

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 AG 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 AG 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 AG, the Austrian government was tested again. By early November 2008 it became apparent that Kommunalkredit AG, 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 AG 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 AG and Kommunalkredit AG, 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

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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 state 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 maturi-

ty 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 FMMSA) 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 (Finanzmarkt-beteiligung 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



About the author

Markus Fellner regularly advises on complex company restructurings and banking and finance generally (including structuring of syndicated loans, mezzanine financing and project finance) as well as high-profile M&A transactions. He also has been heavily involved in the negotiation of bank support agreements. In addition, Markus has advised extensively on the bank rescue of Constantia Privatbank and in the restructuring of the entire Immofinanz Group, one of the largest real estate groups in the CEE region.

Markus Fellner is a founding partner of Fellner Wratzfeld & Partners. He is a member of the supervisory board of numerous renowned Austrian companies. He is the author of books and numerous articles mainly on the subject areas of

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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 1 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;

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- 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 FMSA 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.



About the author

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.

Paul Luiki is a partner at Fellner Wratzfeld & Partners. He also practiced for many years as a lawyer in the US prior to moving to Austria, where he is also admitted to the bar. He is the author of numerous articles and regularly holds seminars on the topics of M&A, joint ventures, syndicated loans and contract law.

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