal Institute of Specialists in Concurso Procedures (IFECOM).

The Concursos Law forms part of the Federal commercial legislation of Mexico. It requires certain jurisdictional prerequisites. Jurisdiction over a commercial insolvency case lies in the Federal District Court of debtor's corporate domicile, or its principal place of business, as the case may be. The Concursos Law further provides that all claims against debtor must be brought before the court hearing the case, in order to avoid different courts hearing claims against the estate in a piecemeal fashion.

Involuntary or voluntary proceeding

As a first step, a creditor is required to establish a valid claim for payment of an obligation against debtor. If appropriate, the creditor would proceed to serve official notice to debtor through a notary public or court officer, requesting payment of a debt. At such stage, the creditor would request the notary public or court officer to attest to the inactivity of debtor or its inability to perform its payment obligations. The purpose of this request would be to establish that debtor is in a condition where it can no longer perform its obligations, giving rise to a valid cause for commencing a Concurso procedure. Having established a valid cause, creditor could then file a petition with the court requesting the commercial bankruptcy of debtor. The debtor itself, any creditor, the district attorney, a court (if the situation ever actually arises), and tax authorities in their capacity as creditors, may file insolvency claims.

A debtor may be declared insolvent if it has generally failed to comply with its obligations. For purposes of the Concursos Law, an individual or entity has failed to comply with its obligations if it has failed to repay its due obligations to two or more different creditors. The obligations of the debtor must have been due for at least 30 days and represent at least 35% or more of all the debtor's obligations on the date on which the demand or insolvency petition is filed.

Failure to comply is also indicated if the debtor does not have any of the following assets in an amount sufficient to repay at least 80% of its obligations due on the date on which the demand or insolvency petition is filed:

- cash and demand deposits;
- term deposits and investments becoming exercisable or due in a term no longer than 90 calendar days following the date on which the demand or insolvency petition was filed before the Court;
- customer receivables with a maturity date not exceeding 90 calendar days after the date on which the demand or insolvency petition was filed before the Court;
- securities or negotiable instruments available at the relevant markets which may be sold within a term of 30 business days, with a known value on the date on which the demand or insolvency petition was filed at the Court.

The debtor itself, any creditor, the district attorney, a judge, and tax authorities in their capacity as creditors, may file insolvency petitions.

With the involuntary petition filed by creditors, or the voluntary insolvency petition filed by the company, a guarantee must be posted to secure the examiner's fee payment.

The court will rule against the creditor that filed the involuntary petition, or the company that filed the insolvency voluntary petition, to pay attorney's fees and expenses (the amount is regulated by statute), including the examiner's fees, if any dismissal judgment is issued declaring that the company is not in insolvency status.

Preliminary stage

Immediately after the insolvency petition is filed and accepted by the court, it must request the IFECOM for the appointment of an examiner. Once the examiner has been appointed, it must report to the court, within the following 15 to 30 days, whether the debtor is in fact insolvent andi f it is in one or more of the hypothesis contemplated by the Concursos Law to be declared in Concurso. The debtor and, in cases where the insolvency petition is filed by creditors (involuntary procedure), such creditors, may challenge the examiner's report. The Court must resolve as to the solvency or insolvency of the debtor within the 15 days following the date of its receipt of the examiner's report. If the court resolves that the debtor is solvent, the Concurso procedure ends. If the court resolves that the debtor is in fact legally insolvent, it must so declare and the conciliation stage shall begin.

The declaration of insolvency must establish that the debtor has incurred a general default of its payment obligations, and must include a provisional list of creditors identified in the debtor's accounting records. This list does not exhaust the proceeding for recognition, ranking and determination of the priority of creditors' claims.

Pursuant to the Concursos Law, the declaratory of insolvency will include the look-back date (the date to which the effects of the Concurso Procedure will be applied retroactively – 270 days hardening period). It also includes a declaration that the conciliation stage has commenced and instructions to the IFECOM to appoint a professional conciliador. There is also an order to the debtor to immediately provide to the conciliator debtor's books, records and all other documents, and allow the Conciliator and interveners, if any, to carry out the activities necessary to accomplish their duties, and to suspend the payment of debts.

The declaration of Concurso will also include an order to register the resolution with the Public

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Previously he was founder of Riveroll y Martínez-Rueda and senior associate at Jáuregui Navarrete y Nader. He was also the manager of banking projects at the National Banking and Securities Commission.

While a government official he was in charge of the working group who prepared the amendments to several financial laws, including the Mexican Banking Act and the Stock Exchange Act. Additionally, he developed the Code of Best Practices of Corporate Governance for Mexico (issued by the CCE in a Joint effort with the CNBV). He worked also in the preparation of the current Banking and Savings Deposits Insurance Act (LPAB). Finally, he was also involved in the process by which the Mexican Insolvency Law was enacted as well in the creation of the Savings and Public Credit Act. Currently, he is legal counsel of several banking clients and publicly held companies. Additionally, he regularly advises real estate developers.

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Registry of Commerce corresponding to debtor's domicile. It also provides for the Publishing of an abstract in the Official Gazette and in one of the newspapers of largest circulation in the domicile where the procedure is taking place. Finally, there is an order to the Conciliator to begin the proceeding of acknowledgement or recognition of creditors, and to notice creditors to request the recognition of claims.

Stages

Conciliation stage

The first stage of a Concurso Procedure is the conciliation stage, which is purported to encourage a binding reorganisation agreement among the debtor and its creditors. This is a plan to avoid the debtor's bankruptcy or liquidation. The conciliation stage may not last more than 185 calendar days unless extended for up to two additional consecutive periods of 90 calendar days each. However, the Conciliation stage cannot last more than 365 calendar days.

Once the commercial insolvency of the debtor has been declared, the conciliation stage will initiate and attempts to find formula to allow the debtor and creditors to come to an agreement will begin. A conciliator, who initially acts as an intermediary between the company and its creditors, must direct this attempt. The roll of the examiner and of the conciliator may be performed by the same person.

Pursuant to the purposes of the Concursos Law, the idea is for the conciliator to act as an amicable intermediary between the parties. One of the functions or powers of conciliator is to recognise claims based on the debtor's accounting records in order to make the claim recognition process faster. The conciliator will also collaborate in the decision on whether the business will continue to be operated by debtor's restructuring the debt, or whether it is necessary to remove existing management from the operation of the company.

The objective of the conciliation stage is to preserve the operation of the debtor's business. The conciliator is responsible for publishing the deadline for creditors to submit proofs of claims, processing proofs of claims, serving as a mediator among the debtor and creditors, and proposing to the court a plan of reorganisation.

Bankruptcy stage

The second stage of a Concurso Procedure is the bankruptcy stage. The debtor may be declared bankrupt if: (i) the conciliation stage finishes without having reached a creditors' agreement; (ii) the debtor fails to comply with the creditors' agreement; or (iii) the debtor requests its bankruptcy, or the conciliator requests the debtor's bankruptcy and the court agrees to grant it.

In addition to the effects attributed to the declaration of insolvency, the bankruptcy judgment:

(i) suspends the ability of the debtor to perform legal acts;

(ii) causes the appointment of a receiver, with full authority, to replace the debtor or the conciliator in the management of the debtor's business;

(iii) orders the debtor and any third party having possession of the debtors' assets to deliver all such assets to the receiver;

(iv) requires that payments to the debtor only be made with the receiver's authorisation (failure to obtain such authorisation causes double payment);

(v) invalidates any acts performed by the debtor or its representatives after the bankruptcy judgment without the receiver's authorisation; and

(vi) invalidates any payments made by the debtor after the bankruptcy judgment.

Special rules for insured depositary institutions

Under the Concursos Law, special rules are provided for the Concurso procedure of insured depositary institutions. It provides that only the IPAB or the CNBV may request the Concurso of an insured depositary institution. From the date on which a petition for the Concurso Procedure of a insured depositary institutions is filed, such insured depositary institutions shall shut down all the offices that provide service to the public. It must also suspend any type of borrowing, lending and service transactions. The court may adopt such preventive remedies as may be necessary for the protection of the workers, premises and assets of the institution. Moreover, it provides that when the Concurso of an insured depositary institution is declared, the procedure will be commenced in all instances with the bankruptcy stage.

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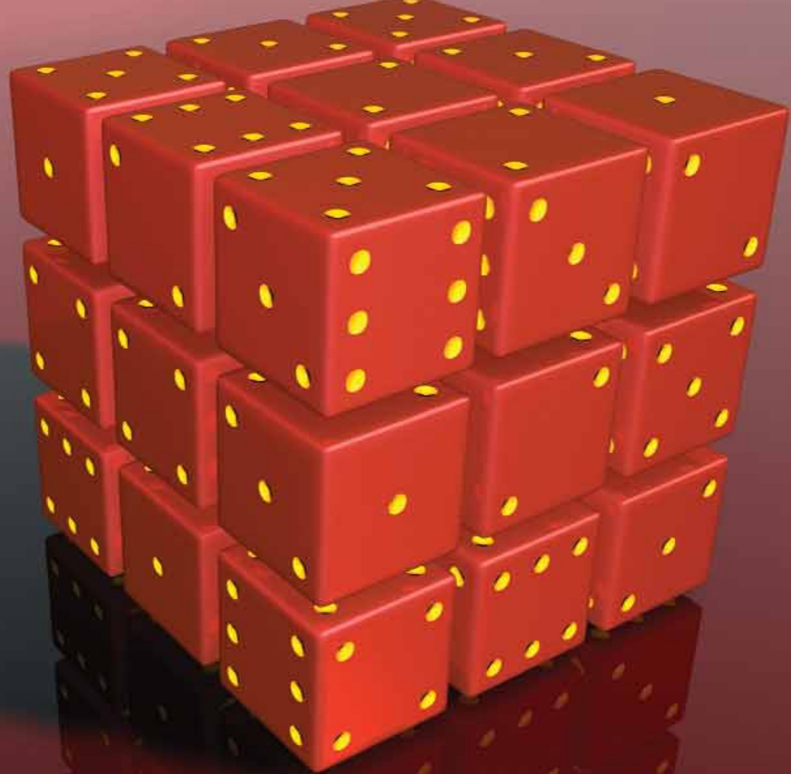

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The lender versus the borrower

Fred Litsheim of Kvale & Co discusses some international syndication issues Norwegian agent banks found themselves dealing with during the credit crunch

International syndicated banking is a highly developed trade in Norway. For ship financing Norway is an international centre. Norwegian banks initiate and administer loan facilities issued by international bank syndicates on a large scale. This capacity is normally referred to as an agent bank. The handling of legal disputes which may arise out of or in connection with the loan agreements governing such facilities are among the various responsibilities of an agent bank. Norwegian agent banks will normally use Norwegian civil courts as the venue of jurisdiction and Norwegian law as governing law in the facility agreements.

Therefore, a number of legal issues that became apparent under the recent credit crunch, and which, pursuant to the loan agreement shall be solved on the basis of Norwegian law, are not without international interest.

Two particular issues arose out of the credit crunch. Both are based on the Norwegian Agreement Act § 36. This is a clause also known as the contractual general clause on adoption of contracts. It gives a party to an agreement a general right to demand the unilateral revision of an agreement, to be imposed by the courts, if there are grounds present that make the current agreement unreasonable. Needless to say, such a clause will come to the forefront during times of unexpected turmoil. Due to the financial crisis, and the very real fear of a collapse in the global financial system that prevailed at times, the Agreement Act § 36 suddenly became of acute interest, in a field where this was not to be expected.

Firstly for periods, the two issues are, related to the fact that, the interest rates which the borrower had to pay pursuant to loan agreements fluctuated wildly. That the loan agreements under such circumstances may be adapted subject to Agreement Act § 36 is readily apparent, and in most cases the only practical claim a borrower might set forth.

Secondly, the fear of a collapse also led to the lenders in the syndicates depositing their available funds long-term, to preserve them for future obligations to contribute funds to facilities. This is a problem, since the facility agreements are normally based on the presumption that lenders make short-term deposits to match the borrower's drawdown of the facilities. In these cases an adaptation of the loan agreements on the basis of the Agreement Act § 36 is an apparent claim a lender may set forth.

As to the parties' regulation of their relation, they commonly use one of the English Loan Market Association's (LMA) Primary Documents, which are used as the basis for drafting the Norwegian agent banks' standard terms. Each agreement must, as always in the sphere of party autonomy, be interpreted on its own merits. However, the banks and borrowers have tended to rather uncritically rely on the form as it is, especially as to its technical provisions, including interest rate regulation. Therefore, and due to the fact that it would be of minor general interest to consider specific modifications by random parties, the LMA Single Currency Term and Revolving Facilities Agreement – Primary Documents (the Agreement), will be used as the legal starting point for the issues we will discuss herein. Nonetheless we must emphasise that it is the concrete facts in each actual case that will be decisive. We are in this format limited to highlighting and discussing relevant legal aspects and providing tentative conclusions in the light of typical circumstances.

The Agreement Act § 36 is a mandatory rule, and therefore applicable no matter how unsuitable it may be considered in an international legal relation. As long as it is deemed unreasonable to uphold an agreement's original content it may be revised pursuant to the Agreement Act § 36 . This does not mean that a possible international aspect of an agreement is without relevance. This must also be taken into consideration in the assessment of whether the Agreement Act § 36 shall be applied in any given case.

> **"The banks and borrowers have tended to rather uncritically rely on the form as it is"**

If applicable, the Agreement Act § 36 gives the court a discretional scope to adapt the legal agreement. The clause states that an agreement may entirely or partially be set aside or adapted. The adaptation must be done subject to the main criterion unreasonable, which means that the mandate is to restore reasonability.

The Agreement does not provide a basis for the borrower to enjoy any relief from his obligations in case interest rates soar to unexpected levels. Therefore, the borrower must be understood to have assumed the risk of all moves in interest rates and must perform accordingly *pacta sunt servanda*, which is the starting point and general rule of all law.

The question that arose under the credit crunch was if it would be unreasonable that the lenders affirm the Agreement, or had the circumstances become so extreme that this would be unreasonable, thereby giving the borrowers a legal right to revise the obligations.

The wording of the Agreement Act § 36 instructs that a high threshold for applying the provision prevails. In the preparatory works the legislator states that positively unreasonable matters must be present, and that it is of course not sufficient that there more reasonable solutions exist. Principally the Agreement Act § 36 was passed to give a general provision to protect consumers, especially when entering into agreements based on non-negotiated standard terms. This suggests a restrictive application of the provision to commercial agreements between professional parties. In the plenary decision published in Rt 1990 on page 284 (the Norwegian periodical for issuing the Supreme Court's decisions) the Supreme Court also stresses that it is supposed to be used with caution.

The criterion unreasonable is vague and discretional and so it directs towards a concrete, holistic evaluation of the circumstances. The provision defines the point in time for the assessment to be when the agreement is affirmed, at which time events subsequent to entering into the agreement are relevant.

It is assumed that the Agreement Act § 36 has consumed the former, unwritten doctrine on subsequently failed contractual assumption. In the preparatory works the lawmaker guides that "the assessments with regards to the relevance of subsequently occurring circumstances at the whole would be the same as pursuant to the doctrine on subsequently failed contractual assumption." Furthermore it stated that "the doctrine and case law under this gives guiding and is directional to the courts practice of the mitigation rule insofar as the significance of subsequent occurring circumstances." The lawmaker also emphasises that adaptation or mitigation only is possible in the more extraordinary of cases.

"The unwritten doctrine has common features with the principles of *force majeure*"

The unwritten doctrine has common features with the principles of force *majeure*, but is not identical to this. One criterion is that the assumption must have been motivating to the party wanting to mitigate his obligation, meaning that its promise to perform had not been given if the promisor had known of the subsequent occurring events. If so, the assumption is said to have significance. The promisor's assumption must, furthermore, have been apparent to the other party. And finally, it must be reasonable that the other party, post-signing, assumes the risk for the failed assumption. For this to be reasonable, a minimum requirement is that the promisor could not foresee or should not have foreseen the subsequent circumstance, and even if all these criterions are fulfilled it must also constitute an adequate allocation of the burdens from the subsequent circumstances that the other party must carry these by mitigation.

Normally, it may safely be assumed that the borrower has agreed to the agreement knowing that the interest rate could fluctuate higher and maybe much higher. This is a risk assumed by the borrower. Hence, the assumption in most cases would not fulfil the criteria of being motivating. The borrower's failure to fulfil this criterion under the doctrine makes a compelling argument against the agreement being unreasonable to affirm. Having regard to the legislators comments provided above and the general rule (*pacta sunt servanda*), little room should then be left for the application of the Agreement Act § 36.

However, a distinction between the Agreement Act § 36 and the older doctrine is that the doctrine operates with firm criteria whereas the Agreement Act § 36 provides for a concrete holistic evaluation of the reasonability. It is hence necessary to examine the circumstances closer.

The Agreement Act § 36 decides that the parties' resources shall be emphasised in the evaluation. Parties to a commercial loan agreement must be assumed to be resourceful and capable of protecting their interests. In the case issued in Rt 2003 page 1132, the Supreme Court also holds out that there must be extremely good reasons to find unreasonableness and set aside agreed criteria in commercial contracts between professional parties. One further factor in the evaluation of the reasonability is,

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naturally, the contents of the Agreement. If the loan costs for the borrower become extremely, or even unmanageably, high this weighs in direction of applying the Agreement Act § 36. In a case published in Rt 1999 s 922 the minority of the Supreme Court based its decision not to apply the Agreement Act § 36 on the situation being unlikely, but foreseeable. All-in-all it cannot be excluded that the Agreement Act § 36 is applicable in more extreme cases.

Consideration shall also be given to the circumstances at the time of the formation of the agreement. Such circumstances present during the formation of agreement may be similar to for instance the situations described in the Agreement Act §§ 28 to 33 – such as duress and coercion. Normally, this gives little guidance when using the Agreement.

The Agreement Act § 36 also allows for many other circumstances to be considered. In light of this any breach of any obligation to renegotiate a contract, if such an obligation can be established, is relevant. This means that the Agreement Act § 36 could provide a remedy to such a breach.

The threshold for being excused for non-performance of payment obligations is higher than for other commitments, for the case issued in Rt 2000 page 610.

As the almost invariable rule, the borrower cannot have his obligations under the agreement adapted or terminated due to soaring interest rates. Other relevant and particular circumstances must be present.

The Agreement contains a market disruption clause. One situation the Agreement fails to recognise is that one or more lenders cannot obtain funds in the interbank market at all, a key topic of the credit crunch. The lenders would nevertheless be obliged under the Agreement to provide the facility. This would constitute a very serious problem, since the lenders would be exposed to the knock on effect of the borrower's lack of funds, which could be huge losses. However close this never became a reality during the credit crunch.

Another situation to which the market disruption clause does not provide a solution is more practical. Driven by concerns raised by rating agencies, lenders participating in revolving loan facilities structured as rollover loans felt compelled to fund their participation on an unmatched basis. A revolving loan made to refinance another revolving loan which matures on the same date as the drawing of a consecutive revolving loan is known as a rollover loan. Funding on an unmatched basis means that the lenders deposit more money than they are obliged to provide to the facility on the rollover date, in order to preserve liquidity in case they cannot obtain new funding on the next rollover date.

The problem with this arrangement is that the lenders under the Agreement are only entitled to interest fixed for the interest period selected by the borrower. If the interest rate at the quotation day for the next rollover interest period is for instance lower than the interest rate on the lenders' deposits, the lenders would be operating with reduced margins, and possibly large negative margins. In periods with fast and large interest rate fluctuations lenders may be exposed to heavy losses. Similar to this situation is that the lenders, to consolidate their participation in a term loan or a normal revolving facility, make deposit before the quotation day of the loan.

Unlike the situation for the borrower, the Agreement cannot in most cases be interpreted to mean that the lenders have undertaken this risk. On the contrary, the parties have adopted measures to limit lenders risk for subsequent events, by using a market disruption clause. The effect of which is to entitle the lenders to cover their real costs of funding plus revenue in different subsequent events. The market disruption clause in the agreement, however, fails to regulate the issues set out above.

One possible legal basis for the Norwegian agent banks to resolve this situation is by demanding an interpretation or supplementation of the Agreement under the present facts. An alternative is applying the Agreement Act § 36, and revising the agreement in order to avoid unreasonable results. The connection between these two approaches is strong, and the matters and arguments to be considered would, to a large degree, be the same. This is apparent from the Supreme Court in the case published in Rt 2000 s 806 which states that the "starting point is that the agreement's provision on price is clear, and that there must be strong arguments to set it aside – either this is denoted as a result of general principles of interpretation or as a result of adaptation (by use of the Agreement Act § 36) of a contract."

We consider adaptation the honest approach, as it rules out the parties becoming exposed to a *de facto*, but not openly discussed, reasonableness test by the courts, under the guise of interpreting the agreement.

The question then becomes whether or not the Agreement Act § 36 is applicable in the situation outlined above. The case *Breivik v Oslobanken AS* published in Rt 2000 s 610 has already been mentioned above. In the liquidation of a bank it was alleged that the bank was not obliged to perform its pension commitments, *inter alia* owing to it suffering general problems with settling its debts. The Supreme Court's retort to this was that the bank's "payment problems (its insolvency) cannot amount to it being unreasonable to affirm the pension rights. It still must be a clear general rule in Norwegian law (which must prevail with few exceptions) that an obligor, and indeed a bank, cannot consider itself unbound to a monetary obligation owing to its own payment problems." Even more this must be the case if a lender was not suffering such payment problems, but only was dissatisfied with narrowing or negative margins.

In an arbitration award, the so called Mascot case, two shipping companies entered into an agreement priced in dollars. The agreement contained a clause which was supposed to hedge Mascot's exposure to fluctuations in the dollar's exchange rate. If the clause was given effect in accordance with its wording, a long term move in the dollar led to unforeseen consequences for Mascot. The arbitration court declared that the clause was not adequately formulated with regards to its intended purpose, and based on this and other arguments, it found that the agreement was unreasonable to affirm and that Agreement Act § 36 was applicable. Confer also cases printed in Rt 1991 page 220 and Rt 1935 page 122. The fact that the parties have tried, even unsuccessfully, to regulate their relation so that the lenders are entitled to real costs, seems to be a viable argument for the application of the Agreement Act § 36 if a situation occurs where lenders begin to take losses.

It is of course the parties themselves that must suffer the consequences of a financial crisis and a credit crunch. However, a well functioning credit market is of high public interest. The lenders using the Agreement will almost exclusively be large financial institutions, which if troubled can cause widespread disruptions to society in general. They are indeed subject to strict public regulations directed at securing sufficient capital. An interesting question in this context is whether it is acceptable or not to take the interests of society at large into consideration when applying the discretional Agreement Act § 36? This would lower the threshold of applications for larger banks. In our view the Agreement Act § 36 is a provision aimed at the relation between private parties, and that as the general rule considering the interest of society may not be done. In extreme cases, where the banking industry may be at risk of collapse, this may, nevertheless, form a valid argument.

It is not possible to form any general conclusion, but in our view, a borrower is more at risk than a lender to have an agreement revised subject to the Agreement Act § 36 due to extreme fluctuations in interest rates.

There is no doubt that interest rate regulation in the Agreement, which Norwegian agent banks and other financial institutions use in a large number of their facility loan agreements, functions satisfactory under all but the most extreme circumstances. In light of our findings, a few remarks are nevertheless in order. With regards to the borrowers, it is clear that they have a strong interest in ensuring that their position in cases of rate fluctuations is strengthened. The lenders on their side should provide for a more adequate regulation of the problems faced when unmatched funding takes place and when funds cease to be available in the interbank market in general.

Restoring confidence

The effects of the financial crisis on banking are now familiar; primarily risk aversion and slow lending. Paulo Câmara of Sérvulo & Associados looks at how the Portuguese government reacted to mitigate the situation

Following the international economic downturn, the Portuguese government reacted by taking essential policy measures to offset the exposure arising from the dramatic downturn in the market and to relaunch the Portuguese economy. Each measure taken by the Portuguese government has been devised and administered in order to restore confidence, integrity, stability and growth in the market.

Integrity and confidence

Since the start of the crisis, the primary concern for Portugal was reducing the risk aversion and strengthening the inter-bank market. So the Portuguese government reacted by establishing a state scheme for granting guarantees to Portuguese credit institutions, through Law 60-A/2008. These state guarantee schemes are aimed at re-establishing liquidity in financial markets to preserve financial stability and regain investors' confidence.

Under the state guarantee scheme, the Portuguese government was authorised to offer personal guarantees, up to the aggregate amount of €20 billion, to credit institutions and international banks with registered offices in Portugal. This guarantee scheme was approved by the European Commission and considered to be in line with state-aid rules under the EC Treaty.

The terms of the guarantee scheme sets forth that until full repayment of the guaranteed debt, the state can, if and to the extent deemed necessary to protect the public interest: convert the credit against the credit institution into share capital; adopt corporate governance principles on dividend policies and on the remuneration of the credit institution's officers; and appoint one or more temporary directors. According to follow-up reports, seven Portuguese credit institutions have been granted a state guarantee, between the start of the scheme and June 2009, totalling €4.35 billion.

Portugal also introduced a recapitalisation scheme for credit institutions registered in Portugal. This was tailored to improve the financial soundness of Portuguese credit institutions, to avoid systemic risk and bolster the financing of the real economy. The measure, Law 63-A/2008, November 24 2008, which was approved by the Portuguese Parliament, improves the financial soundness of Portuguese credit institutions by making up to €4 billion available to Portuguese banks to strengthen their capital ratios.

The measure would make new capital available to eligible credit institutions, whether financially sound or not, in exchange for instruments eligible as Tier 1capital (according to European Directive 2006/49/EC). It is intended to enable credit institutions to strengthen their own funds against potential losses, in-line with the recommendations of the Portuguese Central Bank to establish a Tier 1ratio not lower than 8%. Furthermore, the recapitalized Tier 1ratio should not exceed 8% on the day the recapitalisation is implemented. Under the recapitalisation scheme, two different regimes are anticipated: an increase in the level of own funds of credit institutions already having an acceptable solvency and stability, seeking to bring them in-line with their European counterparts; and a direct state intervention in the recovery and remedial processes.

The scheme is also temporary in nature and divestment by the government should be concluded after a period of three years, which may be extended in exceptional circumstances to five years. The stringent state intervention measures that accompany this recapitalisation plan lead to its unattractiveness to credit institutions. In fact, up to present it was only used once.

> "A mandatory say-on-pay rule was introduced, covering members of public interest entities"

Deposit guarantees

The Portuguese government was intent on curing the dwindling confidence in its banking system, and took as many measures to regain trust. Accordingly, on October 6 2008, in the interests of its depositors, investors and other creditors and for the safeguard of normal functioning in the market, the Portuguese government increased its guarantee of bank deposits from €25,000 to e100,000 per depositor and institution, anticipating the transposition of European Directive 2009/14/EC. The same grounds lead to a reduction of maximum payment period to 20 business days.

The legal framework of the Portuguese investor compensation scheme (Sistema de Indemnização dos Investidores) also suffered some amendments, through Decree-Law 162/2009, although maximum compensation amount remained unchanged at €25,000 per investor. These changes to the regime on the Portuguese investor compensation scheme proved to be controversial. This is because the Portuguese Constitution imposes that such changes, once affecting mandatory financial contributions from financial intermediaries, must be approved by the Parliament and be solely valid for the future, while the Government approved them and labelled them as being of interpretative (retroactive) nature.

Short-selling regulation

Among the measures to tackle the current challenges facing the market were new prohibitions and regulations for short-selling transactions. Beginning in September of 2008, Portugal's securities market regulator (CMVM) decided to implement prohibitions and regulations on short selling of financial stocks, as a reaction to the extraordinary instability of the market. The CMVM decided that for a limited period, the members of Euronext and PEX should refuse orders for selling shares and other relevant securities relating to financial firms listed on Euronext Lisbon, in the event that the person issuing the order is not in a position to ensure in advance that the said securities will be available.

The CMVM also stipulated that market members shall disclose information to the public on investors who assume short positions on the shares of financial firms that surpass 0.25% of said financial firm's capital. A regulation was also approved that extends the obligation to disclose to its own investors, and likewise imposes the duty on its investors to report to the CMVM the said short positions and others held in the shares of non-financial firms listed on Euronext Lisbon.

As of January 2009, the CMVM repealed instructions that required daily reporting duties of short positions since the gathering and processing of such information was no longer called for in light of the costs involved. However, under its supervisory powers the CMVM may request information from any market member carrying out short-selling transactions on its own or client's behalf, where it is deemed necessary.

Remuneration policies

Another area garnering increased attention is the reform of remuneration policies. As it is commonly recognised, the general concern is to ensure that the level and structure of remuneration is consistent with the long-term performance of the company, and that the remuneration of directors aligns interests of directors and shareholders. It is also desirable that rewards for managerial failure are, to the extent possible, avoided.

These are global concerns that were reinforced during the crisis, although generally in Portugal remuneration packages are more modest than in other comparable European countries. Nevertheless, according to the widespread *zeitgeist*, it was felt as important that a reform be adopted in Portugal to address such a highly visible corporate governance topic.

A mandatory say-on-pay rule was the result, covering all members in supervisory and managing board roles in all public interest entities. This comprised financial firms, listed firms, venture capital funds and pension funds. Law 28/2009 required such companies to submit their remuneration policy for shareholder approval. The policy must describe: i) the mechanisms for alignment of interests between members of the corporate bodies and the company; ii) the criteria for variable remuneration; iii) the existence of stock-option plans; iv) the possibility of deferred compensation; and v) the mechanisms of remuneration limitation once financial results deteriorate considerably.

It could be said that the Portuguese say-on-pay rules are paradoxical. In fact, officially the legal intervention is aimed at giving shareholders more influence over determining directors' salary, although general Portuguese company law already gave shareholders direct or indirect power to establish directors' remuneration (article 399 of the Portuguese Companies Code). However, it is expected that the Law will considerably increase awareness in respect to the structure of remuneration of corporate bodies' members and will hopefully allow best practices to disseminate.

Restructuring the banking system

In an effort to strengthen the position of key financial players in the market, Portugal created rescue packages for the banking system to ensure individual banks' sustainability.

Notably, in November 2008, the government nationalized Banco Português de Negócios (BPN), which had run up accumulated losses of €700 million and was facing an imminent breakdown of its ability to meet payments. BPN was nationalised to contain systemic risks and protect deposits. Through this nationalisation, BPN became a public limited company fully owned by the state, but continues to be governed by the legal provisions, as well as its statute, regulating its activity except as otherwise provided for in the legal framework of the State corporate sector. Also, BPN management is now the responsibility of Caixa Geral de Depósitos. A privatisation of BPN is likely to occur in the upcoming months and some financial groups have publicly displayed manifestations of interest.

In December 2008, the Portuguese government decided to increase Caixa Geral de Depósitos' capital by €1 billion to strengthen its lending capacity. Caixa Geral de Depósitos is a bank wholly owned by the Portuguese state and, apart from significant shareholdings in several listed companies, holds about one-third of the mortgages in Portugal. The Portuguese government also passed a law enabling a consortium of six banks to grant Banco

> "One of the central lessons the Portuguese state rightly drew concerned the need for increased transparency"

Privado Português (BPP) a €450 million loan and to draw on a state guarantee to back the loan. The state guarantee underwriting the loan was approved by the European Commission on March 13 2009 as a temporary measure, and Portugal has committed to provide a restructuring plan for BPP within six months of the law being passed. At present, the future of BPP remains very uncertain, as a recent buy-out and re-capitalisation proposal, presented by the Portuguese group Orey, was turned down by the Government.

Strengthening sanctions

Parliament recently approved a law that increased the maximum penalty for crimes against the financial market, which is regulated under Title VIII "Crimes and Administrative Offenses" of the CMVM's Securities Code (SC). Within the SC, there is a system of administrative offences for violations to the securities laws and regulations. Sanctions include warnings as well as fines that depend on the offences. In addition, the system is complemented with criminal sanctions for insider trading and market abuse.

Within the scope of crimes approved to have the maximum penalty increased to five years are crimes for exercising illegal activity of deposits or other repayable funds, transmission or action based on insider information and market manipulation, and unlawful practice of insurance, reinsurance and pension fund management operations. Parliament also approved lifting the maximum amount of fines, now set at €5 million, which may be increased by twice of the economic benefit if it exceeds that amount. Furthermore, a summary process was created, resulting in a quicker administrative process in the insurance and banking regime. This follows the example of the regime already in force in the capital markets sector.

Improving transparency

One of the central lessons the Portuguese state rightly drew from the financial crisis concerned the need for increased transparency. Therefore, the Portuguese government took measures to significantly strengthen transparency duties in order to boost informed investment decision-making, and to reduce the level of financial illiteracy in retail financial consumers.

Through amendments to the credit and financial companies' regime, the amount of required pre-contractual information was strengthened on consumer credit, in addition to explaining the duties of clarity and completeness in contractual and advertising terms. In the latter case, it requires that whenever possible advertising messages are illustrated by representative examples.

A regulation was also approved that strengthened the information requirements relating to disclosure of banking services, particularly through advertising. The duty to report to the supervisory authorities of credit institutions, financial intermediaries and insurers with respect to their degree of solvency and liquidity and the risks that it incurs has also been increased.

Within the framework of the banking business, certain regulations sought to introduce greater transparency in the relationship between the bank and its clients. A financial ombudsman (Mediador do Crédito) was created in order to respond to queries and concerns of banking clients, through Decree-Law 144/2009. Furthermore, regulations have imposed uniform criteria for determining the interest rate on credit contracts by imposing the convention 30/360, aiming at greater comparability in banking contract terms.

In the same vein came a change in the Securities Code (new article 350-A), which forced financial intermediaries to notify the CMVM the assets held by them or by a company dominated by them, who are domiciled or managed by entities based in states that are not members of the European Union. Moreover, publicly held companies have now to notify shareholdings in countries that are not members of the European Union. The concern behind these duties was, in particular, the risk underlying investments in offshore jurisdictions.

Lastly, an additional disclosure obligation (Law 28/2009 of June 19) was recently approved requiring disclosure, on an aggregate or individual basis, of the remuneration of the corporate bodies' members. This legislative intervention emerges as a result of the failure of a soft law approach in this field. In fact, the mandatory disclosure obligation follows a recommendation from the CMVM's Corporate Governance Code of voluntary disclosure of remuneration of directors on an individual basis, which for years remained unobserved by a the majority of listed companies. This disclosure duty also adds to the duty to present annually the remuneration policies to shareholders (say on pay), as discussed above.

Duties of information

After the market turmoil, many new demands resulted, among them being the greater demand, from retail investors, for clear information in sophisticated financial products. In Portugal, the call for transparency as regards contractual conditions focused on financial contracts and instruments of the national financial system whose profitability depends on other financial assets, the so-called complex financial products. This was mainly the case for derivative securities, structured deposits, dual deposits and unit-linked insurance contracts.

These complex financial products are legally defined as financial instruments that, while assuming the form of a financial instrument already have

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characteristics that are not directly identifiable with that instrument, because they have associated with other instruments of development depends wholly or partially, its profitability.

A comprehensive set of duties was imposed to the issuers of these products through Decree-Law 211-A/2008. This includes, on the one hand, the duty of identification of the financial product as complex in the information rendered to investors and clients and in the advertisements thereof. On the other hand, during the distribution of complex financial products, either in private or public placement, clients must previously receive a note (prospecto informativo) that summarises the basic features of the product, in order to enable the said investors to understand the investment proposed. The information it contains must be: complete, real, updated, clear, concise, objective and legible.

Advertisement messages must also now be previously submitted for approval to the competent supervisory authority when related to complex financial products. Subsequent to the imposition of these duties, the CMVM prescribed in detail the content of the note and the advertisement requirements (Regulation 1/2009), when it takes the form of a capital markets instrument. The Portuguese Central Bank (Banco de Portugal) also imposed further disclosure duties to complex financial products that are based in deposits (*inter alia*, structured deposits and dual deposits). It should be noted that the content of the note has in this case has to follow Order 5/2009.

> **“Financial crises do not terminate by decree”**

This difference in the regime of complex financial products according to their banking or capital markets nature leads to the crucial need to clearly distinguish complex financial products that are deposits from other financial instruments. In the first case, the Central Bank Order is applicable, while in the latter it's not. Paramount is the indication that, regardless of its calculation method, the interest rate in a deposit cannot be negative (Order 6/2009).

A bigger role for regulation

Financial crises do not terminate by decree. Nevertheless, the role of regulators and supervisors, in any jurisdiction, is decisive in order to restore confidence and to safeguard the integrity of the markets. Crises demand therefore a bigger role for regulation and enforcement in the market. In this respect, Portugal proved to be no exception. The state and financial regulators acted timely and broadly followed the same guidelines as other European countries.

In their essence, most of these measures have a clear temporary nature; they are aimed at being in force solely while the crisis lasts. But overall, investors and market participants have regarded these measures as both necessary and adequate as responses to challenging times experienced after the summer of 2007. So this regulatory setting presents itself as a facilitator for financial recovery, and has played and will continue to play a role in the change of the economic cycle in the direction of greater stability, prosperity and growth.


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Relaxed regulations

Razvan Stoicescu and Silviu Cojocaru of Bulboaca & Asociatii discuss regulatory changes since the financial crisis

The past year has brought a number of interesting changes to the Romanian financial markets. The financial crisis which started in the summer of 2007 echoed in Romania, determining a substantial refocusing of the law and of its application.

As in other jurisdictions, the Romanian authorities passed new legislation and legal practitioners developed new strategies to better respond to the changing economic environment and to restore confidence in the system.

Whether these measures will restore the confidence in the financial and legal system remains to be seen. It is however certain that more care needs to be taken to preserve and exercise legal rights, given the increased likelihood of a subsequent challenge in the current economic climate.

Insolvency

Recent legislative changes are to be noted in the field of insolvency. The amendments appear to be more caring for the defaulting debtor, more encouraging of restructurings rather than simple liquidations, and more inclined to decrease the powers of the judge supervising the procedure in favour of the creditors or the liquidator or the bankruptcy manager.

It is now more difficult to initiate insolvency. The amount of debt which allows one to file for insolvency has tripled, increasing from €2400 to €7200. This means that whenever debts are less than €7200, insolvency is no longer a solution and the parties will have to negotiate or make recourse to standard litigation.

Fewer approvals from the judge supervising the insolvency procedures are now required. Shares held in the insolvent debtor by its directors can now be transferred by the latter without approval by the judge supervising the insolvency procedure. Initially, the absence of the approval triggered the nullity of the transfer.

Insolvency is no longer a termination event and cherry picking powers have been increased. It is now expressly provided that any clause establishing the termination of an agreement on the grounds that an insolvency has been initiated is null and void. As market practice shows, almost all contracts include insolvency-related termination events; this provision will fuel substantial litigation. However, qualified financial contracts (such as transactions under the ISDA master agreements) may not be subject to such provisions.

Creditors may now improve their ranking within the insolvency distribution procedure with a registered security agreement. Assuming that there is a security agreement dating prior to the opening of the insolvency procedure, its registration with the competent registries will most likely allow the respective creditor to outrank other unsecured creditors.

The court has now a maximum five day term to rule on claims regarding the opening of an insolvency procedure.

And a clearer regime for certain presale contracts has been introduced. Presale contracts having a date which is prior to the opening of the insolvency procedure where the insolvent debtor is a promissory seller will be performed upon request by the promissory buyer if: (1) the price has been fully paid or it can be fully paid on the date that the request is made and the asset is in the promissory buyer's possession; (2) the price is not lower than the market value of the asset; and (3) the asset is not determinant for the success of a reorganisation plan.

Capital markets

Measures have also been taken in the field of capital markets with a view to ensuring the maximisation of trades and the offering of incentives to investors.

“A clearer regime for certain presale contracts has been introduced”

The National Securities Commission has agreed to decrease fees applicable to public sale offers, as well as to trades on the Bucharest Stock Exchange. Furthermore, certain per value fees applicable to trades with treasury bills, as well as for admittance to trading on a regulated market, have been suspended.

The exchange and the Romanian Central Depository have also invested in opening the capital markets to new products. Starting from July 2009, specific over the counter transactions have been implemented. The financial instruments currently available for settlement are: (i) international financial instruments admitted to trading at least on a regulated market, including the regulated market managed by the Bucharest Stock Exchange; and (ii) Romanian financial instruments with fixed income, including treasury bills admitted to trading on the regulated market managed by the Bucharest Stock Exchange.

Credit institutions

The National Bank of Romania and governmental authorities focused on increasing the liquidity on the market and restoring confidence in lending. Measures such as those below have been taken.

- The monetary policy interest rate has been gradually reduced to 8.5% from 10% in February 2009.
- The minimum mandatory reserves rates that have to be kept by the credit institutions in accounts opened with the National Bank of Romania have been reduced. The current values of the minimum mandatory reserves rates have been diminished from 18% to 15% for Romanian lei and from 40% to 30% for foreign currency.

"Changes are expected in the field of budgetary expenses"

- The Romanian state agreed to guarantee loans less than €60,000 for the purposes of acquiring homes, under very favourable lending terms, i.e. Euribor 3M plus a margin of maximum 4% per year for loans in euros and Robor 3M plus a margin of maximum 2.5% per year for credits in Romanian lei.

The VAT rate applicable for these transactions was decreased to 5% as opposed to the standard 19% rate.

Public projects

The Ministry of Public Finances and the National Authority for the Regulation and Monitoring of the Public Procurement have provided supplementary guidance with respect to the public-private partnerships, jointly adopting guidelines on the implementation of public-private partnerships via contractual frameworks in compliance with the public procurement legislation.

The issuance of promissory notes by the Romanian public entities through their accounts opened with the State Treasury is now no longer possible. Whereas the rule is public entities must open accounts only with the State Treasury, this measure will substantially limit the possibility of financing via discounting promissory notes.

Changes are expected as well in the field of budgetary expenses. New laws are being prepared to ensure a unique grid of salaries of all budgetary employees and to allow a more efficient restructuring of the Romanian governmental agencies.

Tax wise, it is expected that reinvested profit will no longer be taxed starting from October 1 2009.

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Urgent changes to the insolvency framework

Alberto Núñez-Lagos and Ángel Alonso of Uría Menéndez look at how Spain's new bankruptcy laws are alleviating the worries of the financial crisis

The development of the global economic crisis following the Lehman Brothers' collapse, and its impact on the Spanish economy have forced a quick legislative reaction from the Spanish government. In particular, certain insolvency provisions have been improved and adapted to suit the current economic environment. The new changes to the Spanish Insolvency Act have been carried out by virtue of Royal Decree-Law 3/2009 of March 27 on urgent measures on taxation, financial and insolvency matters (RDL 3/2009).

Apart from these changes, the Spanish Ministry of Justice also announced its intention to carry out a fundamental reform of the Insolvency Law in the near future and a commission has been established for that purpose.

In 2004 the Spanish insolvency legal framework was changed considerably by the introduction of Law 22/2003 on insolvency (Insolvency Law), which came into force on September 1 of that year. The rules of the Spanish insolvency system dating back to the 19th century were invariably outdated and provided inadequate answers to the challenges of the global economy in the 21st century.

Five years after the Insolvency Law entered into force, both its strengths and weaknesses have become apparent. Insolvency practitioners generally consider that despite certain favourable solutions provided by the Insolvency Law to problems existing under the old insolvency framework, fine-tuning must be carried out in order to cope with the current challenges resulting from the economic crisis.

As an example, more than 90% of insolvency procedures end with the liquidation of the company. This high figure confirms the failure to achieve the fundamental aim of the Insolvency Law: the preservation of the viability of the insolvent company and the liquidation of companies that are unviable in the market.

The main amendments introduced by RDL 3/2009 are: (i) the possibility of reaching out-of-court refinancing agreements (including the benefit of new security) with no claw-back risk (except in case of fraud) with the support of 60% of the creditors and a viability plan approved by an independent expert (Refinancing Agreements); (ii) protection of the debtor in pre-insolvency negotiation of an early creditors agreement; (iii) clarification on the status of certain claims; (iv) early liquidation of the debtor's estate; and (v) measures to reduce costs and simplify and speed up insolvency proceedings.

> "Several provisions of the new framework are subject to interpretation"

Refinancing agreements

The Spanish lawmaker embraces the reasonable interest and preference shown by creditors regarding out-of-court restructurings due to the significant advantages they afford: reduction of costs and the extension of time to help the company overcome its insolvency situation.

Out-of-court restructurings not only enable the survival of the insolvent company but in most cases also avoid the early certificate of death of the company through the insolvency declaration. For that purpose, in order to convince creditors to partially waive their rights in an out-of-court restructuring, it is essential that creditors be protected if the restructuring fails and the debtor ultimately becomes insolvent.

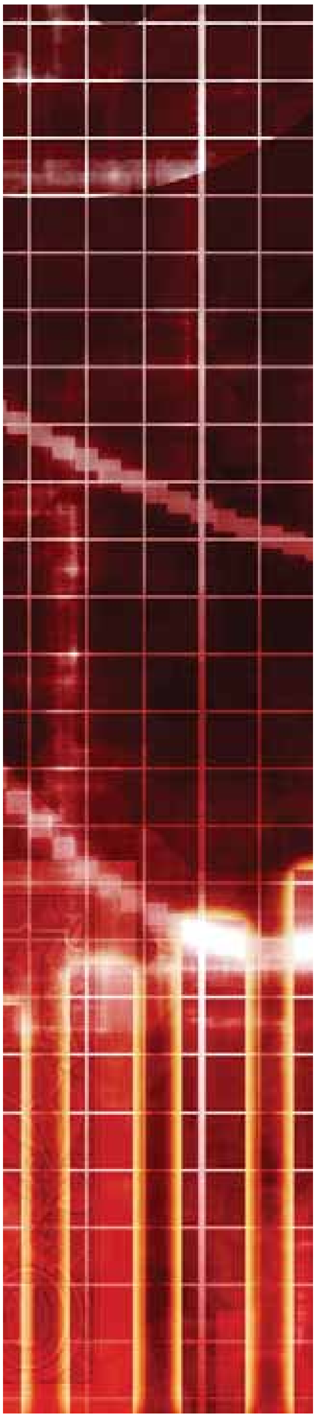
The Spanish lawmaker recognises that it could no longer turn its back on the bulletproof out-of-court restructurings common in neighbouring countries. On that basis, the lawmaker introduced a new framework through RDL 3/2009 in order to give protection to out-of-court restructurings (especially new security granted in connection therewith) against the risk of claw back in a future insolvency.

In general, the basis for the claw-back action under the Insolvency Law is solely based on the observation that the act subject to claw back is detrimental to the estate of the debtor and, therefore, it may be rescinded even in the absence of fraud. New security granted to cover obligations that priorly were unsecured, is presumed detrimental and subject to claw-back. This two-year claw-back period is the major obstacle for most refinancing transactions and generated disturbances in the market for companies requiring debt restructurings in the economic crisis. The new framework governing Refinancing Agreements that fulfil the requirements provided by RDL 3/2009 protects such agreements (including new security) against that claw-back risk.

Notwithstanding the above, Refinancing Agreements remain susceptible to general rescission actions under the Insolvency Law since they may be challenged under articles 1,111 and 1,291 of the Spanish Civil Code. However, these are much more difficult to exercise, since there must be evidence of fraud. The new framework also prohibits creditors from exercising the claw-back action of Refinancing Agreements entered into under such provision, limiting that right to receivers.

Several provisions of the new framework are subject to interpretation. First, the new framework establishes a functional concept of what should be understood as Refinancing Agreements as well as a general framework for the same. This new framework is applicable to restructurings agreed by debtors out of court involving a significant increase of credit or modification of obligations, either through the extension of its maturity or the replacement of obligations. Consequently, strictly speaking, not all agreements are Refinancing Agreements. Second, in order that an agreement qualifies as a Refinancing Agreement it is not necessary that creditors grant new credits in the form of new money or the modification of any other condition (interest rate, the amortisation calendar or other similar conditions).

A Refinancing Agreement must meet the following requirements: (a) to fall under the scope of a viability plan (endorsed by an independent expert) to allow the continuation of the business of the debtor in the short and medium term; (b) be approved by creditors representing at least 60% of the liabilities of the debtor; and (c) be elevated to a public deed. If these requirements are met, the transactions, payments and security executed thereunder will not be subject to claw back.



Creditors' agreements

RDL 3/2009 has introduced several modifications to in-court composition agreements between the debtor and its creditors within the insolvency process, both as an early creditors' agreement (convenio anticipado) or an ordinary composition agreement (convenio ordinario).

As regards early creditors' agreements, if the debtor starts negotiations towards such agreement within the two months after the insolvency situation is known or should have been known, RDL 3/2009 establishes that the debtor will have an additional three months to negotiate the creditors' adherence to that proposal without (i) the obligation to file for insolvency within such period and (ii) the risk that a creditor files for insolvency. Subsequently, the debtor must apply for insolvency during the month following the end of the three-month period.

This measure is designed primarily to avoid certain practices normally carried out under the existing provisions for those cases in which, while a company was negotiating its debt restructuring with its main creditors (mainly financial entities), creditors sought the insolvency declaration of the debtor in order to put pressure on the debtor or financial entities to obtain repayment of credits.

The following requirements must be met in order the extension is granted: (i) the debtor must currently be in an insolvency situation; (ii) the request for an insolvency proceeding must be filed within two months of the time the debtor becomes aware or should have become aware of the insolvency situation; (iii) negotiations have already been initiated in order to obtain adherence to an early creditors' agreement before the end of the two-month period in which to file the insolvency; (iv) the communication of the abovementioned negotiations must be forwarded to the court competent to hear the insolvency proceeding; and, (v) there have been no previous applications for an insolvency declaration made by any creditor.

The purpose of this amendment is to facilitate an early creditors' agreement and is not designed to give rise to a Refinancing Agreement, which would enable the debtor to overcome its insolvency situation. As such, once the three-month period granted to the debtor has expired, the insolvency proceeding will continue its

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course. However, there has been an increase in the time granted to negotiate an early creditors' agreement before the insolvency proceeding has been filed (without the receiver having intervened in the management of the insolvent debtor).

Other innovations introduced by RDL 3/2009 such as the early creditors' agreement offer the possibility that the minimum number of adhesions required for such agreements to come into effect include any type of creditors (whether or not subordinated). Likewise, the minimum credits support for the proposal's filing has been reduced by RDL 3/2009 from 20% to 10% of the total liabilities if the proposal is submitted to the court together with the insolvency application.

RDL 3/2009 also reduces the list of situations that would prevent an early creditors' agreement to the following: (i) the debtor has been convicted in a final judgment for criminal offence regarding the company's assets, social economic order, forgery crimes against workers' rights; or (ii) the debtor has breached its obligation to deposit annual accounts with the commercial registry for any of the last three year periods.

Two additional changes have been introduced concerning the ordinary creditors' agreement. First, a written voting procedure for the creditors' agreement without the need for a creditors' meeting is possible if more than three hundred creditors are involved. Furthermore, if the judge believes there will be opposition due to legal infringement of the written vote process, he or she will be competent to call a meeting according to the same rules applicable before agreeing on a new written vote process for a period no longer than 30 days since the last ruling.

Second, the requirement to obtain the administrative authorisation to overcome the legal limits to exceed the maximum debt reduction threshold (50%) and the maximum debt deferral period (5 years) with respect to entities particularly relevant for the Spanish economy is abolished and the judge will have exclusive authority to permit those limits to be exceeded.

Recognising and classifying credits

RDL 3/2009 adopts certain long-awaited amendments to the credits framework by providing solutions to specific problems raised in its application. In doing so, RDL 3/2009 has settled certain discussions among insolvency courts on the ranking and subordination of credits that, despite having been clarified by the majority of sentences from the Appeal Courts, had still not been accepted by some receiver administrators. In brief, RDL 3/2009 makes the following modifications: (i) clarification of two ranks of claims; (ii) classification of credits granted by parties related to the debtor; and (iii) a new subordination assumption.

RDL 3/2009 clarifies two ranks of claims: (i) credits protected by public law (taxes, social security and so on); and (ii) credits of individuals or companies especially related to the debtor (for example inter-company claims). In relation to the first rank, RDL 3/2009 establishes that claims arising from inspection or verification proceedings will be recognised as contingent until they are determined and, consequently, any late communication to the receiver administration will not result in a subordination of such credits.

On the other hand, credits guaranteed by parties related to the debtor will be classified as subordinated whenever the grantor has paid the creditor concerned and, therefore, subrogates in its position. Consequently, such creditors will have the same rights as ordinary creditors if the party related to the debtor is not subrogated in the credit.

The relevant moment for considering those shareholders as related to the debtor (owner of at least 5% of the share capital if the debtor is a listed company or 10% otherwise) will be the date on which the credit is granted and not the moment at which the relationship to the debtor is made known or when it had been established (before, the subordination took place or even ex post, when the creditor became a partner of the company).

The last amendment to the classification framework involves all claims arising from contracts with reciprocal obligations. As a general rule and, pursuant to the Insolvency Law, the sole declaration of insolvency will neither affect the validity of contracts with reciprocal obligations still pending to be fulfilled between third parties and the insolvent debtor nor will the effects of such contracts be altered. Otherwise, the continuation of the debtors' business throughout the insolvency would not be viable.

> **"The RDL 3/2009 allows for a shortening of the liquidation process"**

Experience has shown that third party debtors of the insolvent company are keen to create obstacles to the fulfilment of their obligations. In such cases, RDL 3/2009 is designed as a coercive measure since their claims will be subordinated if the creditor repeatedly breached such contracts during the insolvency process.

Liquidating the estate

Under the Insolvency Law, an insolvency proceeding may be terminated (i) once a creditors agreement has been agreed and approved or (ii) upon the liquidation of the debtor's estate and subsequent sale of assets owned by the debtor (or by any liable third party) to satisfy the creditors.

The RDL 3/2009 allows for a shortening of the liquidation process by virtue of which the debtor may request early liquidation of the debtor's estate during the ordinary phase of the insolvency proceeding. This proposal may even be sought (and used to pay creditors with the amounts obtained

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from the liquidation transactions) without waiting for the decision on the challenge of the receivers' report.

The principal characteristics of the new procedure are the following: (i) it must be requested by the debtor within 15 days of the issuance of the receivers' report; (ii) it must be evaluated by the receiver administration; (iii) the judge will approve or reject the proposal; and (iv) payment to the creditors will be the same as under the general framework established by the Insolvency Law, but the judge may authorise payment to creditors without waiting for the decision on the claims filed against the receiver's report.

The advantages of this alternative are that the liquidation and sale of assets will begin after the issuance of the receiver's report, saving time and creating the possibility to obtain a better price for the assets (the length of insolvency proceedings is inversely related to the value of the assets). The time saved with respect to the normal liquidation process is therefore the period of resolution of the creditor's list or the inventory list.

Simplifying proceedings

RDL 3/2009 has introduced further changes designed to speed up, simplify and save costs associated with the insolvency proceeding.

First, a new system is established for publicising the initiation of the insolvency process. Edicts related to the insolvency declaration are published in the Official Spanish Gazette without cost and a new Insolvency Public Registry is established to publish other resolutions issued by means of edicts, which can be accessed without cost via the internet.

"RDL 3/2009 is a small step in the larger reform of the Insolvency Law"

Second, RDL 3/2009 has modified the retribution system for the receiver administration including, in particular, the following measures: (i) limiting the receivers' fees; and (ii) establishing a mechanism to ensure receivers are paid a minimum fee by means of the creation a common fund for cases involving companies with insufficient assets to cover fees of the receiver. Finally, the scope of cases to which the abbreviated insolvency process (process deadlines are halved and only one receiver is appointed) is applicable has been extended.

The functions expected from insolvency proceedings have not been fully achieved throughout the past five years. RDL 3/2009 takes a step in the right direction by protecting out-of-court restructurings, providing more time for negotiations prior to insolvency without incurring liability, reducing the time for liquidation in order to limit the losses to the value of assets, and reducing costs.

RDL 3/2009 represents a small step in the larger reform of the Insolvency Law that was recently announced by the Spanish Ministry Justice. Hopefully, all these new changes will help debtors and creditors to better overcome the negative consequences of the economic crisis.

The Swedish authorities takes a stand

Marcus Johansson of Gernandt & Danielsson Advokatbyrå discusses the Swedish authorities' role during the latest financial crisis

In the early 1990s, Sweden had a domestic financial crisis that was mainly caused by imprudent lending into the real estate sector. That financial crisis and the government's management of it have served as a model, or at least an inspiration, for other countries since. The lessons learned then could only partially be used by Sweden and its various agencies during the 2008 and 2009 financial crisis. This 2008 and 2009 crisis had its roots outside of Sweden and manifested itself differently. It may be interesting to see how Sweden has reacted this time around, in light of the fact that, since July 1 2009, Sweden holds the Presidency of the EU and has a central role in the management of the financial and economic crisis in Europe.

The consensus is that the root of the financial crisis was the US mortgage sector and the collapse of the US subprime loan market in particular. This was aggravated by the spread of securitisation of such assets. However, Swedish banks have traditionally stayed away from structured securities based on subprime loans. Moreover, the Swedish financial system is not particularly exposed to the US mortgage market. The financial crisis in Sweden was therefore caused by the US crisis itself rather than the same factors that caused the US crisis. The crisis did not even begin to affect the Swedish financial market in a more appreciable way until the collapse of Lehman Brothers in September 2008, almost one and a half years after effects had started to show in the US.

The direct losses suffered by Swedish banks on account of positions against Lehman Brothers were relatively small and manageable. However, Sweden is a small country and heavily dependent on exports. Its financial system is integrated with the global financial market. Sweden is therefore sensitive to changes in foreign financial and general economic markets. The Lehman Brothers collapse triggered public concern and distrust primarily in the financial industry, which followed in the footsteps of the collapse of the financial industry in the US and a number of euro zone countries.

An early signal was the sudden exceptional demand for secure short-term investments, notably Swedish treasury bills, in October 2008. The liquidity problems in the US and in the euro zone started to affect the Swedish financial market. It was, *inter alia*, manifested in increased liquidity risks on Swedish securities. This caused Swedish financial institutions to hoard liquid assets and to be more reluctant to lend money over the interbank market. Some banks had difficulties funding themselves on reasonable terms.

The liquidity of Swedish banks deteriorated a lot during the last months of 2008. The more cautious attitude between the banks led to reduced interbank lending, rising interbank interest rates and increased funding costs for the banks.

Starting in October 2008, the Swedish Central Bank began to actively provide liquidity to the financial sector. Initially, loans were provided with three and six months maturities against collateral in certain listed debt securities and certain foreign currencies. In May 2009 the Central Bank also started providing loans at 12 months maturity. In cooperation with the US Federal Reserve, the Central Bank also offered loans in US dollars. Concerns over Swedish companies' ability to finance themselves by corporate certificates led the Central Bank to launch facilities under which banks could lend from the Central Bank using corporate certificates as collateral.

The Swedish Central Bank also cut the repo interest rate, successively decreasing it from 4.75 % in September 2008 to the current level, 0.25 % (as of August 31 2009).

True to its strategy of offering bank deposits at an interest rate generally 0.5 % lower than the repo rate, the Central Bank became the world's first central bank to introduce negative interest rates on bank deposits (at -0.25 %) in July 2009.

Between the end of December 2008 and the middle of March 2009 all four major banks, tapped

"Swedish banks have traditionally stayed away from structured securities based on subprime loans"

into the capital market to strengthen its capital base. In October 2008 Swedbank announced a rights issue to and raised SEK 12.4 billion (before transaction costs). In December 2008, SHB raised SEK 2.1 billion through an issue of hybrid debt. Then, in the beginning of 2009, both Nordea and SEB announced rights issues raising €2.5 billion and SEK 15.6 billion respectively. Swedbank announced a second issue of some SEK 15 billion in August 2009.

On October 20 2008, the Swedish government proposed a stabilisation plan to secure the stability of the financial system. The purpose of the stabilisation plan was to strengthen the stability of the Swedish financial system and deal with the negative effects of the global financial crisis, including the lack of liquidity in the financial system and the increasing cost of funding. Some days later, the Swedish Parliament approved a government bill designed to enhance the stability of the Swedish financial system. New legislation, the Act on Government Support to Credit Institutions (Support Act) was implemented.

The Support Act provides for a stabilisation fund for financing the stabilisation plan. The stabilisation plan also includes powers to provide targeted support to ensure the stability of the Swedish financial system, a guarantee programme and a recapitalisation scheme. The stabilisation plan is administered by the Swedish National Debt Office on behalf of the government.

The objective of the stabilisation fund (together with the deposit guarantee fund) shall equal an average of 2.5% of Sweden's GDP within 15 years. Initially, the government provided SEK 15 billion by special appropriation. It is contemplated that payments to the stabilisation fund will comprise guarantee fees, stability fees, deposit guarantee fees and recoveries from support measures provided under the stabilisation plan.

The Swedish National Debt Office has been vested with certain extraordinary powers under the Support Act, if a financial institution encounters severe financial difficulties, creating a risk of serious disruption to the Swedish financial system. It may then intervene with support to continue the business of the institution if its business is considered sustainable or to organise reconstruction or winding-up of an institution that is not profitable in the long term.

It is suggested that support shall primarily be provided by the National Debt Office subscribing for preference shares with high voting power. The support must be provided at arm's length and must not unduly distort competition.

"The Support Act provides for a stabilisation fund for financing the stabilisation plan"

Further, the National Debt Office is given the right to compulsorily redeem shares issued by a financial institution if such redemption is considered of exceptional importance from a public policy perspective. Further requirements are that (i) the institution or the relevant shareholder has not accepted a support agreement proposed by the Swedish National Debt Office which has been considered reasonable by a special appeal board; (ii) the institution or a shareholder has not fulfilled a material obligation under a support agreement; or (iii) the capital base of the institution is less than 25% of the required level.

The government has also launched a guarantee programme to facilitate borrowing for financial institutions. Under the guarantee programme, an eligible financial institution can draw down a guarantee issued by the Swedish government, represented by the Swedish National Debt Office, for part of its borrowings, provided the institution enters into a specific contract with the government, a guarantee agreement. The guarantee agreement contains, *inter alia*, caps for increases in the wages of executives and restrictions on bonus payments, severance packages and increases in board remuneration during the term of the guarantee.

The guarantee programme is open to banks and major mortgage institutions based in Sweden, as well as credit market companies incorporated in Sweden serving municipalities. In order to obtain a state guarantee, the applicant must meet certain requirements regarding the composition and size of its capital base.

The purpose of the guarantee programme is to facilitate borrowings of banks and certain credit market companies and to reduce their borrowing costs during the prevailing global financial crisis. The total financial limit of the guarantee programme is SEK 1.5 trillion. Guarantees under the guarantee programme can be issued up to November 1 2009 unless prolonged by the government. By June 2009 only a handful institutions had signed up for the guarantee programme, most notably SEB, Swedbank, state owned mortgage institute SBAB, car leasing institute Volvo Finance Bank and Swedish investment bank Carnegie Investment Bank.

Under the recapitalisation scheme, the Swedish National Debt Office may, after obtaining government approval, provide capital to banks, mortgage institutions and credit market companies serving Swedish

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municipalities. The total limit for the recapitalisation scheme is SEK 50 billion. The capital provided to a particular institution may amount to no more than the equivalent of an increase of 2% in the institution's capital ratio. The injection of capital must be provided as share capital or as subordinated debt capable of being included in the institution's core capital.

The recapitalisation transaction itself can take different forms. The National Debt Office can participate in a market transaction, whereby it acquires up to 70% of the shares or debt instruments issued at the same terms as other investors. Additionally, it may subscribe for securities in a directed issue, whereby the state acquires shares or convertible debt instruments on terms decided by the National Debt Office. In the case of a directed issue where the state acquires more than 70%, the Swedish National Debt Office will set the price based on a model reflecting the risk of the issuing institution and the returns on similar financial instruments under normal market conditions. The returns must always at least equal the level calculated according to the ECB model. The recapitalisation scheme is funded through the stabilisation fund.

The Swedish financial crisis started as a liquidity crisis. Over time, the lack of liquidity by banks and the resulting difficulty for businesses to borrow money has affected the economy. In 2008, the number of bankruptcies rose 7% compared with 2007. In 2009, the bankruptcies have risen even further. The aftermath of the crisis has been significant adverse effects on employment and economic growth. According to the Central Bank, recession will be deep in 2009 and interest rates are expected to remain at low levels until autumn 2010.

So far, the Swedish economic crisis has had its fair share of corporate victims. For instance, Swedish private equity house Nordic Capital found it impossible to save car component manufacturer Plastal, which consequently went bankrupt in March 2009.

Swedish car manufacturer SAAB applied for company reorganisation in February 2009. It was recently announced that GM and Swedish sports car manufacturer Koenigsegg had signed an agreement for the sale of SAAB. Although the deal is yet to close, recent information suggests that the required financing may soon be in place. Several smaller businesses, especially in wholesale, have suffered bankruptcies.

In the financial sector, however, the only true Swedish victim of some size is the Carnegie group. D Carnegie & Co (D Carnegie), with its investment banking subsidiary, Carnegie Investment Bank, was for some time one of Sweden's most esteemed and profitable investment banking groups. In 2001, the shares of the parent company, D Carnegie, were listed on the Stockholm Stock Exchange.

Unlike many other banks, Carnegie Investment Bank did not have access to funding through the Central Bank's repo programme and therefore relied heavily on the interbank market. When the finance crisis began to affect the Swedish financial market in the autumn of 2008, Carnegie Investment Bank found it increasingly difficult to borrow at the interbank market. Moreover, Carnegie Investment Bank's principal bilateral lender informed that it would reduce its credit line by the end of October 2008. Facing a liquidity deficit, Carnegie Investment Bank applied for and received a SEK 2.4 billion loan from the Central Bank on October 28 2008 as liquidity support. (This was done under the old regime which was subsequently replaced by the stabilisation plan.) The parent company, D Carnegie, supported the credit, *inter alia,* by a pledge over its shares in Carnegie Investment Bank in favour of the Central Bank.

Around about the same time, Carnegie Investment Bank reported large provisions related to credit engagements with a long-term customer and Swedish securities and real estate tycoon. Carnegie sought to reduce its exposure against the customer gradually, but the Lehman Brothers collapse and the sharp decline in share prices on the stock market triggered margin calls which could not be met by the customer. The whole situation caused the Swedish Financial Supervisory Authority (FSA) to initiate an investigation

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regarding, *inter alia*, breach of the large exposure regulations.

On November 10 2008, the National Debt Office and the FSA took some extraordinary actions against Carnegie. Initially, the loan from the Central Bank was repaid by a SEK 2.4 billion loan granted by the Swedish National Debt Office to Carnegie Investment Bank pursuant to the newly implemented stabilisation plan. Half an hour later the FSA decided to revoke Carnegie Investment Bank's licence to conduct banking and securities business. Just two minutes after that decision was announced, the Swedish National Debt Office declared that it realised its security in, *inter alia*, the shares in Carnegie Investment Bank by taking over ownership. Then, eight minutes later, the FSA announced that it changed its decision to withdraw the licence and issued a warning to Carnegie Investment Bank instead. The motive was that the state, in the guise of the National Debt Office, during the last couple of minutes had taken over the ownership of Carnegie Investment Bank.

The legality of the realisation of the pledge is subject to pending litigation in the Swedish courts between the parent company, D Carnegie, and the National Debt Office. The matter of the valuation of the collateral taken over by the National Debt Office is pending before the Stabilisation Plan Appeal Board. In the spring of 2009, the National Debt Office sold Carnegie Investment Bank to private equity company Altor and investment company Bure.

Looking specifically at the Swedish banking sector, focus has now shifted considerably from liquidity to a feared surge in credit losses in Eastern Europe.

Over the last couple of years, certain Swedish banks have expanded quite aggressively into the Baltic states and Ukraine. Swedish banks are said to account for around 50% of the banking market in Latvia and Lithuania and around 75% of the Estonian banking market (based on the volume of lending). They are responsible for around SEK 500 billion in lending to borrowers in the Baltic region. As the Baltic states' economies have become increasingly strained there is a growing concern that credit losses in the Baltic states will pile up, especially in the event the Baltic states would decide to devaluate its currencies.

Indeed, for Swedbank and SEB credit losses in the Baltic states rose considerably in 2009 and are expected to increase even further. According to the Central Bank's stability report, the major Swedish banks are expected to suffer credit losses of SEK 170 billion in 2009 and 2010. Out of this, 40% are estimated to be caused by the banks' Baltic and eastern European activities. According to the Central Bank, the major Swedish banks can sustain this level of loss without the need for additional capital to meet capital adequacy requirements. In a stress test in August 2009, the Central Bank stated that the Swedish banks could sustain credit losses of some SEK 350 billion and a serious recession in both Sweden and the Baltic States, yet still meet capital adequacy requirements.

“Sweden wants joint actions in the financial and economic sectors as well as on the labour market”

One of the main issues during Sweden's ongoing Presidency of the EU is obviously the global financial crisis. The president and member states will jointly continue to work to reduce the negative impact of the crisis on growth and jobs. Sweden therefore wants joint actions in the financial and economic sectors as well as on the labour market. The government's ambition is to restore confidence in the financial markets, realising economic recovery as soon as possible and creating long-term solutions for sustainable growth, employment and open markets.

Sweden has, *inter alia*, declared that it will work for a new supervisory framework and strengthened supervisory bodies. The objective of the president is to reach consensus and support for a European body to supervise stability in the financial system as a whole. This proposed body also contains a European system for financial supervision at micro level. The work at the micro level will ensure reinforced cooperation among national supervisory authorities and more efficient supervision of cross-border banks.

Although Swedish authorities may be seen as having been reasonably successful in managing the 2008 and 2009 crisis, the lesson seems to be that only a sound and restrained global financial market supervised by an effective cross-border regulatory framework may mitigate future financial crises, in Sweden as elsewhere. It will be fascinating to see whether the Swedish Presidency can facilitate that development. Sweden's own management of the 2008 and 2009 financial crisis and its aims for its Presidency of the EU seem to suggest that Sweden will indeed advocate a strong and proactive cross-border supervision of the European financial market.

Alternative financing sources

Johannes Bürgi, Thomas Meister and Lukas Wyss of Walder Wyss & Partners describe how banks refinanced Swiss assets when the Interbank lending markets came also to a complete halt

Since late spring 2007, the disruption in the credit market has forced banks to create new structures to gain access to liquidity and refinance credit portfolios. Regular financing through the unsecured interbank lending market and, loan assets securitisation and sale of such portfolios to the capital markets used to be a standard means of refinancing. In the current climate, the latter sources of refinancing simply do not exist – the interbank lending market almost came to a complete halt after the collapse of Lehman Brothers in September 2008 – and are expected to recover very slowly. As a result, banks are trying to use alternative structures.

In recent deals, credit portfolios have been sold and transferred to selected investors at substantial discounts rather than to the broader capital markets. Governments around the world have intervened to support financial institutions. Securities satisfying certain collateral eligibility criteria set up by central banks have been created to allow banks access to various liquidity programmes introduced by central banks. Also, clients have been offered early redemption solutions at a discount. In recent deals, UBS and Credit Suisse issued Swiss Pfandbriefe (covered mortgage-bonds) through the Swiss mortgage-bond bank (Pfandbriefbank) in private placements aimed at Swiss local retail banks. Volume, private placement, and the lending of the proceeds to one specific member bank only are new elements to these structures. Most recently, UBS publicly announced it would set up a covered bond programme under which it will issue covered bonds through its London branch. Such covered bonds are guaranteed by a newly set up SPV and ultimately backed by Swiss mortgages. Such covered bonds will be issued outside the legal framework of the Swiss covered bond system.

Past deals seen in the Swiss market

Sale of loan portfolios to a single or limited number of investors

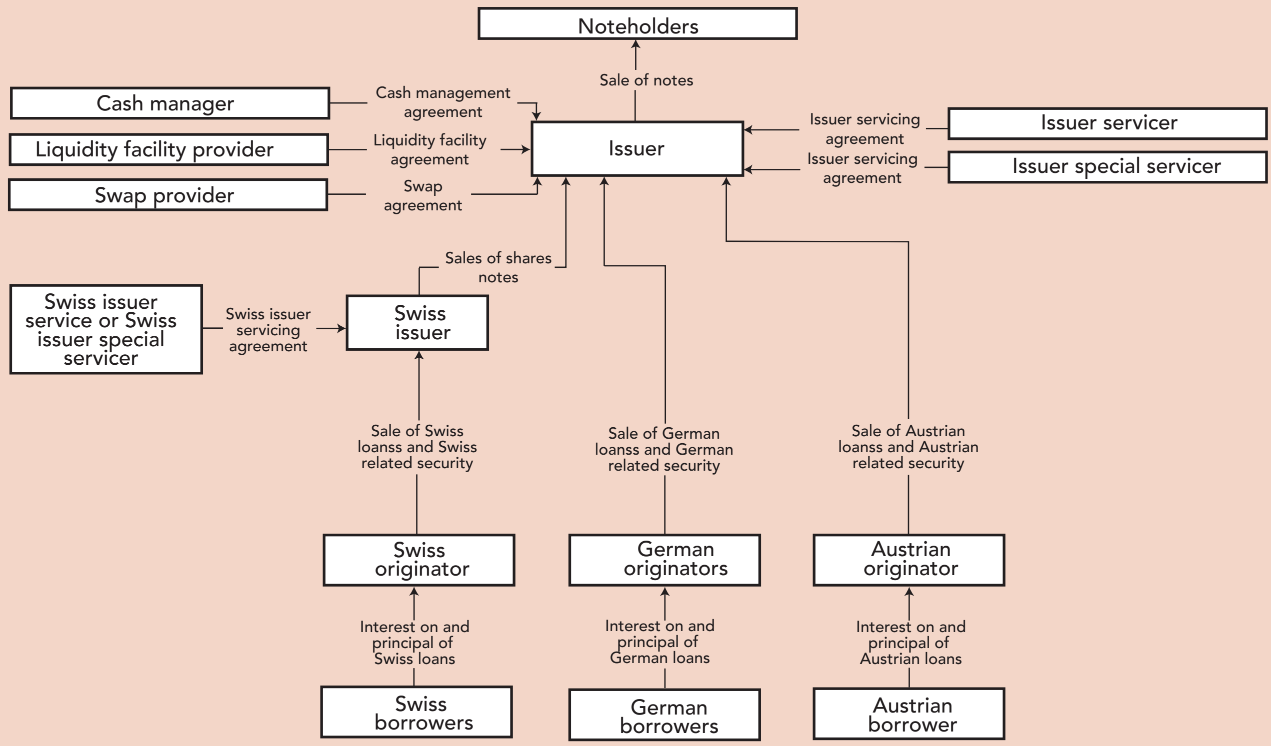
Rather than selling loan portfolios to the broad capital market, financial institutions have started to seek selling opportunities with selected investors. Pressure on the liquidity markets resulted in prices for loan portfolios decreasing dramatically; this presented investors with some attractive investment opportunities. Also, some borrowers started to purchase their own loans or to negotiate an early redemption at a discount. The quality of the underlying asset is far from the only element relevant to the price-building process. However, legal and operational limitations may make it somewhat cumbersome and time-consuming to transfer large portfolios of residential mortgage loans.

Two major transactions involving Swiss banks have been publicly announced and closed already at an early stage of the financial crisis: In May 2008, UBS sold a pool of mortgage loans to BlackRock for a purchase price of $15 billion (originally acquired at $22 billion). Even though 75% of the purchase price was financed by a secured facility provided by UBS, the sale resulted in a significant improvement to UBS's risk profile. First, UBS hedged itself against further price fluctuation of the loan portfolio up to 25%. Second, the risk weighting of the secured loan advanced to BlackRock is less severe than the risk weighting of the pool of mortgagee loans. A second deal announced in summer 2008 involved the sale by Credit Suisse of a mortgage loan portfolio to GE Real Estate. This portfolio involved a small number of large mortgage loans forwarded to high-quality borrowers and secured by real property located in the UK, Germany, Spain and Switzerland. There have been a large number of smaller deals, mostly involving single loan transactions and often only involving a subordinated tranche of a loan.

> **“Credit portfolios have been sold and transferred to selected investors at substantial discounts”**

Sale of subordinated tranches of mortgage loans to borrowers or third party investors

Box A: typical Swiss CMBS



Structure overview from the prospectus, dated June 27 2007 relating to the issue of commercial mortgage-backed floating-rate notes due 2018 in a total amount of €1,445,342,232 by DECO 15 – Pan Europe 6 Limited (a private company incorporated with limited liability under the laws of Ireland with registration number 440952)

During the years 2004 to 2007, the CMBS wave hit Switzerland and numerous Swiss commercial mortgage loans were sold to the market through CMBS structures, most often as part of a larger pan-European mortgage loan portfolio [See Box A for typical structure].

In order to structure the portfolio to be refinanced and in order to create LTVs (loan-to-value ratios) in the pool that would be acceptable from a rating perspective, the loans that went into the structures have most often been split in advance, creating an A Tranche and a (subordinated) B Tranche. In the Swiss context, this split occurred by the Swiss issuer (holding the Swiss assets) refinancing itself for each Swiss commercial mortgage loan through two tranches: The A Tranche financed by the issuer (thus becoming part of the CMBS issue) and the subordinated B Tranche financed by another investor. Often, originators financed the B Tranche in a first instance before placing such B Tranches in the market. B Tranches have been relatively high-return investments. The Tranches were structured as loans or notes.

During the last year, the market for such B Tranches was very active in Switzerland as banks that still had B Tranches on their books were urged to refinance such assets. However, no investors was willing to buy a B Tranche at nominal value and accordingly, B Tranches have been sold in most cases at a discount. In such an environment, borrowers (or affiliates of borrowers) were the most important B Tranche buyers. They started to buy B Tranches with their own mortgage loan as underlying. Economically, this resulted in an attractive opportunity for such borrowers to reduce the loan amount at a discount. Also, as the return on the B Tranches is higher than on the A Tranches, the reduction in interest costs is more than proportional to the reduction of the nominal amount of the mortgage loan.

> **“During the last year, the market for B Tranches was very active”**

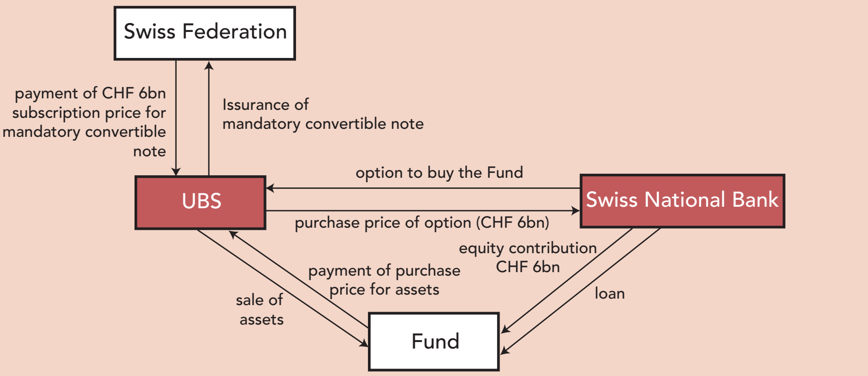
Sale of loan portfolios to structures sponsored by governments or national banks

Another source of liquidity has been made available to banks by setting up government or national bank-sponsored structures to which troubled assets have been transferred. For example, under the Emergency Economic Stabilisation Act 2008, the US House of Representatives and the US Senate created the Troubled Asset Relief Programme (Tarp), giving the secretary of the treasury the authority to purchase or insure troubled assets or use other means to stabilise the markets. UBS and the Swiss National Bank set up a special purpose vehicle (SPV) that was funded with equity of CHF6 billion (made available by UBS which raised such funds by issuing a mandatory convertible bond to the Swiss Federation) and debt provided by the Swiss National Bank, and bought an entire pool of troubled assets from UBS [See Box B]. In August 2009, the Swiss Federation exited the transaction. After early conversion of the mandatory convertible bond, its stake has been placed in the market.

According to public sources, UBS is currently trying to repurchase the assets transferred to the SPV in order to achieve again full independence (as many other banks did in the last couple of months).

Creating ABS that are eligible as collateral for

Box B



Swiss cantonal banks may become members of the Pfandbriefzentrale. Further, any bank licensed to do business in Switzerland may become a member of the Pfandbriefbank, provided that: (i) it is headquartered in Switzerland; and (ii) at least 60% of its balance-sheet assets consist of Swiss mortgage loans. The Pfandbriefbank waived the second requirement and reduced the threshold to 10%. Foreign banks may not become member banks and, accordingly, will not have access to the Swiss mortgage bond system. Most of the banks that are licensed to do business in Switzerland and headquartered in Switzerland are members and thus have access to the system. The Pfandbriefbank has roughly 240 member banks.

central banks

Various national banks established liquidity programmes under which secured short-term facilities could be provided to banks. The aim was to allow banks to access liquidity for collateral that would otherwise not be liquid in circumstances when the unsecured interbank markets are under stress. Accordingly, many asset-backed securities (ABS) transactions, some also involving Swiss assets, have been set up and structured in a manner so as to create ABS notes that meet the eligibility criteria of the relevant national bank. Such notes are created even in situations where there is no imminent need to trade these notes with national banks, as they simply want to be in a position to have ABS readily available that are more liquid than the underlying assets.

Swiss mortgage bond system

The Swiss mortgage bond system was introduced in 1930 and is generally regulated by the Mortgage Bonds Act (1930). Within the legal framework of the Swiss mortgage bond system, *Pfandbriefe* are issued to investors. The funds raised by the *Pfandbrief* agencies are then lent to the member banks against mortgage security (consisting of mortgage loans). Thus, the system allows member banks to refinance their Swiss mortgage lending business. The *Pfandbrief* is a covered bond-like investment instrument and is (indirectly) fully secured by real property located in Switzerland. The mortgage bond system essentially involves four parties [See Box C].

Pfandbrief agencies

Pfandbrief agencies issue *Pfandbriefe* to investors and lend the funds to their member banks on a secured basis. Only two *Pfandbrief* agencies have been authorised by the Swiss regulator. The Pfandbriefzentrale with cantonal banks as members and shareholders and the Pfandbriefbank with non-cantonal banks as members and shareholders.

Member banks

Member banks may borrow funds from the relevant *Pfandbrief* agency, secured by mortgage loans (and the related mortgage security) granted by the member bank to its clients (mortgagors). Such lending will match a certain issue of *Pfandbriefe* by the relevant *Pfandbrief* agency.

Mortgagors

The ultimate asset able to be refinanced through the Swiss mortgage bond system is a mortgage loan granted by a member bank to the mortgagor.

Investors

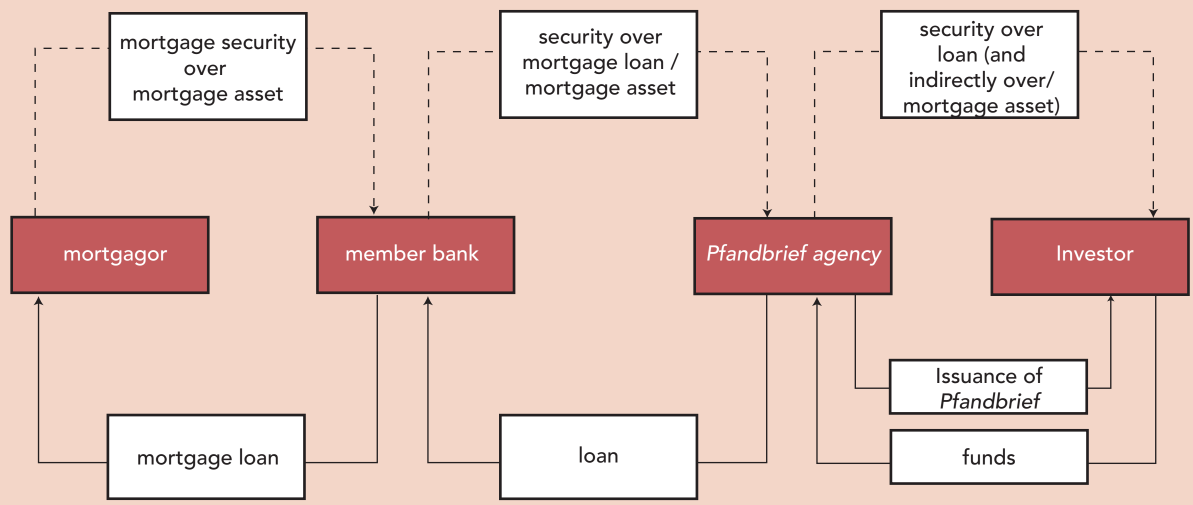
Investors subscribe for the *Pfandbriefe*. Each holder of a *Pfandbrief* is – by law – secured by the loans granted by the *Pfandbrief* agency to its member banks, and such loans are again secured by the cover pool. Hence, *Pfandbriefe* are rated triple-A by Moody's.

Security System

Pfandbriefe are ultimately secured by the mortgage security securing the mortgage loans granted by the member banks to the mortgagors (by law under the Mortgage Bonds Act).

- Investors in *Pfandbriefe* have a direct security interest in all loans granted by the relevant *Pfandbrief* agency to its member banks.
- The loans granted by the *Pfandbrief* agency to a member bank are secured by a direct security interest over the mortgage loan (and the related mortgage

Box C: Parties involved in mortgage bonds



security) granted by the member bank to its mortgagor.

- The mortgage loans granted by the member banks to the mortgagor must be secured by mortgage security over real property located in Switzerland.

Both *Pfandbrief* agencies and the member banks must maintain a collateral register. Subject to proper registration of the cover pool assets in such collateral register, the security interest exists by law (no further documentation is needed).

Cover pool

The rules on the cover pool are minimal requirements set up by the Mortgage Bonds Act. Each *Pfandbrief* agency may set up more restrictive principles (and both *Pfandbrief* agencies have done so).

Loans made available by *Pfandbrief* agencies to their member banks plus interest thereon must be covered by eligible mortgage loans in an amount of not less than 100% of the loans. Interest mismatches must be covered additionally. Both *Pfandbrief* agencies increased the coverage ratio with regards to principal and interest. Such requirements may occasionally change.

Cover pools may be dynamic and assets may have to be added in case the relevant coverage requirements would not be met. Also, according to regulations set up by the Pfandbriefbank, impaired loans or non-performing loans must be substituted. Cash or marketable bonds issued by the government, the cantons or the municipalities may serve as substitute assets in order to cover any (temporary) shortfall.

> **"The LTV of mortgage loans may not exceed two-thirds of the fair market value of the property"**

Real property located in Switzerland

The mortgage loans must be secured by real property and land located in Switzerland (or *Pfandbriefe* that satisfy all criteria). Public sector assets do not qualify as eligible collateral. Also, real property exposed to a decline in value due to exploitation (e.g. mines) is not eligible.

Loan-to-value ratios of mortgage loans

The LTV of mortgage loans may not exceed two-thirds of the fair market value of the property. Even more conservative LTVs apply for agricultural land and construction sites. *Pfandbrief* agencies may impose stricter LTVs where they see fit (eg, the Pfandbriefbank requires an LTV of one-half with regards to commercial property and holiday homes).

Holding of mortgage loans and mortgage security by operation of law

As the security interest is created by operation of law under the Mortgage Bond Act, no physical transfer of title to the mortgage security is required (as would be the case outside the framework of the Mortgage Bond Act). The servicing of the asset remains with the member bank, thus avoiding issues relating to banking secrecy, outsourcing rules and data protection, that would otherwise materialise.

Valuation of real property

The act provides certain valuation principles, compliance

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with which by the *Pfandbrief* agencies is monitored by the Financial Market Supervisory Authority (e.g. valuations must be conducted periodically and by steadily applying the same valuation rules; revaluation may be required where a fundamental change of circumstances has occurred).

> "UBS and Credit Suisse raised funds with local retail banks that had excess cash readily available"

Characteristics of Swiss mortgage bonds system

Access for Swiss banks only

Only banks headquartered in Switzerland may become members (and accordingly shareholders) of the Pfandbriefbank. With regard to the Pfandbriefzentrale, the circle of members is limited to cantonal banks. Thus, no foreign banks have access to the Swiss mortgage bond system. The act, allows for loans to be granted to non-member banks. However, increased coverage requirements and the non-availability of the security register system make it less attractive to enter the system.

Conservative legal framework

Due to the various structural elements and requirements, the system is regarded as reliable and stable, even during financial crises. The bonds issued by the *Pfandbrief* agencies are rated triple-A by Moody's. With regards to *Pfandbriefe* issued by the Pfandbriefbank, in November 2005 Moody's wrote:

"The triple-A long-term rating assigned to the *Pfandbrief* issues (covered bonds) of Pfandbriefbank Schweizerischer Hypothekarinstitute (Pfandbriefbank) ... is underpinned by the strong institutional framework within which Pfandbriefbank operates, as well as by the specific characteristics of the *Pfandbriefe* which result in a negligible expected loss for investors. The triple-A-rating is not an issuer rating but is only applicable to the covered bonds issued by Pfandbriefbank."

On-balance sheet financing

Typical for a covered bond and other than in the framework of most of the ABS issues, the issue of *Pfandbriefe* is an on-balance-sheet lending transaction; that is, the assets remain on the balance sheet of member banks and the Pfandbriefzentrale.

No limited recourse

Whereas the limited recourse element is typical of ABS transactions, the investor in a *Pfandbrief* is secured not only by the cover pool, but also has full regress to both the relevant *Pfandbrief* agency (directly) and the member banks (indirectly).

No segregation of assets in cover pool

Typically in an ABS issue, specific assets cover a specific issue of an ABS. However, under the Swiss mortgage bond system, all assets of the cover pool cover all issues of a series of *Pfandbriefe*. Accordingly, investor risk with regards to different series of *Pfandbriefe* does not vary, since the same cover pool and the same *Pfandbrief* agency and member banks provide security for such *Pfandbriefe*.

Past deals

Structure

In recent deals, both UBS and Credit Suisse raised funds with local retail banks that had excess cash readily available. Up to several billion Swiss francs were raised in each deal. The first deal was announced in December 2008. In the framework of these deals, funds have been made available by a selected number of lenders (rather than by a larger number of investors) by subscribing to specific series of *Pfandbriefe* issued by the Pfandbriefbank and by the Pfandbriefbank, then lending the funds raised to UBS and Credit Suisse against mortgage security.

Particularities of unilateral covered bond issuance

The transactions were set up within the framework of the Swiss mortgage bond system in order to facilitate the transaction and strengthen the security package analysis. The new element is that single specific transactions are arranged with the aim of allowing a very limited number of subscribers to lend funds to specific borrowers. Normally, the transaction under which institutions lend funds from the *Pfandbrief* agencies and transactions under which the investors subscribe for *Pfandbriefe* are not arranged as a single transaction but coordinated in order to ensure the matching of interests and terms. The standard procedure is that, before the issuance of a new series of *Pfandbriefe* (usually CHF200 million and CHF300 million), the *Pfandbrief* agency offers its member banks the refinancing of existing loans that are due for repayment or the granting of new loans.

The unilateral transactions seen since December 2008 show that the Swiss mortgage bond system may become or has become a refinancing tool in situations where secured refinancing transactions are difficult to structure or an off-balance sheet securitisation is not possible due to a lack of market. The benefit of using the mortgage bond system is that the security interest is created by law (by register), with no physical transfer being necessary. This allows the member bank to continue to service the assets contained in the cover pool. Also, the monitoring of the cover pool is facilitated due to the registration system as well as under the control (and additional supervision) of the Pfandbriefbank.

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From the lenders' (or investors') perspective, excess liquidity may be invested into an interest-bearing instrument that is liquid and secure even in times of economic crisis. The system offers attractive terms for refinancing where it would otherwise be costly and complicated.

However, the downside is the stringent LTV requirements for assets included in the cover pool.

Most recent announcements

In early September 2009, UBS announced to set up a programme under which it will issue mid and long term covered bonds through its London branch to investors. The covered bonds are guaranteed by an SPV incorporated under the laws of Switzerland that is ulti-mately backed by part of UBS' Swiss mortgage loan portfolio. For purposes of backing the guarantee, UBS provides security in favour of the SPV over part of its Swiss mortgage loan portfolio. However, the mortgage loans will not be sold to the SPV and will remain on UBS' balance sheet. Also, the client relationship will be maintained by UBS.

This is the first transaction under which a Swiss bank will issue covered bonds outside the legal framework of the Swiss mortgage bond system.

The way ahead

The market for the sale of loan portfolios will still be a source of refinancing. As markets recover, newly set up government-sponsored transactions will probably no longer be pursued or needed.

"The market for the sale of loan portfolios will still be a source of refinancing"

With regards to transactions in the legal framework of the Swiss mortgage bond system, it may be expected that further transactions will follow in the near future. According to public information, a total of up to CHF20 billion of volume may be expected for the year of 2009. Such volumes and the particularities of unilateral covered bond issues might require some adjustment of the legal framework. The Pfandbriefbank would need further equity in order to comply with the leverage ratios imposed by the Mortgage Bonds Act (by way of capital increase or subordinated debt provided by the member banks). Also, the *Pfandbrief* agencies would be exposed to an increased risk related to single loans made available to member banks in the framework of such transactions.

One solution to mitigate this risk would be to bring back a (limited) element of limited recourse into the structure. That is, investors agree not to enforce under the *Pfandbrief* they are holding unless the relevant member bank repaid the respective loan or the relevant assets of the cover pool were enforced. Otherwise, the *Pfandbrief* agency would risk running short of liquidity in situations where the Pfandbrief became due and payable and the relevant member bank had not repaid the corresponding loan.

With regard to covered bonds issued outside the framework of the Swiss mortgage bond system, it may be expected that once UBS successfully places covered bonds through its newly set up covered bond programme, other banks might follow in order to refinance their Swiss mortgage loan portfolio.

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Supporting and safeguarding

The UK Government's efforts to stabilise the financial system and increase confidence have been many and varied. Matthew Tobin and Guy O'Keefe of Slaughter and May look at how the schemes are working

Since the onset of the global economic downturn, the UK Government has responded with a package of measures designed to reinforce the stability of the financial system, to increase confidence and capacity to lend and, in turn, to support the recovery of the economy.

On October 8 2008, HM Treasury announced a recapitalisation scheme and a credit guarantee scheme. This announcement was followed on October 13 2008 by an announcement of the implementation of these measures. The overall aim of these measures was (i) to support stability in the financial system; (ii) to protect savers, depositors, businesses and borrowers ; and (iii) to safeguard the interests of the taxpayer.

Recapitalisation scheme

The purpose of the Recapitalisation Scheme was to make available new Tier 1 capital to UK banks and building societies to strengthen their capital resources. This would permit them to restructure their balance sheets, while maintaining their support for the real economy. In November and December 2008 the shareholders of the Royal Bank of Scotland (RBS), Lloyds TSB and HBOS approved their recapitalisation through the Recapitalisation Scheme and the Government subsequently invested £20 billion in RBS and £17 billion in what is now Lloyds Banking Group (created following the merger of Lloyds TSB and HBOS in January 2009).

Other financial institutions announced plans to raise their capital levels without Government support. The Government has since agreed to convert the RBS and Lloyds Banking Group (Lloyds) preference shares, plus accrued coupon and underwriting fees, into ordinary shares.

Credit Guarantee Scheme

The purpose of the 2008 Credit Guarantee Scheme (CGS) is to help restore confidence by making available to eligible institutions Government guarantees of eligible debt issuance. HM Treasury acts as guarantor for the use of the CGS, while the Debt Management Office handles the operational aspects of the CGS. UK incorporated banks (including UK subsidiaries of foreign institutions) that have a substantial business in the UK and UK building societies are eligible to participate in the CGS. Any other UK incorporated bank (including UK subsidiaries of foreign institutions) may apply for inclusion.

Debt instruments eligible to be guaranteed are certificates of deposit (CDs), commercial paper (CP), and senior unsecured bonds and notes. Originally, instruments were required to be denominated in sterling, euro or US dollars. On December 15 2008, the Government announced that it would also permit the issue of instruments in Japanese yen, Australian dollars, Canadian dollars and Swiss francs.

As announced on October 13 2008, the drawdown window for the CGS was for a period of six months. On January 19 2009, the Government announced that the drawdown window would be extended. Following approval from the European Commission, the window has been extended from April 9 2009 to October 13 2009.

Guaranteed debt instruments can have maturities of up to three years. After the closure of the drawdown window, participants can continue rolling over any outstanding guaranteed debt (all of it until April 13 2012 and up to one-third of the total until April 9 2014). The CGS has been widely used – over £100 billion of debt issued by eligible institutions has been guaranteed under the CGS. Participants to date include Tesco Personal Finance, Close Brothers Finance (the issuance subsidiary of Close Brothers

"The Asset Protection Scheme will remove continuing uncertainty about the value of participant banks' past investments"

Limited), Investec Bank (formerly known as Investec Bank (UK) Limited) and Standard Life Bank.

These are in addition to those eight who were initially eligible, namely Abbey National, Bank of Scotland, Barclays Bank, HSBC Bank, Lloyds TSB Bank, Nationwide Building Society, The Royal Bank of Scotland and Standard Chartered Bank.

The UK Financial Services Authority (FSA) has deemed that, under the standardised approach, guaranteed securities would qualify for zero risk weighting for capital adequacy purposes. The Bank of England has confirmed that guaranteed instruments constitute eligible collateral in all its extended-collateral operations, which included the Special Liquidity Scheme and includes its successor, the extended Discount Window Facility.

Further measures

On January 19 2009, the UK Government announced a further package of measures that were designed to support lending. The package of initiatives included (i) extending the drawdown window under the CGS (see above); (ii) establishing the asset-backed securities guarantee facility; (iii) extending the 30 day maturity date for the Bank's Discount Window Facility to 365 days, thereby providing liquidity to the banking sector by allowing banks to swap less liquid assets; (iv) establishing the Bank's asset purchase facility; (v) offering an asset protection scheme for banks; and (vi) clarifying the regulatory approach to capital requirements, through an announcement by the FSA.

Asset Purchase Facility

The Asset Purchase Facility (APF) was set up to increase the availability of corporate credit and was then further utilised for the purposes of quantitative easing.

The first market notice of February 6 2009 detailed the intended parameters for the Bank to purchase up to £50 billion of high-quality private sectors assets, namely (i) commercial paper (CP), (ii) corporate bonds, (iii) paper issued under the CGS, (iv) syndicated loans, and (v) asset-backed securities created in viable securitisation structures.

Companies eligible are those that make a material contribution to economic activity in the United Kingdom, most likely to be UK corporates (including those with foreign parents) with existing CP programmes with a genuine business in the UK.

"Companies eligible are those that make a material contribution to economic activity in the UK"

Credit Easing (CE)

The first phase became operational on February 13 2009 and authorised the Bank to only purchase investment grade commercial paper in the primary market via dealers and in the secondary markets from eligible counterparties. These purchases were to be funded by the issuance of Treasury Bills by the Debt Management Office for the purposes of CE. The purchase of CP was subject to the £50 billion cap mentioned above.

Quantitative Easing (QE)

The second phase became operational on March 5 2009 and introduced the Monetary Policy Committee's £75 billion (completely separate from the £50 billion mentioned above) programme of asset purchases, which was to include the purchase of medium and long maturity conventional gilts in the secondary market. This programme was initiated to effect QE and was to be funded by central bank reserves rather the issuance of Treasury Bills from this point in time.

The programme was increased to a total of £125 billion on May 7 2009. In July, the Bank passed the £125 billion mark of asset purchases targeted under its quantitative easing policy, with the majority of purchases made up of gilts (£122,374 million), alongside smaller quantities of commercial paper (£1,804 million) and corporate bonds (£918 million) and the APF was further increased by £50 billion to £175 billion on August 6 2009.

In the intervening periods, two further limbs of the APF were introduced. The Corporate Bond Secondary Market Scheme (regular small purchases of a wide range of high-quality corporate bonds through weekly reverse auctions) was put into place on March 25 2009 and on July 30 2009 the Bank announced the extension of the APF to allow for the purchase of asset-backed commercial paper securities.

Secured Commercial Paper Facility

The Secured Commercial Paper Facility (SCPF) technically became available from August 3 2009, though it will, in fact, only become operational as secured commercial paper programmes are deemed eligible. This is intended to help improve the function of the private market by standing ready to make primary market purchases and by acting as a backstop for secondary market investors.

About the author

Matthew Tobin became a partner in the financing group at Slaughter and May in 2005, having trained and practised at the firm since 1996. He advises on a wide range of banking and financing work, including acquisition and bid financing, capital markets and securitisation transactions.

Matthew advised HM Treasury on the 2008 Credit Guarantee Scheme for UK incorporated banks and building societies, the Asset Protection Scheme, the administration of Kaupthing Singer & Friedlander Limited (a subsidiary of the Icelandic bank Kaupthing), the administration of Heritable Bank plc (a subsidiary of the Icelandic bank Landsbank Islands hf) and the transfer of Bradford & Bingley's UK and Isle of Man retail deposit business along with its branch network to Abbey National plc and HM Treasury's acquisition of rights in respect of the proceeds of the wind-down and realisation of the assets of the remaining business of Bradford & Bingley in public ownership.

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Newly issued secured commercial paper (SCP), as for the current commercial paper facility, will be purchased by a wholly owned subsidiary of the Bank, namely the Bank of England Asset Purchase Facility Fund Limited. Such purchases will be made using central bank reserves or funds raised by the Debt Management Office, in the primary market via dealers, and after issuance from other eligible counterparties by acting as a backstop for secondary market investors.

The SCPF will run for as long as it is required to aid the markets and the Bank will only withdraw the SCPF on twelve months' notice. The Bank has said that it will not serve such notice in the first three months of the life of the SCPF to take account of the time taken to set up new programmes.

Eligibility

The Bank has stipulated a number of eligibility criteria and has made it clear that it will be focussing particularly on the assets underlying the security to ensure that the purpose of the SCPF is met – namely to ensure that the assets are purchased from companies that contribute to activity in the UK economy. Eligible assets will be those that provide direct short-term credit to companies, such as trade receivables and equipment leases and short-term credit to consumers, such as credit cards and short-term loans. The Bank has identified assets that will likely not be eligible, such as term ABS bonds (those with average maturities longer than nine months), emerging market transactions and synthetic assets.

Ratings of the underlying assets in the programme must be consistent with the A-1/P-1/F1 programme rating from at least two of Standard & Poor's, Moody's and Fitch (including those on negative watch at these ratings) and sponsors will be required to provide information sufficient for the Bank to assess the underlying quality of each asset pool, such as the models used to determine levels of credit enhancement. The weighted average life of the programme's assets must not exceed nine months, with no underlying asset to have an expected final maturity of more than one and a half years.

In addition, for securities to be eligible, they must (i) be denominated in sterling, (ii) have a maturity of one week to nine months if purchased in the primary market or an original maturity of nine months or less if purchased in the secondary market, and (iii) not have any non-standard features (such as extendibility or subordination).

Programme limits

There are limits by programme on how much SCP the Bank will purchase. They are based on what proportion of the underlying assets providing credit to borrowers make a material contribution to economic activity in the UK.

Pricing

Pricing in the primary market will be discounted using a rate based on the maturity-matched overnight index swap (OIS) rate, with an initial spread to the OIS rate of 100 basis points.

Asset-Backed Securities Guarantee Facility

In November 2008, the Crosby Report stated that it is "the inability to refinance existing mortgage-backed funding and the continuing pressures in wholesale funding markets which is really hitting the banks' capacity to make new loans... ." Crosby continued by stating that, despite Government intervention designed to help banks cope with the closure of wholesale money markets which removed the immediate threat to financial stability, he "still expect[s] that mortgage lenders will have to live with little or no access to asset-backed funding through 2008 to 2010, together with having to cope with in excess of £160 billion of redemptions of existing paper over the same period".

The 2009 Asset-backed Securities Guarantee Scheme (ABSGS) was launched on April 22 2009 in response to the Crosby recommendations. Under the ABSGS, HM Treasury can provide one of two types of guarantee to be attached to eligible triple-A rated asset-backed securities, initially in respect of residential mortgages, issued under the sponsorship of UK banks and building societies. The ABSGS is aimed at reinvigorating the issuance of residential mortgage-backed securities.

Credit and liquidity guarantees

The ABSGS offers a credit guarantee and a liquidity guarantee, though an eligible instrument may only benefit from one, not both of these.

The credit guarantee is a traditional guarantee and follows that of the CGS in that it constitutes an unconditional and irrevocable guarantee of the timely payment of all interest and principal due from an issuer and payable in respect of the eligible instruments.

The liquidity guarantee is essentially a guarantee of an issuer's obligation to redeem or repurchase securities pursuant to an issuer's call option or a noteholder's put option under the terms of the eligible securities. In the event that the issuer is unable to honour its obligation (for example, having not been put in funds by the originating entity), HM Treasury, as guarantor, will purchase the securities from the holders at the relevant price.

The relevant price will be the principal amount outstanding of the eligible instruments as at the due date, adjusted to include accrued but unpaid interest but reduced to reflect any principal losses on the loan portfolio allocable to the eligible instruments.

Eligible instruments

The criteria for the ABSGS are geared primarily toward assessing the underlying quality of the mortgage portfolios as this is thought to make the securities ultimately marketable to third party investors. Securities must be single currency denominated, rated AAA (or the equivalent) at the time of issue by at least two international credit rating agencies (ignoring the availability of the applicable credit or liquidity guarantee), listed in London, Ireland or Luxembourg. In addition, mortgage loans must be made after January 1 2008, secured by a valid first ranking mortgage and have a loan-to-value (LTV) ratio at origination not exceeding 90% of the lower of the purchase price or the then most recent valuation of the mortgaged property.

Also, the weighted average LTV ratio of all the mortgage loans in the pool must not, by reference

About the author

Guy O'Keefe became a partner in the financing group at Slaughter and May in 2007, having trained and practised at the firm since 1998. He advises on a wide range of banking and financing work, including capital markets, securitisation and structured finance transactions.

Guy recently acted for HM Treasury in connection with the 2009 Asset-backed Securities Guarantee Scheme for RMBS and on certain aspects of the Banking Act 2009. He also advised HM Treasury on the temporary public ownership of Northern Rock, the administration of Icelandic banks Kaupthing Singer & Friedlander and Heritable, the sale of Bradford & Bingley's retail deposit business to Abbey National plc. He currently advises HM Treasury in relation to its interests in Northern Rock plc and Bradford & Bingley.

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to the mortgage loans at their respective origination, exceed 75% of the lower of the respective purchase prices of the mortgaged properties or the most recent valuations as at the time of origination. Borrowers must not have an adverse credit history, cannot self-certify their mortgages and must not have had any history of arrears.

Indemnities

Under the Credit Guarantee, HM Treasury is entitled to be indemnified by both the originator and the issuer for any amounts paid out but only by the originator under the Liquidity Guarantee. HM Treasury will effectively step-in to the shoes of the security holders in terms of any claims it has against any issuer and this will include rights over the underlying security.

Periodic reporting

Issuers will be required to produce periodic reports, at least quarterly, to investors and HM Treasury in line with international best practice and the rules cite the RMBS Issuer Principles for Transparency and Disclosure, Version 1 as an example, which was published by the European Securitisation Forum in February 2009. Version 2 of the same is currently under consultation and may include looking at developing due diligence procedures based on the new buy side requirements part of the Capital Requirements Directive.

The ABSGS has been welcomed by the securitisation world, most notably by SIFMA's (Europe and Asia) executive vice president, Karsten Moller as "an important additional step in helping to restore investor confidence". She lauded the Government for "wisely utilising securitisation as an important solution to increase funding for potential homeowners" and hoped that those on the continent would follow their example. The essence of these comments has been mirrored by others, such as the Council of Mortgage Lenders and the Royal Institution of Chartered Surveyors.

Asset Protection Scheme

The purpose of the Asset Protection Scheme (APS) is to remove continuing uncertainty about the value of participant banks' past investments, to clean up participant banks' balance sheets and to provide them with greater confidence to rebuild and restructure their operations and increase lending in the economy.

Portfolio composition

Under the APS, in return for a fee, HM Treasury will provide to each participating institution protection against credit losses incurred from January 1 2009 on assets covered by the APS to the extent that they exceed a first loss amount to be borne by the institution. Such assets may include portfolios of commercial and residential property loans, structured credit assets (including residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), collateralised loan obligations (CLO) and collateralised debt obligations (CDO)), certain other corporate and leveraged loans and any closely related hedges, in each case held by the participating institution as at December 31 2008.

First loss amount

HM Treasury will cover 90% of the credit losses that exceed this first loss amount and each participating institution will be required to retain the remaining 10% residual exposure that exceeds the first loss amount. The first loss amount and the residual exposure are designed to incentivise participating institutions to keep losses to a minimum.

Eligibility

The conditions for participating in the APS include requirements that each participating institution is adequately capitalised, has a sustainable business model and that its senior management team is credible.

Agreement in principle

RBS announced on 27 February 2009 that it had reached an agreement in principle in respect of its participation in the APS in respect of £325 billion of assets. Subsequently, in March 2009, Lloyds announced that it had reached an agreement in principle in respect of £250 billion of assets.

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