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Measures by the Austrian Regulatory Authorities in Response to the Financial Market Crisis

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Abstract

The financial crisis has severely hit the Austrian banks and the financial market as a whole. Austrian banks sold ‘Lehman-products’ to a disproportionate extent, banks invested far too high amounts in Iceland, and finally and most importantly, Austrian banks did and are doing their main business in CEE countries, which have been heavily affected by the crisis.

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The Austrian government and parliament have reacted by taking different measures to support the near-collapsing banks. Apart from granting guarantees and promoting interbank business through different measures, the main instrument has been to improve the capital ratio by issuing so-called participation capital subscribed for by the government. Although generally the holders of participation capital do not have membership rights, the state is entitled to exercise control rights via a special company.

**Keywords:** Austria, financial market crisis, monitoring of participation capital.

1. **INTRODUCTION**

The financial market crisis has had a disproportionately strong impact on Austria; this is due to a combination of several factors:

(i) Austrian credit institutions have been engaged to a disproportionately large extent in the brokerage and placement of ‘Lehman certificates’, which now lack their guarantor or other partner.

(ii) There have been a great number of investments in Iceland-related products. Not long before the collapse, for instance, a branch office of Kaupthing Bank, one of the three major Icelandic banks, was established in Vienna. Many credit institutions and other financial services providers themselves invested in instruments of this type or recommended them to private and public entities.

(iii) However, the main reason why Austria was so massively affected by the general financial crisis lies in the disproportionately large degree to which Austrian banks have been active in CEE and SEE (Central and South East European) countries, i.e., markets which now suffer doubly from the impact of the crisis. Nevertheless the involvement of Austrian credit institutions should not be considered wholesale as risky; rather, each individual institution and the type of involvement in the relevant countries should be assessed separately. In some East European countries, the loan default rate, and therefore the loss of earnings, has reached dramatic proportions, in particular in Ukraine. The extensive brokerage of foreign currency loans constitutes a special problem. In other countries, most particularly Russia, the government takes an interest in the continuation of existing business relationships and therefore supports the borrowers. In countries where the euro has not yet been introduced, Austrian banks have pursued a rather aggressive policy of granting foreign currency loans, both as consumer loans and for investment purposes; due to the considerable devaluation of many currencies (e.g., Hungarian forint, Bulgarian lira) these loans have become substantially more expensive, often requiring repayment of two or four times the original amount.
(iv) Lastly, it has also become clear that some Austrian banks (e.g., Hypo Alpe Adria) maintained extremely extensive business relations with unreliable business partners, some of which are even said to be part of mafia-like organisations; the near-collapse of these banks was not caused by the financial crisis but simply became evident sooner and more plainly in its aftermath.

2. MEASURES INTRODUCED IN AUSTRIA

In Austria, like in Germany and many other countries, a new legal framework and a number of new regulatory tools were introduced in autumn 2008 to help deal with the consequences of the financial crisis.

The essential elements of the Austrian financial market stability framework are:

- the Interbank Market Support Act (Interbankmarktstärkungsgesetz – IBSG); in conjunction with
- the Act on the Improvement of Corporate Liquidity (Unternehmensliquiditätsstärkungsgesetz – ULSG); and
- the Financial Market Stability Act (Finanzmarktstabilitätsgesetz – FinStaG).

The aim of these legal provisions is to protect the public interest in maintaining the stability of the national economy.¹

The main objects reflected in the three laws are:

(a) to stimulate the interbank market;
(b) to stimulate the credit market for non-credit institutions;
(c) to support the stabilisation of individual institutions;
(d) to promote confidence in the financial markets (deposit guarantee, ordinance prohibiting short sales); and
(e) to improve supervision.²

3. STIMULATION OF THE INTERBANK MARKET

The Interbank Market Support Act (IBSG)³ constitutes the basis for liability-related provisions introduced within the framework of the 2009 stimulus package aimed at securing and stimulating the interbank market.

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³ BGBl I 136/2008.
3.1 Clearing house for loans

For the purpose of stimulating the interbank market, Austria, other than Germany and Switzerland, chose a model involving a clearing house. In accordance with its § 1, para. 1, the IBSG assumes the existence of a company established for the sole purpose of borrowing funds, in its own name and for its own account, from credit institutions or insurance companies via the interbank market, and lends these funds, in its own name and for its own account, to other credit institutions and insurance companies via the interbank market. Only credit institutions, insurance companies and their respective statutory representative bodies within the framework of the trade associations may be owners of such a company.

The Oesterreichische Clearing Bank AG (OeCAG) is owned by the Austrian credit institutions, whereby the sectors are represented by their leading organisations. The relevant share stakes were determined in the course of negotiations among the institutions. The operational side of the business is handled by the Oesterreichische Kontrollbank AG (OeKB), a special institution which is owned by the banks and is in charge of guarantee operations in connection with international transactions; it is also the Austrian central securities depository. The equity of OeCAG amounts to EUR 180 million and its business volume is limited to a maximum of EUR 10 billion. A capital increase would have been possible following an evaluation period, but no such increase was effected. The deposit and lending operations of OeCAG are available to all banks and insurance companies; there are no limits for subscriptions for OeCAG’s issues. The business model of OeCAG is based on a mapping of the interbank market, and the bank therefore performs no maturity transformation; the funds can be provided by the participating banks by way of deposits or through OeCAG securities issuances. The matching of available deposits and demand for credit for fixed terms, in particular three and six months, is effected through regular auctions, with both sides of the market entering their bids in terms of price and volume. Transactions are therefore concluded only where the demand for a loan at a certain price can be matched with an available offer on the deposit side. Of the proceeds of issues generated by OeCAG, 50% are distributed to the banks based on the deposit ratio and the other 50% through auctions.

The Federal Minister of Finance is authorised to assume a liability for a limited term on behalf of the Federal Government towards OeCAG in respect of loan losses in connection with these transactions, and to assume liability, including in particular guarantees and sureties, for specific obligations.  

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4 M. Posch, R. Schmitz and H. Weber, OeNB-Finanzmarkstabilitätsbericht 17 (June 2009), at p. 72.
The Republic of Austria may only assume a liability if it is limited to a maximum term of three years. In certain exceptional cases, the term may be extended to five years, but any such extension must be justifiable.\(^7\)

The underlying aim of the IBSG provisions and the establishment of OeCAG as a clearing house is to enable the banks, from a business management perspective, to regain access to the market for unsecured interbank loans. Since the introduction of the bailout package, the liquidity risk of Austrian banks has in fact decreased.\(^8\)

### 3.1.1 Issuance of securities by OeCAG

For the issuance of short-term securities (one year) by OeCAG the assumption of liability by the Federal Government as surety and payer for a total volume of not more than EUR 5 billion can be agreed until 31 December 2009. The Federal Government is also liable to OeCAG for a loan loss up to a maximum amount of EUR 4 billion. If a loan loss occurs and results in a shortfall below the minimum equity requirement which the clearing house has to meet, the Federal Government will be obliged to inject sufficient funds to meet the equity ratio of 8%.

Within the framework of the OeCAG’s clearing bank system, the role of the Federal Government as guarantor is only of secondary importance; first and foremost, the equity capital raised by the banks themselves serves as a guarantee fund. OeCAG therefore works as a kind of safety buffer intended to absorb potential loan losses and thereby reduces the potential moral hazard at the expense of the Federal Government and the taxpayers.\(^9\)

### 3.1.2 Liability for credit institutions’ own issues

Under the new legal framework the Federal Minister of Finance is also authorised to assume a liability on behalf of the Federal Government, as surety or as surety and payer or as guarantor, for securities issues by other credit institutions in accordance with § 1, para. 1, subsec. 10 of the Banking Act (Bankwesengesetz – BWG). If the Federal Government assumes such direct liability towards a credit institution, the relevant agreements about the assumption of liability must include specific criteria relating to remuneration, fees, measures for avoiding distortions of competition, information duties and accountability; these criteria are stipulated in § 2, para. 5 of the Financial Market Stability Act (FinStaG). The fee for the assumption of liability


\(^9\) Posch, Schmitz and Weber, supra n. 4, at p. 74.
by the Federal Government is 50 basis points, which are added to the loan interest.\textsuperscript{10} This possibility of obtaining a state guarantee has already been tested in practice. Within the said framework, the issuance of commercial papers, one-off issues of bonds and issues in connection with so-called debt issuance programmes (DIP) or so-called medium-term notes (MTN) programmes are provided with an irrevocable guarantee by the state.\textsuperscript{11}

4. \textbf{ACT ON THE IMPROVEMENT OF CORPORATE LIQUIDITY (ULSG)}

The ULSG is designed to alleviate the credit crunch, which makes it difficult or often impossible for companies to raise debt capital from banks. In addition to the assumption of an overall guarantee in favour of OeCAG and the benefiting insurance companies and credit institutions, the Act on the Improvement of Corporate Liquidity\textsuperscript{12} is another pillar of the new law. The aim of the law is to ensure liquidity, not only for insurance companies and credit institutions but also for other companies in Austria.

Under the ULSG, the Federal Government is authorised, in the interest of the Austrian national economy, to make it easier for individual companies in need of funds to raise financing by assuming a relevant liability.\textsuperscript{13} The ULSG is based, \textit{inter alia}, on the Communication from the European Commission by which it allows a temporary framework for state aid measures to support access to finance in the current financial and economic crisis.\textsuperscript{14} Other bases under European law include state aid decision No. 47a/2009 of 20 March 2009 (\textit{Österreichregelung Kleinbeihilfen}) and state aid decision No. 317/2009 of 15 June 2009, which stipulate regulations applicable between Austria and the European Community in respect of agreed limited amounts of state aid.

Pursuant to § 5 ULSG, OeKB is authorised to implement the measures regulated under the ULSG on behalf of the Federal Government, in particular to handle the bank-related aspects (commercial evaluation through credit assessment and processing) of applications for the assumption of a liability, to draft relevant liability agreements and to exercise the rights of the Federal Government under the liability agreements. § 6 ULSG provides that an advisory committee is to be established by OeKB, which shall be in charge of reviewing the applications for the assumption of a

\textsuperscript{10} Posch, Schmitz and Weber, \textit{supra} n. 4, at p. 72; cf. Niedermayr-Kruse and Bernkopf, \textit{supra} n. 5, at p. 145.
\textsuperscript{11} 683 BlgNR 23. GP 2 (Report of the Financial Committee); Putzer, \textit{supra} n. 2.
\textsuperscript{12} BGBl I 78/2009.
\textsuperscript{13} 683 BlgNR 23. GP 1.
\textsuperscript{14} \textit{OJ} C 83 of 7.4.2009, p. 1.
liability and shall submit a relevant recommendation to the Federal Minister of Finance.

The beneficiaries under the ULSG are companies that meet the following cumulative requirements:

- the beneficiary company shall have its registered seat or place of operations in Austria;
- the company shall carry out its principal operational activities in Austria;
- the beneficiary company shall not carry out any business activities in the financial sector;
- it shall not be a micro, small or medium-sized enterprise;
- the company had a sound economic basis prior to 1 July 2008, and a forecast justifies the expectation that the guaranteed obligations can be complied with;
- the assumption of the liability risk is reasonable, taking into account a balanced risk diversification;
- therefore, in accordance with § 2, para. 3 ULSG, credit institutions in accordance with the Banking Act (BWG), insurance companies in accordance with the Insurance Supervision Act (Versicherungsaufsichtsgesetz – VAG), securities companies and securities services providers in accordance with the Securities Supervision Act (Wertpapieraufsichtsgesetz – WAG) 2007 and pension funds in accordance with the Pension Fund Act (Pensionskassengesetz – PKG) are excluded.

In particular working capital loans, loans for investments in Austrian production and service provision which promise sustainable economic success, and loans taken out for the purpose of servicing bonds or the due repayment of existing loans are eligible for a guarantee. On the other hand, guarantee credit agreements with credit institutions and receivables of credit institutions from factoring and leasing transactions are not eligible for a guarantee. In accordance with section 3.2 of the guidelines issued by the Federal Minister of Finance, the amount of liability per company is limited to a maximum of EUR 300 million. Groups of companies regulated by Recommendation 2003/361/EC are included. Guarantee letters from the Federal Government are issued by OeKB as its representative.

Pursuant to section 8.3 of the ULSG guidelines, any breach of the contract shall trigger a contractual penalty equalling 1% of the outstanding guaranteed amount as per the end of the month during which the breach of contract occurred, whereby the court’s right to reduce the fine shall not apply. Therefore, all rules relating to the assumption of liability as well as all aspects of processing and fines are based entirely on the law of obligations.15

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15 Cf. Rebhahn, supra n. 6.
5. **FINANCIAL MARKET STABILITY ACT**

The equity ratios of banks and insurance companies are a central topic of discussion in connection with the financial market crisis. The reason for this is simple: the equity ratio is regarded as an essential indicator of the stability of these enterprises.\(^{16}\) As a result of the financial crisis, the likelihood of losses for some financial institutions has increased to such an extent that they run the risk of falling below the minimum level required by the statutory framework, in particular of no longer being able to reach the equity ratio. These circumstances also increase doubts about the quality of balance sheets issued by credit institutions.\(^{17}\) In order to prevent such a worrying situation – which at worst may result in insolvency – the credit and financial institutions affected need to actively reduce the risk weights and/or raise new capital. By injecting equity, banks aim at strengthening their core capital, given that the core capital ratio is the essential indicator of a bank’s ability to sustain risk. Austria promised the European Commission that equity would be granted to banks only if this would enable their equity base to reach a core capital ratio of not less than 7%.\(^{18}\) The Financial Market Stability Act constitutes the applicable legal framework.\(^{19}\)

Beneficiaries under the FinStaG are credit institutions pursuant to § 1 BWG and insurance companies within the meaning of the VAG. In accordance with § 2 FinStaG, the following instruments are available to the Federal Minister of Finance for the purpose of recapitalising individual institutions:

- the assumption of liability (guarantee, surety, assumption of joint liability) for obligations owed by the relevant entity (subsec. 1);
- the assumption of liability (guarantee, surety, assumption of joint liability) for obligations owed to the relevant entity (subsec. 2);
- the granting of loans to, and the injection of equity into, credit institutions in accordance with §§ 23 and 24 BWG and insurance companies in accordance with § 73 VAG (subsec. 3);
- the acquisition of shares in the company or of convertible bonds in connection with a capital increase (subsec. 4);


\(^{17}\) Posch, Schmitz and Weber, *supra* n. 4, at p. 79.


\(^{19}\) BGBl 136/2008.
- the acquisition of existing shares in the company on the basis of a legal transaction (subsec. 5);
- the taking over of a company’s assets by way of a merger in accordance with § 235 of the Act on Joint Stock Companies (*Aktiengesetz – AktG*).

In addition to these general measures, § 3 FinStaG allows for the possibility of compulsory purchase of an interest in a credit institution or insurance company for a fair consideration.\(^{20}\) In cases where the above-described instruments prove insufficient and there is danger of delay regarding the relevant credit institution’s compliance with its obligations, the Federal Minister of Finance is authorised, pursuant to § 2, para. 2 FinStaG, to take over ownership rights in that entity in order to prevent severe damage to the national economy. Such a takeover of ownership rights is effected on the basis of an ordinance issued by the Federal Minister of Finance.

### 6. Finanzmarktbeteiligung Aktiengesellschaft (FIMBAG)

For implementing the measures described in the FinStaG, the Federal Government employs a special company, namely *Finanzmarktbeteiligung Aktiengesellschaft* (FIMBAG). FIMBAG is a subsidiary of *Österreichische Industrie Aktiengesellschaft* (ÖIAG); it was established on behalf of the Federal Minister of Finance on the basis of § 3, para. 5 FinStaG. In accordance with § 2, para. 3 FinStaG, ÖIAG or another company to be established by ÖIAG is entrusted with the application of measures under the FinStaG; this authorisation is supported by § 9a of the ÖIAG Act as amended in 2008. The Federal Minister of Finance can authorise ÖIAG or FIMBAG to implement the measures under the FinStaG; in respect of the measures stipulated in § 2, para. 1, subsec. 4 and 5 FinStaG, ÖIAG or FIMBAG can be given a relevant mandate. In the former case, ÖIAG and FIMBAG respectively act as direct representatives, in the latter case as trustee on behalf of the Federal Government. On the basis of an authorisation, FIMBAG acts directly in the name and for the account of the Federal Government, and the Federal Government is directly entitled to rights and bound by obligations; if a mandate is given, however, FIMBAG acts as a trustee,\(^{21}\) i.e., FIMBAG becomes entitled to rights and bound by obligations and will be liable to the Federal Government on the basis of the mandate agreement as a trustee and mandatee. It is acknowledged by relevant literature that for the purpose of holding participation capital it is also possible to appoint FIMBAG not only as an authorised representative but also as a trustee, i.e., as an indirect representative,

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\(^{21}\) FIMBAG Management Report 2008 (abridged business year).
despite the fact that this measure is actually listed in § 2, para. 1, subsec. 3, but not in
subsec. 4 or 5.\textsuperscript{22} While the actions taken by an authorized representative are directly
attributed to the represented party, an appointment as trustee and mandatary affords
FIMBAG a greater degree of independence in decision making. Therefore, FIMBAG
can act as a mandatary or trustee on behalf of the Federal Government.

The scope of duties to be performed by FIMBAG is restricted by law.\textsuperscript{23} In accor-
dance with the provisions of the FinStaG, FIMBAG is not allowed to engage in any
activity which is not expressly included in the list of activities set out in the FinStaG.
This constitutes a restriction of the company’s objects and an instruction to the
management board. FIMBAG’s legal capacity is not limited as a result of the
aforesaid. The object of the company is the implementation of the measures for
which responsibility can be transferred to ÖIAG under the FinStaG.\textsuperscript{24} The law
includes only one special corporate law provision in respect of FIMBAG, namely
that the members of the supervisory board and the management board are to be
appointed upon nomination by the Federal Government. This is the only special
provision in terms of stock corporation law applicable to FIMBAG; in all other
respects, general stock corporation law applies. The current management board of
the company has two members; the supervisory board has six members. FIMBAG
commenced its operations on 14 November 2008.\textsuperscript{25} Its task is to support capital
measures taken by the Federal Government pursuant to § 2, para. 1 FinStaG. In
accordance with the company’s own assessment, FIMBAG shall be involved mainly
in taking over – as a trustee – participation capital\textsuperscript{26} first subscribed for by the
Federal Government, in managing and monitoring such an interest, which is
governed by the law of obligations, in its capacity as trustee, and in organising the
subsequent divestment thereof. Any takeover by the Federal Government and
FIMBAG respectively of a capital interest in the form of common stock should only
occur in exceptional cases. Currently, the only stocks held by FIMBAG are those of
Kommunalkredit.\textsuperscript{27} FIMBAG exercises the rights of sole shareholder on behalf of the
Federal Government.\textsuperscript{28}

In addition to the shareholdings under corporate law, FIMBAG holds participa-
tion capital in Hypo Alpe Adria AG, Österreichische Volksbanken AG, BAWAG,
RZB and Erste Bank on behalf of the Republic of Austria.\textsuperscript{29} It has further been

\textsuperscript{22} H. Krejci, ‘Finstres im FinStaG? Darf der Bund selbst Partizipationskapital erwerben und
der FIMBAG zur treuhändigen Verwaltung übertragen?’, \textit{Festschrift Manfred Straube} (2009) p. 55,
at p. 57 ff.
\textsuperscript{23} Ibid., at p. 56.
\textsuperscript{24} Cf. Parlamentskorrespondenz 02/23.06.2009/no. 561.
\textsuperscript{25} FIMBAG Management Report 2008 (abridged business year).
\textsuperscript{26} Cf. Krejci, supra n. 22, at p. 57 ff.
\textsuperscript{27} FIMBAG Management Report for 2008 (abridged business year).
\textsuperscript{28} The Association of Municipalities holds a small stake of 0.22% in Kommunalkredit.
\textsuperscript{29} Cf. Parlamentskorrespondenz 02/23.06.2009/no. 561.
agreed between the Republic of Austria and Erste Bank that supplementary capital will be granted, which has however not – yet – been subscribed for. Therefore, only credit institutions but no insurance companies are among the beneficiaries. The aggregate volume of participation capital managed by FIMBAG corresponds to EUR 5.8 billion.

As mentioned earlier, FIMBAG has the duty to monitor the credit institutions under the relevant master agreement,\(^3^0\) this duty is imposed on FIMBAG on the basis of an Assumption Agreement concluded between the Republic of Austria and FIMBAG. Pursuant to § 10 of the Requirements Ordinance, the benefiting credit institution is obliged at all times to furnish information, grant permission for the performance of audits and tax audits of the accounts, and submit any and all documents to the Federal Minister of Finance and FIMBAG respectively. The relevant information shall be communicated by FIMBAG to the Federal Minister of Finance in agreement with the Federal Chancellor. On this legal basis the Republic of Austria has, as the equity provider, represented by its trustee or authorised representative FIMBAG, certain rights of information and control which clearly exceed those granted to other providers of participation capital while at the same time permitting only indirect control. The Federal Minister of Finance is not the direct recipient of the information provided; the owner’s rights are exercised through FIMBAG. FIMBAG’s right of information is therefore derived from an agreement governed by the law of obligations and from the direct legal bases pursuant to the relevant laws and ordinances. This right of information must be clearly distinguished from the right of information granted to the bank supervisory authority; it is, at least pursuant to the underlying concept of the law, aimed solely at securing the equity provider. Any conflict of interests is to be resolved by way of disclosure, given that the interests of the supervisory authority and those of the owner cannot be separated entirely; this is particularly evident in the case of institutions whose economic situation is especially critical.

7. **LEGAL BASES REGULATING THE DETAILS**

The individual measures aimed at securing the equity base under the FinStaG are based on a number of different legal and contractual provisions, namely:

(a) the Financial Market Stability Act (FinStaG);
(b) the ordinance by the Federal Minister of Finance laying down detailed provisions regarding the conditions and requirements in connection with measures under the FinStaG (Requirements Ordinance),\(^3^1\)

\(^3^0\) 2777 BglNR 24. GP 2 (Report of the Financial Committee).
\(^3^1\) BGBl II 382/2008.
The Financial Market Stability Act constitutes the essential legal framework, which is naturally subject to the relevant requirements under European law and constitutional law. Under the FinStaG, no limitations apply to the interventionist measures implemented by the government; however, Austria was requested by the European Commission to agree that new measures would be approved only until 30 June 2009. Approvals at any later time may only be granted by way of exception. The legal timeframe was extended by the December 2009 amendment, but no substantial changes were made in terms of the content of the law.

7.2 Requirements Ordinance

In accordance with § 2, para. 5 FinStaG, the Federal Minister of Finance is authorised to determine detailed conditions and requirements in respect of measures for financial market stability. The Minister issued a relevant Ordinance which stipulates a guideline and a framework as to the requirements to be included in the terms and conditions agreed between the Republic of Austria and the relevant beneficiary. Therefore, the Ordinance, based on the sovereign authority to lay down rules, specifies details in respect of the contents of the actual contracts. The Requirements Ordinance, in accordance with § 2, para. 5 FinStaG, constitutes an initial specific framework which can be individualised for each credit institution pursuant to § 1, para. 2 of the Ordinance. It comprises many rather vague legal terms. For instance, it includes several references to the ‘appropriateness of measures’ or to ‘deliberations’. The use of vague legal terms makes the provisions more flexible and facilitates the drafting of made-to-measure solutions for each individual case. However, it also gives rise to questions in respect of constitutional law issues and, even more importantly, creates a very broad framework for

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32 State Aid Decision No. 557/2008 Austria; cf. Wollmann, supra n. 7.
33 BGBI II 2008/382.
34 Putzer, supra n. 2, at p. 52.
35 Cf., e.g., Putzer, supra n. 16, § 2 FinStaG, note 9.
negotiations with credit institutions, which makes negotiating a difficult task. The Ordinance specifies the scope of application, the sustainability of the relevant measure, requirements regarding the use of funds and requirements relating to the remuneration of corporate bodies of the benefiting financial institutions (limiting the amounts, defining the structure); it also includes minimum requirements for the equity base, rules on the distribution of profits, on the maintenance of jobs, on the avoidance of distortions of competition, and on fees and information duties, and lays down rules on letters of undertaking subject to private autonomy.

7.3 Master agreement

On the basis of the master agreement concluded between the Republic of Austria and the relevant credit institution or insurance company, the detailed contractual provisions are negotiated and agreed. The specific covenants governed by the law of obligations are stipulated, e.g., in the terms and conditions for participation capital, which constitute an integral part of the master agreement concluded between the issuer of participation capital, i.e., the beneficiary credit institution, and the Republic of Austria. The need for a division is evident if we consider that participation capital is not only granted to and subscribed for by the Republic of Austria, but also to/by private entities. The terms and conditions regarding participation capital are therefore part of the master agreement between the issuing credit institution and the Republic of Austria but are not applicable beyond this scope.

7.4 Assumption Agreement between the Republic of Austria and FIMBAG

On the basis of an Assumption Agreement concluded between FIMBAG and the Republic of Austria, FIMBAG undertakes to monitor compliance with the conditions and requirements arising under the master agreement between the bank and the Republic of Austria, and to submit the required reports to the Federal Government. As already explained above, the specific conditions and requirements are more detailed elaborations of the provisions comprised in the FinStaG and the Requirements Ordinance based on the FinStaG. FIMBAG is obliged to enter into such an Assumption Agreement and has no possibility of changing the agreement in principle, which is neither negotiated nor concluded by FIMBAG. Rather, it is obliged by virtue of the law to perform these monitoring and reporting duties. Within the framework of these duties, FIMBAG shall also monitor the sustainable compliance with the business model adopted by the relevant bank, taking into account a reasonable risk policy.37

36 Putzer, supra n. 2, at p. 52.
8. PARTICIPATION CAPITAL

8.1 General rules

We will not discuss all measures listed in § 2 FinStaG here, but only describe the two measures that are already being applied in practice: on the one hand, the takeover of common stock, a measure being implemented in the case of Kommunalkredit and Hypo Alpe Adria AG, and, on the other hand, the takeover of and subscription for other kinds of equity, in particular participation capital in accordance with § 2, para. 1, subsec. 3 and 4 FinStaG. So far, in the case of Kommunalkredit and Hypo Alpe Adria AG, only participation capital, which is subject to the law of obligations, has been acquired. The takeover of or subscription for nominal capital by the Republic of Austria should only occur in exceptional cases; primarily, any interest in credit institutions acquired by the Republic of Austria shall be based on instruments governed by the law of obligations.

The reason why participation capital is the preferred choice is that it will not result in the Republic of Austria holding any position under stock corporation law. The Republic can therefore exercise any control or influence not by virtue of membership but solely on the basis of the acquired interest governed by the law of obligations, unless any direct legal or otherwise sovereign authority applies under the FinStaG. Even though in extremely critical situations the state will provide funds, support institutions and take a high risk, it appears noticeably restrained in claiming rights of control and influence. The clear preference for equity capital governed by the law of obligations is evidence of the banks’ strong influence on the shaping of law and during the negotiations between each institution and the Republic. In this context it should be noted that bond terms often exclude any direct interest of governments in the issuers of investment products and that therefore the credit institutions concerned would find it considerably more difficult to place certain securities on the international capital market, or would be forced to dump such securities on the market. Participation capital affords the possibility of increasing the core capital ratio while not granting the state any direct influence on the bank by virtue of membership rights.38

Participation capital (Partizipationskapital) constitutes a special form of profit-sharing capital (Genusskapital).39 Participation capital is an instrument generally useful for improving the equity base of credit institutions and insurance companies.

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38 Hödl, supra n. 16, at p. 113 ff.
§ 23, para. 4 BWG and § 70c VAG constitute the essential legal bases. In Austria, participation capital was introduced some 30 years ago. Originally, it was designed specifically for private investors as an instrument for acquiring a capital interest but ultimately did not prove successful in this segment. In spring 2004, for instance, only three participation certificates were quoted at the Vienna stock exchange. In practice, however, it is often used in a business-related context for the purpose of providing equity, and therefore this instrument now plays quite an important role in day-to-day banking practice. Last but not least, the financial crisis has helped to bring participation capital back into the limelight. In accordance with the regulatory framework, participation capital can be acknowledged as equity if the following criteria are met: (i) payment is made; (ii) the contribution is made for the entire duration of the company, whereby any right of termination for convenience or for important reasons must be waived; (iii) a reduction may only be effected by applying mutatis mutandis the provisions on capital reduction and conversion pursuant to § 102a BWG; (iv) the return depends on the performance after reserve-building; (v) full participation in the loss, if any; (vi) the right to participate in the liquidation proceeds is subordinated to the satisfaction of creditors’ claims and the provision of security for creditors.

Participation capital constitutes a surrogate for the equity which was destroyed by the financial crisis and cannot be recovered through a relevant issuance of share capital, so an interim solution must be found. Participation capital is to be regarded as equity if certain requirements are met.

In accordance with § 23, para. 4, subsec. 4 BWG, the holders of participation capital, like stockholders, are not entitled to repayment of their contributions in the event of the company’s bankruptcy. The holder therefore runs the risk of losing the entire participation capital. Participation capital can be acknowledged as paid-up capital only if no deferred payment claim exists. Paid-up capital is regarded as core capital within the meaning of the Banking Act and is basically counted towards the equity without limitation (excepting the items to be deducted pursuant to § 23, para. 13, subsec. 1-3 BWG). If participation capital entitles the holder to a deferred payment claim, however, it is only counted up to an amount equalling 100% of the core capital. Currently, participation capital is qualified as an item under the heading of equity; at European level, however, attempts are under way to discourage such a qualification. Besides the legal and other requirements stipulated by the FinStaG
and the relevant Ordinance, participation capital must also comply with all other requirements under the BWG and VAG. The holders of participation certificates are entitled to attend the general meeting and request information at the meeting. In respect of the holders of participation certificates the rules on banking secrecy must be observed.\footnote{Nowotny, \textit{supra} n. 41, at p. 297; also: F. Sommer and C. Hirsch, in M. Dellinger, ed., \textit{Kommentar zum Bankwesengesetz, BWG} (2009) § 38, no. 105.}

The provisions under stock corporation law are not amended by the FinStaG, and therefore no special corporate law is created for the beneficiary companies. In connection with the issuance of participation capital, the applicability of provisions under stock corporation law is quite straightforward: similar to profit-sharing capital, the issuance of participation capital requires a duly convened general meeting in accordance with § 174 AktG. The shareholders are entitled to subscription rights, and any holders of participation capital are protected by anti-dilutive provisions in accordance with § 23, para. 5 BWG.\footnote{Hödl, \textit{supra} n. 16, at p. 116.} Any dilution must be compensated or otherwise be dealt with correctly through payment of an additional contribution.\footnote{P. Göth, in P. Göth and G. Diwok, \textit{Bankwesengesetz} (Vienna, Verlag Österreich 2003) § 23, no. 36; Hödl, \textit{supra} n. 16.} If the shareholders’ subscription rights are excluded in connection with the issuance of participation capital, a majority requirement of three quarters of the represented share capital is mandatory. If the shareholders’ subscription rights apply and the majority requirements for regular capital increases pursuant to the memorandum of association are lower, such lower majority shall apply and shall be deemed sufficient.\footnote{Hödl, \textit{supra} n. 16.} It is also permitted to issue participation capital by way of authorised capital in accordance with § 174, para. 2 AktG.\footnote{Winner, \textit{supra} n. 39, § 221, no. 409; Zollner, \textit{supra} n. 39, § 174, no. 41; Nagele and Lux, in Jabornegg and Strasser, \textit{supra} n. 39, § 174, no. 19.}

Apart from the requirements under the BWG and VAG and those under the special statutory provisions of the FinStaG and the relevant Ordinance, the specific contractual provisions constitute the essential legal basis. Pursuant to the Supreme Court’s findings, the basis of profit-sharing capital, and therefore also of participation capital, is a contract \textit{sui generis}.\footnote{OGH Der Gesellschafter (GesRZ) (2003) p. 285; OGH 10 Ob 34/05f, \textit{Wirtschaftsrechtliche Blätter} (2006) p. 278; also: VwGH, \textit{Österreichische Zeitschrift für Steuerrecht} (1994) p. 544; Nagele and Lux, in Jabornegg and Strasser, \textit{supra} n. 39, § 174, no. 32.} However, depending on the contents of the agreement, specific types of contract apply to profit-sharing capital.\footnote{Winner, \textit{supra} n. 39, § 221, no. 389; M. Karollus, in J. Geßler and W. Hefermehl, \textit{Kommentar zum Aktiengesetz} (Munich, Vahlen 1998) § 221, no. 278 ff; C. Lindinger, ‘Über Zulässigkeit und Beendbarkeit bestimmter Genussrechte’, \textit{Juristische Blätter} (2003) p. 724, at p. 728 ff.} Within the framework of the above-mentioned legal provisions, the general discretion under civil law applies to participation capital. Given that primarily state-owned (or...
formerly state-owned) institutions and institutional investors are eligible candidates for subscribing for participation capital issued as a result of the financial crisis, the contractual structuring options should be adapted accordingly.\textsuperscript{53} Within the framework stipulated by law, there is much room for manoeuvre for contractual agreements; this room has been used extensively in connection with the conclusion of master agreements pursuant to § 2, para. 1, subsec. 3 FinStaG for the granting of state participation capital by the Republic of Austria or associated institutions or institutional investors to individual credit institutions.\textsuperscript{54}

The terms and conditions for participation capital are subject to an examination of contents. Such an examination shall be aimed at protecting not only the legal position of the holders of participation capital but also that of the shareholders, who are, in the case of an ‘authorisation-based issue’, i.e., an issue delegated to the managing bodies of the company, not involved in the drafting of the essential terms and conditions.\textsuperscript{55} In this context, the special provisions under the statutory regime for participation capital, namely the fact that the subscriber has no right of termination, shall be considered, and appropriate mechanisms, taking into account the relevant interests, shall be created to allow for a termination of the contractual relationship.\textsuperscript{56}

Participation capital provides equity, but it is not subject to the Act on Substitute Equity (\textit{Eigenkapitalgesetz} – EKEG) as the special provisions of the EKEG are applicable to a capital interest created under the law of obligations only if it gives rise to a relevant controlling influence or, in the case of an interest corresponding to 25% or more, at least to rights of participation equalling those of a general partner. Therefore, participation capital is deemed to be subordinated only under special circumstances. An agreement under the law of obligations can be concluded to this effect, but constitutes an exception.\textsuperscript{57} The rights of information and control which are customarily granted to a lender can also be agreed with a holder of participation capital without triggering the applicability of the EKEG.\textsuperscript{58}

8.2 \textbf{Specific structuring of participation capital (state participation capital)}

The specific structuring of participation capital is different for each credit institution; it depends on the economic potential and the current situation of the relevant institution. The only participation capital for which a public offering was made – and for which therefore a prospectus in accordance with the Capital Market Act (\textit{Kapitalmarktgesetz})
**Marktgesetz – KMG** was prepared – was that issued by Erste Bank. The participation capital issued by RZB was also offered to private investors, but only to institutional ones, and thus the duty to publish a prospectus pursuant to § 3 KMG did not apply. The participation capital of all other issuers was subscribed for exclusively by the Republic of Austria (so-called state participation capital). The participation of private investors in the issue is not a prerequisite for the Federal Government to take over equity but merely alters the relevant conditions. The actual terms and conditions regarding participation capital depend on the current situation of the bank, whereby we differentiate between two categories: sound banks and distressed banks.

Tertium non datur: In practice, though, (e.g., in the case of Hypo Alpe Adria AG) a tertium was introduced, namely so-called non-distressed banks, which created yet more room for manoeuvre; however, hardly any structural contents were specified, making monitoring a difficult task, as became evident later.

The assessment of a bank or credit institution as sound or distressed, must be made on the basis of a flexible system. The relevant criteria are described in Annex 1 of the European Commission’s Recapitalisation Communication. The interest payable for participation capital in favour of the holder depends on whether the credit institution is regarded as sound or distressed. This classification depends on the assessment of the equity base, the risk profile, the liquidity, market and interest risks and risks in connection with rate fluctuations, the volume of the recapitalisation, the CDS (credit default swaps) spreads of the relevant bank in proportion to the market average, and the bank’s rating. In the case of sound credit institutions, a market-oriented interest rate is to be agreed which shall correspond to not less than 9.3% p.a. for the core capital. Alternatively, the actual interest return shall not be less than 8% p.a. if a repayment at 110% of the nominal value is agreed. If private investors subscribe for a minimum volume of 30%, no minimum interest requirement will apply. Of the said 30%, not more than one third may be subscribed for by existing shareholders, and at least two thirds must be subscribed for by third parties. For distressed credit institutions, a market-oriented fee of not less than 10% p.a. must be agreed. After a period of six months, the issuing credit institution shall present a restructuring plan.

In respect of dividend restrictions applicable to old shareholders compared to the holders of participation capital, the FinStaG also distinguishes between sound banks and distressed banks. In the case of sound credit institutions, distributions are limited to 17.5% of the distributable profit before reserve appropriation for the period during which state aid is used. In the case of distressed credit institutions, no dividends may be distributed to old shareholders.

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59 Wollmann, supra n. 7, at p. 111.
60 Ibid., at p. 111 ff.
61 At the end of 2008, the European Commission determined that the market price for equity capital in the autumn of 2008 was 15%. From this point of view, a minimum dividend of 10% is a favourable margin.
There are no normative requirements for non-distressed banks, i.e., the above-described tertium, which has in fact become evident in the case referred to above.

In 2009, the provision of participation capital to credit institutions turned out not to be advantageous for the Republic of Austria, given that two of the credit institutions, namely Hypo Alpe Adria AG and ÖVAG, were unable to pay dividend.\textsuperscript{62}

### 8.2.1 Individual requirements

§ 2, para. 5 FinStaG and the relevant Ordinance issued by the Federal Minister of Finance in conjunction with the decision by the European Commission stipulate content-related requirements for the structuring of participation capital. In accordance with § 2 of the Ordinance, the beneficiary shall pursue a sustainable business policy. Transactions involving high risks or ill-defined products or markets should be reduced or abandoned. The beneficiary institution shall use the provided funds also for granting loans or for capital investments on customary terms and conditions for trade and industry, in particular SMEs, and for providing mortgage loans to households. The credit institution is also entitled to provide funds to its subsidiaries.

### 8.2.2 Remuneration

Pursuant to § 4 of the Ordinance, the beneficiary credit institution shall examine its system of remuneration as to its incentive effect and appropriateness, and ensure, within the available civil law framework, that it does not encourage the taking of unreasonable risks and that it is transparent and oriented towards long-term or sustainable goals.\textsuperscript{63}

An appropriate system of remuneration is a clear indicator of good corporate governance in a credit institution. The issue of appropriate rules to govern the remuneration of directors and executives of credit institutions is one of the top legal policy issues on the international agenda, as became evident at the London and Pittsburgh summits. A brief survey shows that this issue is discussed widely and interpreted broadly both on an international level and in terms of legal comparison. The reason is simple: remuneration systems that have a distorting incentive effect may substantially affect a bank’s corporate governance.\textsuperscript{64}

\textsuperscript{62} Cf. annual report of Hypo Alpe Adria 2009, at p. 40; consolidated annual report of ÖVAG 2009, at p. 117 ff. If the negotiations between the Republic of Austria and Unicredit Bank Austria AG had led to an agreement about the provision of participation capital, the Republic of Austria would probably have achieved a positive result for the year 2009.

\textsuperscript{63} 2777 BegrNF 24. GP 3 (Report of the Financial Committee).

In general, the remuneration of members of the management board of an Austrian joint stock company can be determined freely within the scope of entrepreneurial discretion. Pursuant to § 78 AktG, the supervisory board shall observe the principle of proportionality in determining the amount of remuneration. The aggregate remuneration paid to a member of the management board must be reasonably proportional to the duties performed by such member and to the situation of the company. The criteria to be taken into account include, e.g., the economic situation of the company, the duration of the appointment of the board member, the volume of the resources entrusted to the board member, and extraordinary earnings. The Supreme Court has adopted a very liberal interpretation of these rules and grants a wide scope of discretion to the supervisory board. In the Court’s view, only cases of blatant inappropriateness constitute a breach of the law. But even in cases where the remuneration granted to members of the management is too high, subsequent modification is not permitted unless a relevant contractual provision has been agreed.

Pursuant to § 4 of the Ordinance, the beneficiary credit institution is obliged to examine its system of remuneration as to its incentive effect and appropriateness, and shall ensure, within the available civil law framework, that it does not encourage the taking of unreasonable risks and that it is transparent and oriented towards long-term or sustainable goals. Employees and essential agents must not receive inappropriate remuneration components or bonuses or other inappropriate benefits. The remuneration paid to members of the corporate bodies and executives of the beneficiary shall be limited to an appropriate amount, whereby, inter alia, the contribution made by the relevant individual towards the current economic situation of the beneficiary, in particular within the framework of the business policy and risk management, as well as the necessity to offer a market-oriented remuneration shall be taken into account. These criteria shall ensure that the most suitable persons can be employed for realising sustainable economic development. Existing target agreements, rules in connection with stock option schemes and other rules governing performance-related remuneration components must not be altered subsequently in favour of members of corporate bodies, employees or essential agents. § 5, para. 2, subsec. 3 of the Ordinance stipulates that insofar as possible within the applicable civil law framework, stock option schemes benefiting members of corporate bodies or essential agents shall be suspended for as long as instruments under the FinStaG are used. Therefore, the employment contract constitutes the essential legal basis,

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65 Supreme Court OGH 7 Ob 58/08t, GesRZ 6/2008, p. 151 (S. Kalss).
67 Supreme Court OGH 7 Ob 58/08t.
provided it includes a relevant exit clause. Neither the FinStaG nor the Ordinance provide that contractual agreements that may have a distorting incentive effect are to be interfered with by virtue of the law.

In accordance with § 4, para. 3 of the Requirements Ordinance, the beneficiary credit institution shall, within the applicable civil law framework, demand that members of corporate bodies and executives of the company who have substantially and adversely contributed to the economic situation of the beneficiary within the framework of the business policy and risk management, repay, to a reasonable extent, remunerations already received by them, provided the relevant remuneration is not appropriate pursuant to para. 2 and is objectively to be regarded as substantial in terms of amount. A demand for repayment need not be made where it would be considered unfair in view of the financial situation of the relevant person or where it would be uneconomical for the beneficiary owing to the expected duration and costs of the proceedings and the likelihood of a negative outcome. If the claim to repayment is waived, the Federal Minister of Finance must be informed accordingly and the decision must be justified.

The Supreme Court expressly held that any subsequent interference with a contractual claim to remuneration constitutes an inadmissible interference with duly acquired rights and the ownership rights of the board member. This is the reason why the relevant provisions of the FinStaG are worded extremely cautiously. In addition to the possibilities of an exit under the civil law framework, the Act also expressly refers to considerations of fairness.

The version of the Code of Corporate Governance that became effective on 1 January 2010 includes new provisions relating to the remuneration of members of the management boards of listed corporations. In accordance with Rule 27(C), the remuneration paid to a board member depends on the scope of the member’s duties, his/her degree of responsibility and his/her personal performance, as well as on the extent to which the company’s performance targets have been achieved. The variable remuneration components shall be linked to long-term and sustainable performance criteria referring to a period of several years, shall also take into account non-financial criteria and shall not encourage the board member to take unreasonable risks. Measurable performance criteria and caps for variable remuneration components must be determined in advance. The company must also be granted the right to demand repayment of variable remuneration components once it becomes apparent that they were paid on the basis of evidently incorrect data. Any compensation paid upon the early termination of the board member’s appointment without important reasons must not exceed the total amount of remuneration for two years, whereby the board member must not be compensated for more than the remaining term of the employment contract.69 The Code also includes corresponding rules for stock option

schemes. The remuneration principles shall also apply in respect of executive employees.70

9. SUMMARY

The Austrian legislator has responded to the financial crisis in step with other European countries and has created a new legal framework both for the assumption of liability and for the provision of equity. The most characteristic aspect is the possibility to provide equity capital by acquiring an interest governed by the law of obligations through so-called state participation capital. This instrument permits flexibility but also limits the possibility to exercise influence. Experience has shown that influence and control are generally exercised, and work better, on a more informal level.