

Monetary policy and banking business

Interest rate policy and the money market

The monetary policy reins were loosened noticeably in the third quarter. Following the significant intensification of the financial market turmoil and the drop in commodity prices, the Governing Council of the ECB, in a concerted effort with six other central banks, lowered the main refinancing rate by ½ percentage point to 3.75% on 8 October 2008. On 6 November, it was lowered by another ½ percentage point to 3.25%.

Coordinated interest rate reduction ...

At the beginning of October, the Governing Council also announced changes to the operational framework of monetary policy which will initially remain in place until 20 January 2009. Until then, weekly main refinancing operations will be carried out as fixed-rate tenders with full allotment at the prevailing main refinancing interest rate. At the same time, the width of the interest rate corridor around the main refinancing rate, which consists of the rates for the marginal lending and deposit facilities, was reduced from 2 percentage points to 1. This was done by halving the spread between each of the two corresponding interest rates and the rate for the main refinancing operations to 50 basis points. With its longer-term refinancing operation of 30 October, the Governing Council also began carrying out these operations as fixed-rate tenders with full allotment.

... and temporary changes to the operational framework of monetary policy

The Governing Council also decided in October to expand the range of collateral which credit institutions could submit in order to prevent potential liquidity shortages because

Changes to the collateral framework ...

Money market management and liquidity needs

During the three reserve maintenance periods between 9 July and 7 October 2008, euro-area credit institutions' need for central bank liquidity determined by autonomous liquidity factors fell by €7.8 billion in net terms. The continuing strong growth in the volume of banknotes in circulation, which recorded a new high within the period under review when it reached approximately €700 billion on 7 October 2008, absorbed liquidity to the value of €7.1 billion. However, general government deposits with the Eurosystem still decreased by €9.7 billion. If the net foreign reserves and the other factors are taken together, a move which eliminates liquidity-neutral valuation effects, there was likewise a decline of €5.2 billion in the liquidity needs of banks over the three periods. This was caused mainly by Eurosystem purchases of financial assets which are unrelated to monetary policy. The liquidity needs resulting from the minimum reserve requirement expanded by €2.9 billion over the three maintenance periods and could be met by credit institutions without any problems (see the table on page 23).

About a year after tensions had first taken hold on the money market, Eurosystem liquidity management continued to be focused primarily on supporting the functioning of the money markets. To this end, the Eurosystem carried out additional refinancing operations in the period under review, shifted the mix of maturities of these operations further towards longer-term refinancing operations (from 64% to 66%) and provided a generous supply of liquidity (frontloading). Maintaining the overnight rate at a level close to the minimum bid rate continued to be the aim of liquidity management.

During the July-August reserve period, the generous supply of liquidity ensured that the EONIA remained generally stable with an average EONIA turnover of over €43 billion. The fact that the above-benchmark amounts of €18 billion, €14 billion, €10 billion, €8 billion and €3.0 billion were slightly lower than those in the preceding period showed that the situation had eased to some extent. On 12 July, the last day of the reserve maintenance period, the ECB carried out a liquidity-absorbing fine-tuning operation with a volume of €21.0 billion and the EONIA stood at 4.32%.

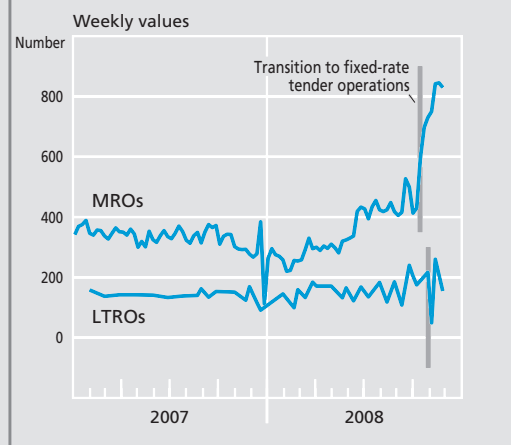
In the August-September reserve period there was a continuation of this comparatively stable development in the EONIA, which remained generally slightly above the minimum bid rate. Exceptions were the "usual" increase at the end of the month and the often increased volatility on the last day of the reserve period.

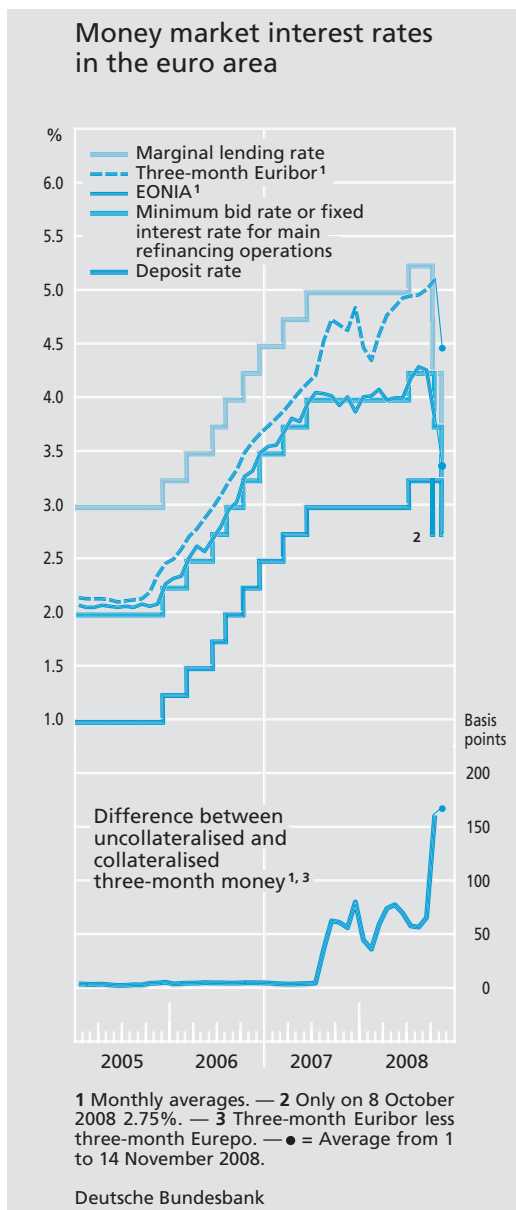
In the September-October reserve period, the insolvency of US investment bank Lehmann Brothers resulted in a significant tightening of the conditions on the money market. Alongside banks' hoarding behaviour, cancelled

credit lines and the problem posed by the drying-up of the longer-term money market sectors, mistrust between banks also became increasingly noticeable in overnight loans; towards the end of the period, EONIA turnover fell to record lows of around €30 billion. In order to curb the strong increase in the overnight money rate, the Eurosystem carried out liquidity-providing fine-tuning operations, significantly increased the above-benchmark amounts in main refinancing operations to up to €230.0 billion and announced an additional longer-term 38-day refinancing operation which ran up to and included the last day of the quarter. The abundant supply of liquidity was likewise absorbed through fine-tuning operations. While these measures gave the banks more security for their own liquidity management, they also led to increased fluctuations in the EONIA of between 3.92% and 4.60%. In addition, average daily recourse to the marginal lending facility and to the deposit facility increased to around €7½ billion and around €20 billion respectively. The fact that redistribution on the money market was heavily restricted was also reflected in the increased number of bidders in the main and longer-term refinancing operations as well as in increased allotment rates. Furthermore, larger turnover on EurexRepo's GC Pooling in the last week of the reserve period indicated a strong preference for secured O/N transactions in times of crisis.

On the first day of the subsequent October-November 2008 reserve period, the ECB announced massive steps to further stimulate the money market as part of coordinated action with other leading central banks.

Bidders in main refinancing operations (MROs) and longer-term refinancing operations (LTROs) in the Eurosystem





of a lack of eligible assets. This measure was flanked by the continuous topping-up of liquidity in US dollars supplied through the Eurosystem to European banks. In consultation with the Swiss central bank, the Eurosystem is now also carrying out temporary foreign currency swap transactions in Swiss francs. The measures agreed with the US Federal Reserve and the Swiss central bank safeguard the refinancing of credit institu-

tions in the euro area in US dollars and Swiss francs.

The adjustments to the monetary policy framework relate directly to the significant intensification of the financial market turmoil since mid-September, which was set in motion by the collapse of Lehman Brothers in the USA. On the money market, this development initially took the form of a considerable increase in the volatility of EONIA, another sharp rise in uncollateralised money market rates and a significant decline in the volumes traded between banks, even in the area of overnight money, which had been relatively unaffected by the tension on the money market until then. Since the interest rate cut at the start of October, the interbank money market rates – including the EONIA – have fallen perceptibly. However, the gap between the (uncollateralised) three-month Euribor and the (collateralised) three-month Eurepo has remained substantial. At the end of the period under review, it was 1.6 percentage points. At the same time, greater use was made of the marginal lending facility and there was a sharp increase in liquid funds invested in the deposit facility. Given this operational shortcoming of the interbank money market, the Eurosystem essentially assumed responsibility for distributing liquidity between credit institutions by offering a generous tender allotment at a fixed interest rate on the refinancing side and providing an open deposit facility with a ½ percentage point discount on the interest payment on the deposit side.

... in response to recent intensification of financial market turmoil

Monetary developments in the euro area

Monetary growth remains strong

Third-quarter growth in M3 in the euro area was roughly on a par with that of the second quarter of 2008. In seasonally adjusted and annualised terms, it rose by 8% from July to September. The extremely liquid monetary components cash and overnight deposits which make up the money aggregate M1 increased again at the end of the period under review after a slight decrease in the second quarter of 2008. By contrast, growth in components remunerated close to market rates slowed somewhat in the third quarter. In particular, banks entered into fewer repurchase transactions with German non-banks than previously in the period under review. The circulation of short-term bank debt securities also slowed somewhat on the quarter. By contrast, seasonally adjusted money market fund shares/units were again in greater demand overall in the third quarter after they were returned in large quantities in the second quarter. However, short-term time deposits again made by far the biggest contribution to monetary growth in the third quarter. They were remunerated at a slightly higher rate in the period under review than in the past.

Slightly slower growth in loans to private sector

The granting of bank loans to the private sector in the euro area was again the main source of money creation in the third quarter. However, the pace of loan expansion to German enterprises and households continued to fall; from July to September, loans grew by a seasonally adjusted and annualised rate of just 6½% compared with more than 7% in the second quarter. In particular, loans to fi-

Factors determining bank liquidity *

€ billion; changes in the daily averages of the reserve maintenance periods vis-à-vis the previous period

Item	2008		
	9 Jul to 12 Aug	13 Aug to 9 Sep	10 Sep to 7 Oct
I Provision (+) or absorption (-) of central bank balances due to changes in autonomous factors			
1 Banknotes in circulation (increase: -)	- 8.9	+ 1.1	+ 0.7
2 General government deposits with the Eurosystem (increase: -)	+ 3.6	+ 0.2	+ 5.9
3 Net foreign reserves ¹	- 1.9	+ 2.1	+ 40.7
4 Other factors ¹	+ 4.7	- 1.8	- 38.6
Total	- 2.5	+ 1.6	+ 8.7
II Monetary policy operations of the Eurosystem			
1 Open market operations			
(a) Main refinancing operations	- 19.1	- 2.8	+ 10.6
(b) Longer-term refinancing operations	+ 23.9	+ 0.7	+ 34.3
(c) Other operations	- 0.1	- 0.1	- 38.9
2 Standing facilities			
(a) Marginal lending facility	- 0.0	+ 0.0	+ 7.4
(b) Deposit facility (increase: -)	+ 0.1	- 0.3	- 19.3
Total	+ 4.8	- 2.5	- 5.9
III Change in credit institutions' current accounts (I + II)	+ 2.1	+ 0.8	+ 2.8
IV Change in the minimum reserve requirement (increase: -)	- 2.2	+ 0.7	- 1.4

* For longer-term trends and the Deutsche Bundesbank's contribution, see pages 14* and 15* of the Statistical Section of this Monthly Report. — ¹ Including end-of-quarter valuation adjustments with no impact on liquidity.

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Open market operations of the Eurosystem *

Value date	Type of transaction 1	Maturity in days	Actual allotment in € billion	Deviation from the benchmark in € billion	Marginal rate/fixed rate %	Allotment ratio %	Weighted rate %	Cover ratio 2	Number of bidders
09.07.08	MRO	7	175.0	18.0	4.32	52.24	4.37	1.51	400
10.07.08	S-LTRO	182	25.0	–	4.93	11.06	5.03	2.98	141
16.07.08	MRO	7	155.0	14.0	4.34	64.00	4.36	1.72	440
23.07.08	MRO	7	175.5	10.0	4.35	73.78	4.38	1.53	461
30.07.08	MRO	7	166.0	8.0	4.38	3.94	4.42	1.49	430
31.07.08	LTRO	91	50.0	–	4.70	86.67	4.76	2.15	189
06.08.08	MRO	7	160.0	3.0	4.38	93.83	4.41	1.51	424
12.08.08	FTO (–)	1	– 21.0	–	4.25	92.80	–	1.08	10
13.08.08	MRO	7	176.0	20.0	4.37	92.37	4.40	1.33	430
14.08.08	S-LTRO	91	50.0	–	4.61	91.48	4.74	1.58	124
20.08.08	MRO	7	151.0	14.5	4.38	66.59	4.40	1.51	454
27.08.08	MRO	7	167.0	9.0	4.39	17.78	4.42	1.36	424
28.08.08	LTRO	91	50.0	–	4.60	72.14	4.74	1.54	191
03.09.08	MRO	7	160.0	3.0	4.39	52.37	4.41	1.41	411
09.09.08	FTO (–)	1	– 20.1	–	4.25	100.00	–	1.00	17
10.09.08	MRO	7	176.5	20.0	4.39	96.37	4.41	1.27	422
11.09.08	S-LTRO	91	50.0	–	4.45	51.10	4.66	1.39	114
15.09.08	FTO (+)	1	30.0	–	4.30	77.62	4.39	3.01	51
16.09.08	FTO (+)	1	70.0	–	4.32	20.88	4.40	1.46	56
17.09.08	MRO	7	150.0	39.0	4.53	28.41	4.58	2.19	533
18.09.08	FTO (+)	1	25.0	–	4.30	29.73	4.39	1.97	43
24.09.08	MRO	7	180.0	59.0	4.73	98.23	4.78	1.86	506
24.09.08	FTO (+)	1	40.0	–	4.25	34.17	4.35	1.26	36
25.09.08	LTRO	84	50.0	–	4.98	58.84	5.11	3.09	246
30.09.08	S-LTRO	38	120.0	–	4.36	21.03	4.88	1.18	210
01.10.08	MRO	7	190.0	230.0	4.65	15.11	4.96	1.20	419
01.10.08	FTO (–)	1	– 173.0	–	4.25	100.00	–	1.00	52
02.10.08	FTO (–)	1	– 200.0	–	4.25	92.57	–	1.08	65
03.10.08	FTO (–)	3	– 193.8	–	4.25	100.00	–	1.00	54
06.10.08	FTO (–)	1	– 171.9	–	4.25	100.00	–	1.00	111
07.10.08	FTO (–)	1	– 147.5	–	4.25	100.00	–	1.00	97

* For more information on the Eurosystem's operations from 16 April 2008 to 8 July 2008, see Deutsche Bundesbank, Monthly Report, August 2008, p 25. — 1 MRO: main refinancing operation, LTRO: longer-term refinancing operation, S-LTRO: supplementary longer-term refinancing operation, FTO: fine-tuning operation (+: liquidity providing operation, –: liquidity absorbing operation). — 2 Ratio of total bids to the allotment amount.

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financial enterprises outside the banking sector grew at a much slower rate than in previous quarters. Unsecuritised bank lending to non-financial enterprises also grew at a perceptibly slower rate from July to September than in the corresponding period a year earlier. This may have been due partly to stricter bank lending standards. Credit institutions at any rate reported a continued massive tightening of their credit standards in the Bank

Lending Survey. At 12.1% in the previous year, however, the increase in loans to German non-financial enterprises was very high in the 12 months up to the end of the period under review. By contrast, lending to households has been extremely restrained for some time, partly as a result of the moderate increase in lending for house purchase. Over these same 12 months, it grew by just 4%.

Strong growth in bank holdings of corporate securities in the euro area

Bank holdings of securities from private issuers in the euro area continued to grow strongly at a seasonally adjusted and annualised rate of more than 16½% from July to September. Conversely, banks sold securities from public issuers in the euro area in net terms. Since loans to general government in the euro area increased, however, new public sector debt vis-à-vis banks decreased only slightly in the third quarter.

Little rise in longer-term investment at banks

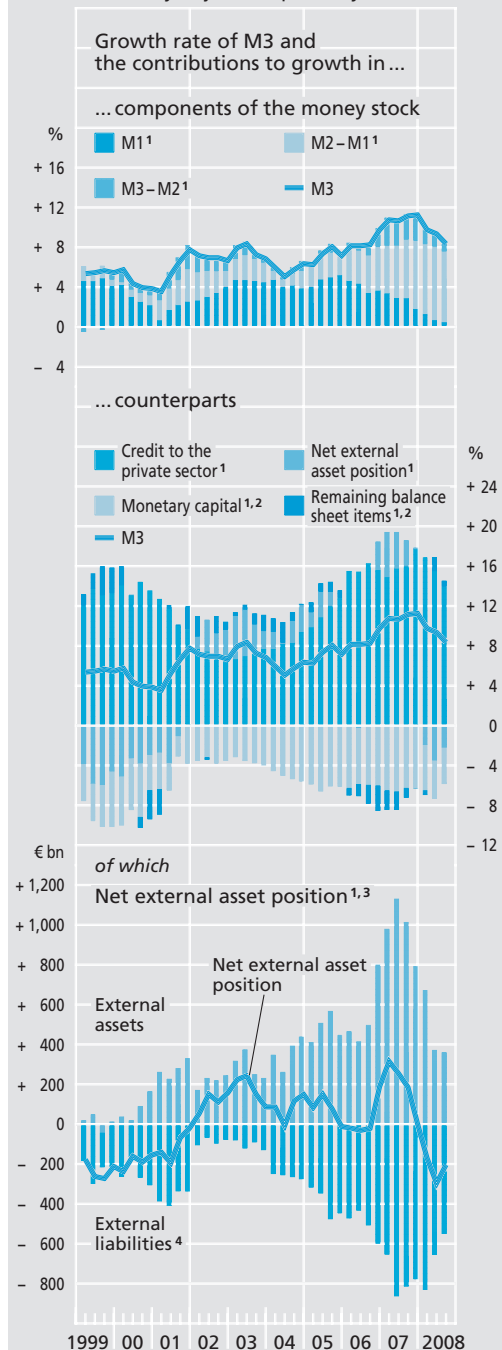
Monetary capital formation in the euro area was fairly strong in the third quarter. This was, however, attributable largely to the sharp rise in banks' equity and reserves, which mainly reflects greater risk provision and, to some extent, state recapitalisation measures. If equity and reserves are excluded, longer-term investment at banks in the euro area increased by no more than a seasonally adjusted and annualised rate of just under 1½% in the period under review compared with 4% in the previous quarter. This was attributable to both the low level of investor interest in longer-term savings and time deposits and limited sales of longer-term bank debt securities to buyers outside the German banking sector. Evidently, the liquidity preference of both banks and non-banks has heightened during the financial market turmoil. Moreover, the pronounced inverse term structure in the third quarter reduced the attractiveness of longer-term investment.

Inflows of funds from abroad

For the first time since the second quarter of 2007, the seasonally adjusted net external assets of euro-area banks rose again in the period under review. This also boosted monetary expansion. Given the sharp rise in finan-

Components and counterparts of the money stock in the euro area

Seasonally adjusted, quarterly



1 Calculated from the changes cumulated over 12 months. — 2 Taken in isolation, an increase curbs M3 growth. — 3 Not seasonally adjusted. — 4 Increase: -.

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Lending and deposits of monetary financial institutions (MFIs) in Germany *

€ billion

Item	2008	2007
	Jul to Sep	Jul to sep
Deposits of domestic non-MFIs 1		
Overnight	- 11.5	+ 9.0
With agreed maturities		
of up to 2 years	+ 48.0	+ 45.7
of over 2 years	- 1.3	+ 4.5
Redeemable at agreed notice		
of up to 3 months	- 11.5	- 13.2
of over 3 months	- 2.7	+ 1.4
Lending		
to domestic enterprises and households		
Loans	+ 19.5	+ 19.0
Securities	+ 31.5	- 0.9
to domestic government		
Loans	- 4.5	- 6.2
Securities	- 12.2	- 6.2

* As well as banks (including building and loan associations, but excluding the Bundesbank), monetary financial institutions (MFIs) here also include money market funds; see also Table IV.1 in the Statistical Section of the Monthly Report. — 1 Enterprises, households and government excluding central government.

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cial market risks in recent times, German residents may have reduced their investment abroad and transferred the money to bank accounts in the euro area.

When assessing the continued strength of monetary expansion in terms of monetary policy, it should be noted that the pace of monetary expansion was boosted by the inverse term structure in the third quarter and the liquidity preference of investors was influenced by the financial market turmoil. Thus, the current strength of monetary expansion probably overstates the monetary growth trend needed for stability policy. But even taking this into account, the continued strength of monetary growth still points to persistent price risks in the longer term. At all events, the longer-term inflation projections based

Monetary inflation projections signal upside price risks despite reduction

on monetary indicators are still well above the level which the Governing Council associates with price stability.

German banks' deposit and lending business with domestic customers

According to the balance sheet data available up to the end of September, German banks' business with customers in Germany has not suffered any serious setbacks as many feared following the developments on the financial markets in the past year. However, German investors favoured more liquid forms of investment, with other financial institutions and insurance companies, in particular, investing in short-term bank deposits in the third quarter. Following the continuous slowing of growth in German customers' deposits at German banks in the first half of 2008, bank balances in Germany grew at a slightly stronger rate in the third quarter of 2008. Deposits of domestic non-banks at German credit institutions increased at a seasonally adjusted and annualised rate of 5½% in the period under review compared with just over 3½% in the second quarter.

Bank deposits record robust growth in third quarter

Of the short-term bank deposits, time deposits remunerated close to market rates with an agreed maturity of up to two years were again almost the only component to increase. They probably benefited above all from the rise in interest rates in the euro area at the beginning of the quarter. In addition to households, "other financial institutions", in particular, invested in short-term time deposits to a large extent and, by contrast, re-

Short-term time deposits again in particular demand

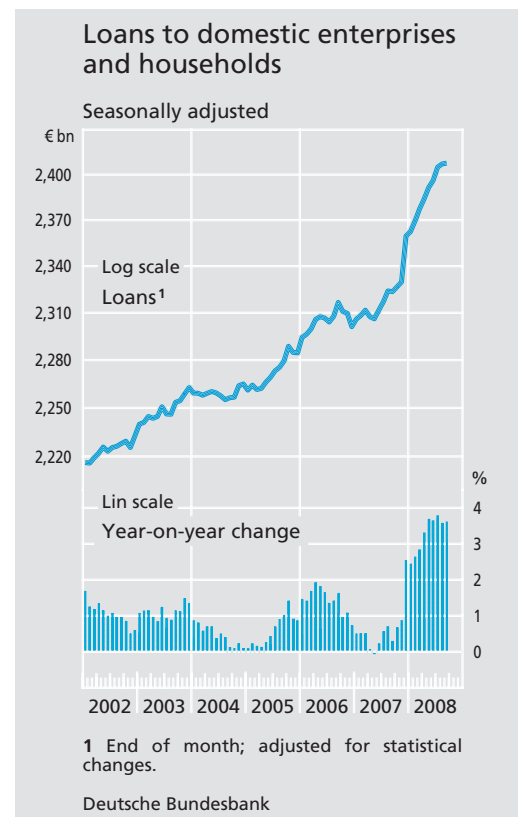
duced their overnight deposits. In addition, German non-financial enterprises and insurance companies built up their very liquid money holdings substantially. Short-term savings deposits (redeemable at notice of up to three months), on the other hand, again experienced an accelerated decrease in the period under review.

*Renewed
reduction in
longer-term
bank deposits*

As in the previous two quarters, German investors again reduced their longer-term bank deposits on a seasonally adjusted basis in the third quarter of 2008. Whereas in the past only savings deposits redeemable at notice of over three months had decreased, there was now also a considerable drop in time deposits with an agreed maturity of more than two years in the third quarter. The impetus for this development came not only from households. Longer-term time deposits held by German insurance companies did not experience the usual seasonal rise in the period under review either.

*Weaker
growth in
private-sector
loans*

In recent months, bank loans have risen sharply, particularly those to the private sector in Germany. This is attributable mainly to German banks having considerably expanded their holdings of securities issued by domestic enterprises in connection with a large securitisation operation in August. If loans to domestic enterprises and households – but not their holdings of securities – are considered, there was a seasonally adjusted and annualised growth rate of 2% from July to September. This means that the fairly strong credit growth of earlier quarters had again slowed somewhat. This was caused, among other things, by slower growth in loans to non-

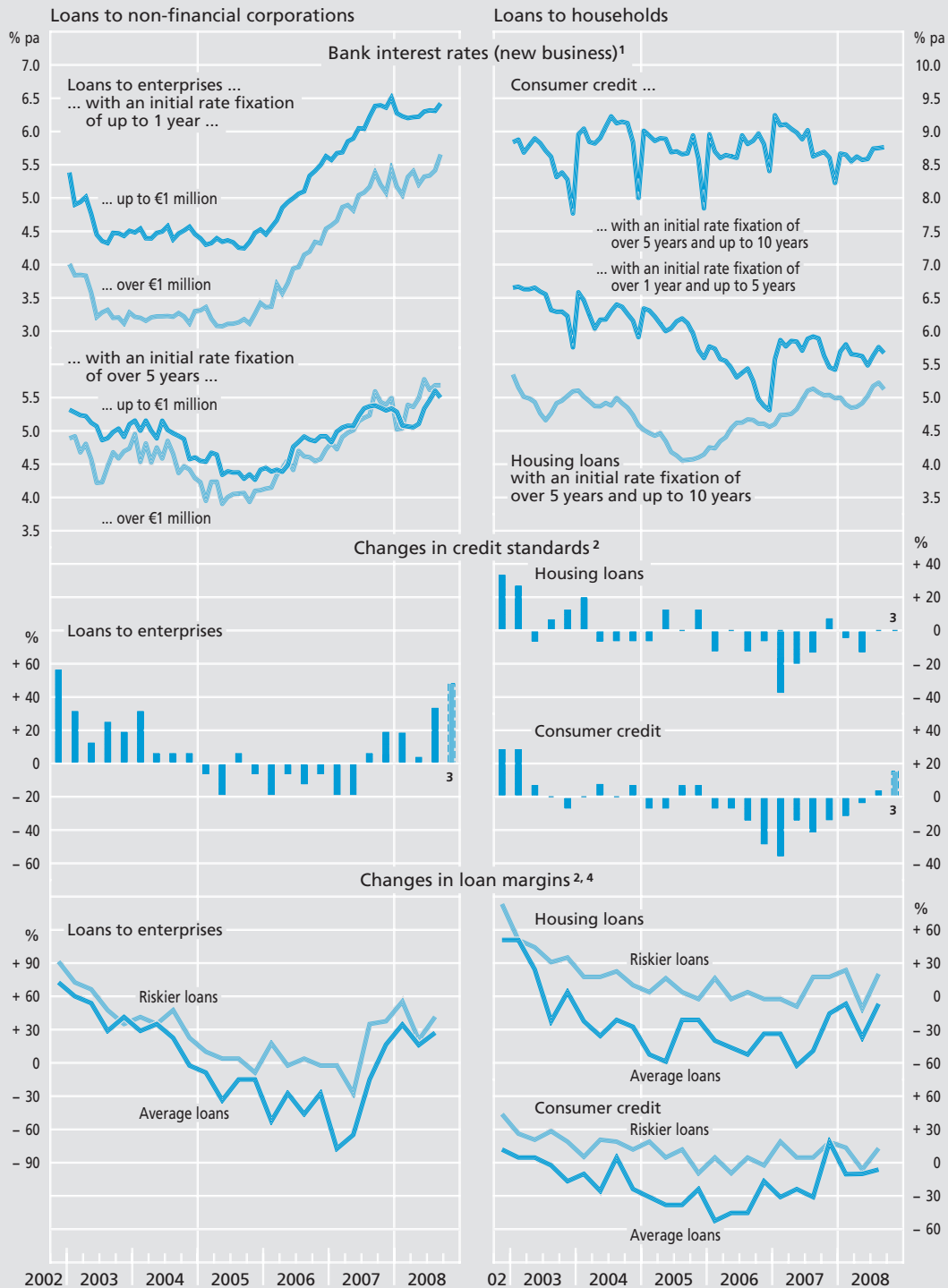


financial corporations and further reduced lending to households. Non-monetary financial enterprises, by contrast, increased their borrowing from German banks significantly in the period under review, with reverse repurchase transactions between banks and foreign financial institutions outside the banking sector again playing a role. Credit institutions also sold large holdings of securities issued by domestic public-sector entities in the third quarter. At the same time, central, state and local government also significantly reduced their loans from German banks.

The comparatively slow quarterly growth in loans to the private sector may have been partly the result of lower demand for funds from borrowers; the German results of the Bank Lending Survey (BLS) would suggest this

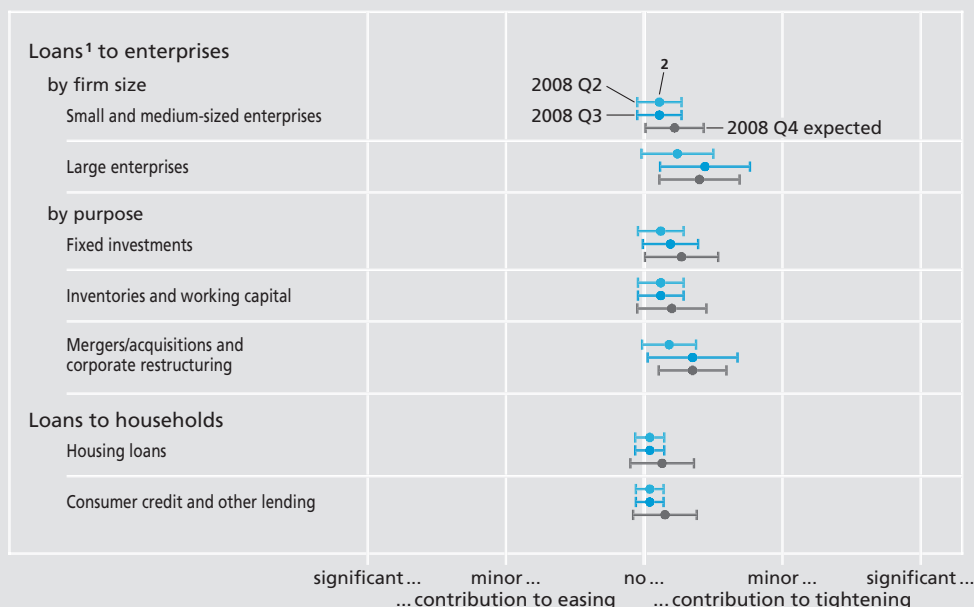
*German BLS
shows slight
drop in demand
for loans ...*

Banking conditions in Germany



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Effects of financial market turbulence on credit standards*



* Selected results of the quarterly Bank Lending Survey for Germany. Full survey results can be viewed at www.bundesbank.de/volkswirtschaft/vo_veroeffentlichungen.en.php. — 1 Including credit lines. — 2 ● = mean; — = the range shown includes one standard deviation.

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in any case. For the first time in three years, the banks surveyed not only reported a drop in demand for loans for house purchase in the third quarter of 2008 – as had been the case for some time – but also a slight decrease in the financing needs of enterprises. Only demand for consumer credits, which are less significant in terms of magnitude, rose at BLS institutions in the period under review.

... and more
restrictive
lending policy

Lending conditions were also tightened, and although the degree to which this was done was less severe than in the euro area as a whole, it was in some cases substantial by German standards. According to the respondents, this was particularly true of lending business with enterprises which was subject to both considerably tighter lending standards and wider margins. In this case, the re-

spondents reported that both refinancing problems on the money and bond markets and the general assessment of the economic situation had played a role. After being relaxed in earlier quarters, the conditions for lending to households for house purchase and consumption purposes barely changed; according to German BLS banks, only margins for riskier loans increased significantly. As has already been the case for some time, the survey for the third quarter of 2008 contained additional questions on the isolated impact of the financial market turmoil on the participating banks' lending policies. The answers to these questions show, in particular, that banks are experiencing greater refinancing difficulties on certain markets and that these difficulties had a larger impact on insti-

Cornerstones of the Financial Market Stabilisation Act (*Finanzmarktstabilisierungsgesetz*)

The aim of the Financial Market Stabilisation Act, which entered into force on 18 October 2008, is to support financial sector enterprises domiciled in Germany when they run into liquidity difficulties and/or have insufficient capital at their disposal, thus strengthening the stability of the financial system and safeguarding the supply of credit to the German economy. The Financial Market Stabilisation Act consists (1) of the Financial Market Stabilisation Fund Act, which, in conjunction with the Financial Market Stabilisation Fund Ordinance, defines the individual stabilisation instruments, the requirements attached to having recourse to the Fund as well as the financing and administration of the package of measures, and (2) of other legal norms which are designed to simplify and accelerate the implementation of these stabilisation measures.

Financial Market Stabilisation Fund Act

In order to implement and finance the stabilisation measures a designated Financial Market Stabilisation Fund (Fund) was established in the form of a special Federal fund with no legal personality. The newly founded Financial Market Stabilisation Agency (FMSA), which is subject to the legal and technical supervision of the Federal Ministry of Finance, is responsible for administering the Fund.¹

Decisions to apply stabilisation measures depend on the application made by the individual company, giving special consideration to its importance for the stability of the German financial system, the urgency of the situation and the principle of the most effective and economical deployment of the means available. All financial sector enterprises domiciled in Germany and listed in section 2 (2) of the Financial Market Stabilisation Fund Act are eligible to lodge an application. These include *inter alia* private banks, banks organised under public law, insurance companies, pension funds and capital investment companies as well as operators of stock and futures exchanges. There is no legal entitlement to receive support from the Fund, nor is it permitted to force (German) financial sector enterprises into making use of the stabilisation measures.

The Financial Market Stabilisation Fund Act specifies three types of stabilisation instrument: assumption of guarantees, recapitalisation and assumption of risk. These instruments may be applied either separately or as a combined package, depending on the nature of the problem, and can be applied until 31 December 2009 only, after which date the Fund will be wound up and dissolved.

Under the ruling on assuming guarantees, the Fund is able to grant a default guarantee for any newly issued debt instru-

ments and liabilities accrued which were incurred by financial sector enterprises between 18 October 2008 and 31 December 2009.² None of the liabilities covered by a guarantee may exceed a term of 36 months. Hence, no guarantee term will exceed beyond 31 December 2012. A precondition for the assumption of a guarantee is capital adequacy, which simultaneously serves as the reference variable for the upper limit of the guarantee assumed for a given enterprise (including any of its affiliates). The Fund is expected to levy a guarantee commission fee in line with market conditions.³ Such guarantees are designed to alleviate liquidity problems arising at corporate level and to support refinancing in the capital market. At a macroeconomic level, the aim of guarantee measures is to bolster confidence in the commercial viability of enterprises by hedging any refinancing difficulties and in turn enhance the smooth functioning of the unsecured interbank market.⁴ Overall, the cost of short-term interbank lending is also likely to be cut back to an appropriate level.

The recapitalisation tool enables the Fund to acquire shares, silent participations or other capital components of enterprises in exchange for an infusion of capital. However, such recapitalisation should be undertaken only in cases where there is a substantial interest on the part of the Federal Government and where the purpose sought by the Federal Government cannot be better and more economically achieved by other means. If the Fund makes use of the recapitalisation tool, then the beneficiary enterprises are required to make an appropriate payment to the Fund in line with market conditions; furthermore, the Fund should aim at obtaining remuneration which is preferential to that received by the original general partners (for example, in the form of preferred dividends). As a general principle, the size of any share in a single enterprise (including its affiliates) must not exceed the amount of €10 billion. In certain cases, however, it is possible to make an exception to this rule. In the longer term, any participations acquired by the Fund should not be allowed to remain in its possession. Instead, they should be dissolved or sold in a manner which is not detrimental to the market.⁵ The purpose of the recapitalisation tool is to provide the enterprise in question with adequate capital for the foreseeable future in order, for instance, to prevent a major curtailment in lending to the non-financial private sectors (ie a credit crunch). Securing capital adequacy has the additional effect of boosting confidence in the soundness of the enterprise concerned and is therefore a vital prerequisite for resolving the functional disruptions currently affecting the interbank market.

Under the assumption of risk provision, the Fund may acquire any risk exposures, – particularly receivables, securities, finan-

¹ The FMSA also describes the Fund as the Special Fund for the Stabilisation of the Financial Market (SoFFin). Further information such as the relevant legislative texts, the ordinance and the Fund's organisational structure is posted on the following websites: www.soffin.de and www.bundesfinanzministerium.de. — ² The Fund may also grant guarantees to special purpose vehicles (SPVs) (which, pursuant to the Financial-Market Stabilisation Fund Act, were not originally deemed eligible to apply), provided these SPVs have assumed risk positions from financial sector enterprises and the associated default and liquidity risks are borne primarily by the enterprise making the transfer (for example, by granting credit lines). — ³ With regard to debt instruments with a maturity of three to twelve months, the level of

the guarantee commission fee should generally stand at 0.5%. By contrast, in the case of liabilities with a maturity of 12 to 36 months, institution-specific fees are to be levied which are based on market interest rates for credit default swaps and therefore also reflect the default risk involved. — ⁴ Generally, a market is described as liquid when transactions can be executed speedily and without any significant impact on the market price. For example, low bid ask spreads are one indicator of a liquid market. — ⁵ The Fund is allowed to hold and dispose of stakes in enterprises beyond 2012. — ⁶ The terms and conditions attached to assuming risks from SPVs correspond to the conditions for assuming a guarantee (see footnote 2). — ⁷ It is, for example, possible for the selling enterprise to commit itself to paying a

cial derivative instruments, rights and obligations arising from loan commitments or warranties and participations in enterprises (together with the corresponding collateral in each case) – which were purchased prior to 13 October 2008 in exchange for a transfer of debt instruments issued by the Federal Republic of Germany. The same applies to special purpose vehicles (SPVs)⁶ which acquired risk exposures from financial sector enterprises. Risk assets are purchased either at the balance sheet value last used by the seller or at a value lower than this and may be combined with a risk participation belonging to the selling enterprise.⁷ The level of the purchasing fee charged by the Fund should reflect the assumed risk and at least be sufficient to cover the Fund's refinancing costs. Use of the tool depends on the availability of adequate capital and is generally limited to €5 billion per enterprise (including its affiliates). Nevertheless, in certain cases, it is possible to deviate from this rule, too. The objective of risk assumption is, first, to make liquidity and eligible assets available and, second, to support the capital position of the enterprise concerned.

In order to make use of any of the three tools the beneficiary enterprise must be able to demonstrate that it is pursuing a sound and prudent business policy. With regard to recapitalisation and risk assumption by the Fund, general provisions apply to the effect that financial sector enterprises must satisfy additional requirements with respect to the structure of their remuneration schemes⁸ and forego any profit distributions, non-consolidation-related capital reductions and buy-backs of shares or other components of the liable capital. Moreover, in the event of a recapitalisation, the beneficiary enterprises are called upon to take particular account of small and medium sized enterprises' borrowing needs by offering a suitable range of services in line with market conditions.

As a means of financing the stabilisation package, the Federal Ministry of Finance may utilise financial resources up to a maximum amount of €100 billion. This funding is provided through government borrowing, dependent on requirements. For the purpose of financing recapitalisations and risk assumption, the Fund is initially able to draw upon resources amounting to no more than €70 billion. Where necessary, however, this sum may be topped up by a further €10 billion, contingent on the approval of the Budget Committee of the Deutscher Bundestag. Under the provisions for assuming a guarantee, the Fund is able to assume guarantees up to the amount of €400 billion. On the basis of an assumed default rate of 5%, the Fund has been equipped with funds of €20 billion to finance any defaults which might occur.

compensation sum if the Fund suffers a loss upon the maturity or the realisation of the respective assets. — **8** This involves *inter alia* examining the incentive effects and appropriateness of existing remuneration schemes, gearing these schemes to long-term and sustainable targets, avoiding the creation of incentives which encourage the taking of disproportionately high risks, restricting the salaries of senior management and members of governing bodies to reasonable levels and a ban on the awarding of bonuses and optional pay components for the entire duration of the stabilisation programme. — **9** Any costs arising from possible use of the Fund by Landesbanken are borne by the federal states in proportion to their respective stakes in the Landesbanken. Accordingly, central government bears the proportionate

It is not yet possible to quantify the financial burden to be borne by the Fund precisely as this will depend on the extent of future recourse to the assistance available. What is more, some of the expenses are of limited duration, not least since acquired shares, in particular, are to be resold at a later date. Moreover, revenues from granting guarantees or assuming risks and potential loss participation on the part of beneficiary enterprises owing to the purchase of risk assets all have a cost-reducing effect. Once the Fund has been wound up, the actual costs incurred will be split between central and state government in the ratio of 65:35 with the limit for each federal state set at €7.7 billion.⁹

Further legal norms laid down in the Financial Market Stabilisation Act

In addition to the Financial Market Stabilisation Fund Act, the Financial Market Stabilisation Act also contains a number of regulations designed to facilitate and accelerate the implementation of the three stabilisation tools. For example, the instrument of statutorily authorised capital was created for the purpose of implementing accelerated recapitalisation measures. This instrument empowers the management board of a public limited company to increase the enterprise's share capital by up to 50% by 31 December 2009 through the issuance of new shares to the Fund while excluding shareholder subscription rights and solely with the approval of the supervisory board. The standard legal requirement set out in the Companies Act (*Aktiengesetz*) that any capital increases require prior consent from a company's general meeting therefore does not apply.¹⁰ To limit the dilution of shareholders' ownership rights the statutorily authorised capital is offset against the existing authorised capital.¹¹

In order to take due account of the exceptionally large losses in value currently affecting a swathe of assets and the accompanying heightened insolvency risks in the entire corporate sector, the Financial Market Stabilisation Act specifies a new definition of the concept of over-indebtedness as contained in the German Insolvency Code (*Insolvenzordnung*), which applies to all enterprises. The reasoning behind this new ruling is that the previous definition would have allowed losses in value – especially those relating to shares and real estate – to result in insolvencies, even in cases with a positive future forecast. Hence, the new version stipulates that enterprises which are over-indebted in purely numerical terms but whose viability as a going concern is deemed highly probable will not be considered over-indebted and are therefore exempt from having to file an insolvency petition.

costs arising from beneficiary financial sector enterprises in which it holds stakes. — **10** Management boards are further entitled to determine the form of the shares – particularly with respect to the granting of preferred dividend rights and the prioritised distribution of the company's assets – subject to the approval of the supervisory board. In addition, boards are able to equip the Fund with profit participation rights without prior consent from the general meeting and excluding shareholder subscription rights. — **11** The instrument establishing statutorily authorised capital applies exclusively to financial sector enterprises operating as a public limited company, as a partnership limited by shares or as a European company (SE).

tutions' lending policies than in the previous quarter.

Overall rise in bank lending rates in third quarter of 2008

Bank lending rates rose across the board, above all, at the beginning of the third quarter of 2008. Most then fell marginally at the end of the period under review. Overall, however, interest rates remained slightly higher owing to the considerable increase in refinancing costs in the capital markets, chiefly at the end of the previous quarter, and the re-

ported margin increases in lending business. The only exceptions were short-term consumer credits and longer-term large-volume loans to enterprises. Ultimately, banks charged 5.7% or 6.5% for short-term loans to enterprises and 5.5% or 5.7% for long-term loans to enterprises depending on volume. At the same time, they demanded 6.2% for housing loans with short-term interest fixation and 5.2% for loans with interest rate fixation of more than ten years.