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FINANCIAL INSTITUTIONS M&A

A Quick Guide to Acquiring a
German Financial Institution



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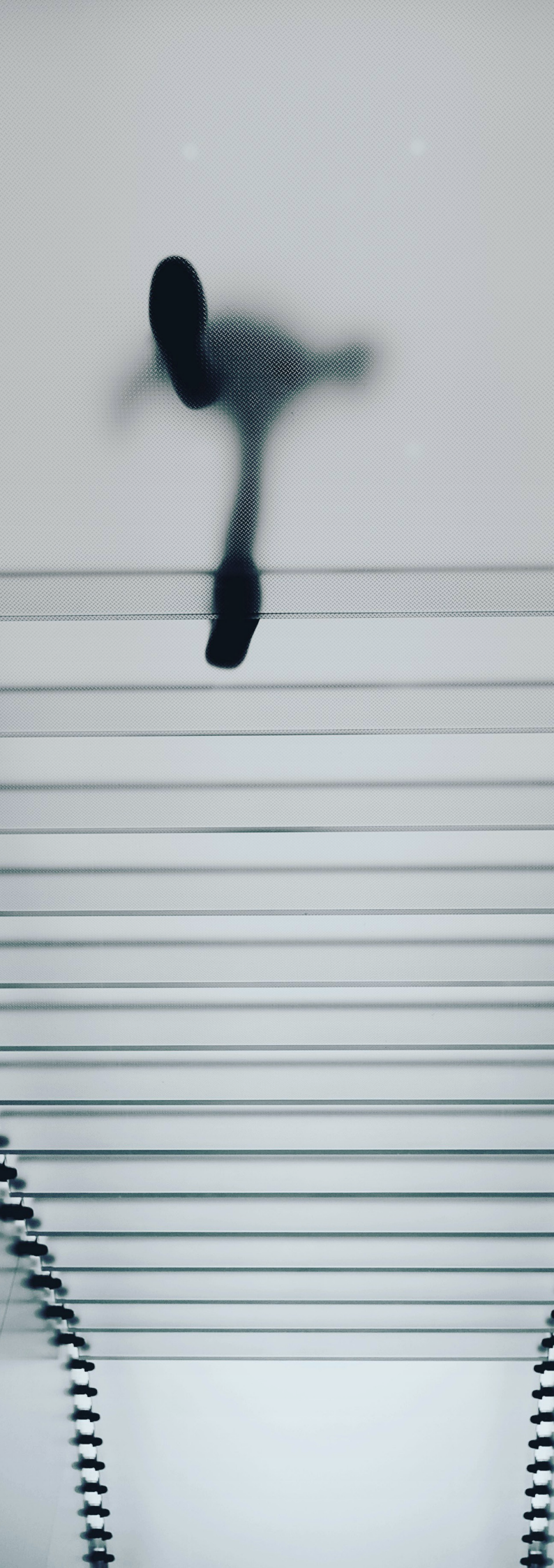
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Germany is not only the strongest economy in Europe, but also offers the largest number of banks in Europe. Located in the heart of Europe, Germany is an ideal basis for covering markets all over Europe.

This presents opportunities for investors who would like to enter the German financial sector. Therefore, it is no wonder that in the recent past, a number of German financial institutions were acquired by foreign investors. However, as the financial sector is heavily regulated, investors should be aware of some particularities when acquiring a German financial institution.

REGULATORY BACKGROUND

In this section, we provide an overview of the different sorts of businesses which are subject to financial regulation and the regulatory framework in which they operate in Germany.

TYPES OF FINANCIAL INSTITUTIONS SUBJECT TO SPECIAL REGULATION

While financial regulation traditionally focused on banks and insurance companies, its scope has broadened significantly over the last years to cover the following businesses:

- Credit institutions: Under German law, this is the category for traditional banks. It covers not only businesses engaged in deposit taking, guarantee business and custody business, but also businesses that grant loans (regardless of whether the loans are granted to consumers or non-consumers);
- Financial services institutions: This term is a German particularity that covers different sorts of businesses, in particular (i) "investment firms", i.e. firms rendering investment advice, investment brokering, portfolio management and multilateral trading facilities, (ii) leasing companies and (iii) factoring companies;
- Payment services institutions: Institutions which conduct different forms of payment services;
- Insurance companies: This term covers insurance companies and pension schemes;
- Funds and fund managers;
- Stock exchanges.

OVERVIEW OF RULES APPLYING TO FINANCIAL INSTITUTIONS

While each sub-group of the financial sector is subject to different rules, certain aspects of regulation apply at least to most types of financial institutions:

- All financial institutions are subject to a license requirement. This requirement generally also covers non-EU firms which intend to open a branch in Germany or to do business on a cross-border basis.
- Most of the rules to which financial institutions are subject are developed at the EU level. The majority of the European rules are still in the form of "EU Directives", which need to be transposed into national law by national rulemaking bodies. As a consequence, while the financial regulatory regime is similar in all member states of the European Union, the specific applicable laws differ between member states. However, there is a tendency in the European Union to enact rules in the form of "EU Regulations" which are directly applicable in all EU member states. This is, in particular, the case with regard to major parts of prudential regulation of banks (i.e. regulation aimed at ensuring the financial stability) which is now regulated by the Capital Requirements Regulation (CRR).

- As a consequence of a wide-ranging harmonization of substantive financial supervisory law in the European Union, most European financial institutions may “passport” their activities into all other EU member states, i.e. may provide services through a branch or on a cross-border basis in all other EU member states without the need to apply for an additional license in each member state in which business is conducted. Therefore, a license in one EU member state will allow investors to cover the entire EU market.
- Most regulations require a “fit and proper” test for members of the management board and the supervisory board in the German two-tier governance structure.
- Most regulatory laws encompass certain restrictions on what can be outsourced and which conditions outsourcing agreements must meet.
- As a consequence of the financial crisis, most regulatory laws contain rules regarding the remuneration systems of financial institutions, with a focus on bonus payments.
- All financial regulatory rules require shareholders to be reliable and therefore provide for a specific shareholder control procedure (see below for details).
- Over the last few years, specific recovery and resolution rules were implemented applying in particular to banks and financial services institutions. These rules provide recovery and resolution plans and certain resolution instruments, including the so called bail-in tool.

COMPETENT AUTHORITIES

In spite of the far ranging harmonization of financial regulatory rules on an EU level, rules are generally enforced by national, rather than by European authorities. In Germany, the key financial regulators are the German Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin*) and the German Central Bank (*Bundesbank*).

Again, there is a particularity specific to banks. In response to the financial crisis, the member states of the Eurozone agreed to establish the so called Banking Union primarily with regard to significant banking groups (a banking group qualifies as significant if, in particular, its balance sheet exceeds 30bn EUR). Under the Banking Union rules, a single European authority is responsible for all significant Eurozone banking groups. The Banking Union currently consists of two pillars: the Single Supervisory Mechanism (SSM) under which, since November 2014, the Frankfurt-based European Central Bank (ECB) is responsible for the prudential regulation; and the Single Resolution Mechanism (SRM) under which, since January 2016, the Brussels-based Single Resolution Board, a new European body, is responsible for key resolution decisions. In November 2015, the EU Commission proposed, as a third pillar of the Banking Union, a euro-area wide deposit insurance scheme (EDIS) which is, however, still subject to intense political discussions.

REGULATORY SHAREHOLDER CONTROL PROCEDURES

STATUTORY SHAREHOLDER CONTROL PROCEDURE

As mentioned above, shareholder control procedures apply to all sorts of financial institutions. They allow BaFin, in case of banks in combination with the ECB, to check in advance investors' reliability. The procedure applies to investors which, either individually or together with other persons or companies, wish to acquire a "significant holding" in a regulated German entity. A "significant holding" means a direct or indirect holding in an undertaking which represents 10 percent or more of the capital or of the voting rights or a holding which makes it possible to exercise a significant influence over the management of that undertaking. The 10 percent threshold can also be reached by several investors acting in concert, i.e. coordinating the exercise of their voting rights and influence on a target company.

Persons or entities intending to acquire a significant holding, or to increase their holding to exceed 20, 30 or 50 percent of the voting rights or capital, must notify this intention immediately to BaFin and the Bundesbank. The first notification must be accompanied by a business plan, statements of reliability and further extensive information on the acquirer, its management, its investors and its group.

Authorities have up to 90 working days to review the filings whereby the clock for the assessment period will only start ticking once all required documentation has been submitted. In practice, this leaves authorities an enormous amount of discretion as to when the 90 working days period starts. While no formal approval of the acquisition

by authorities is required, authorities may, within the assessment period, prohibit the transaction. Thus, they have de facto a veto right.

Investors into all sorts of financial institutions should be aware that the shareholder control procedure will in many cases be time-consuming and onerous in terms of paperwork, in particular if (i) the target is a bank and (ii) the investor does not yet own a financial institution in the EU. In case of banks, authorities also sometimes use their veto power to require from investors certain guarantees not explicitly provided in the law, e.g. a certain capitalization of the target bank. While the shareholder control procedure should therefore be taken very seriously and be prepared carefully, it should also be stressed that in the recent past it has been successfully completed by a number of investors others than traditional European banks. This shows that authorities recognize that the German banking system can strongly benefit from outside investors and their financial strength.

Although it is generally assumed that a veto by BaFin/the ECB would not make the acquisition of an interest in a financial institution invalid under civil law, such acquisition before clearance can qualify as an administrative offence which could be heavily sanctioned by BaFin/the ECB. Therefore, the lapse of the assessment period or a certificate of non-objection by BaFin will generally be agreed as a condition precedent to the closing of a transaction.

FOR BANKS: ADDITIONAL SHAREHOLDER CONTROL PROCEDURE UNDER THE VOLUNTARY DEPOSIT PROTECTION FUND (EINLAGENSICHERUNGSFONDS); DECLARATION OF INDEMNIFICATION (FREISTELLUNGSERKLÄRUNG)

While the statutory shareholder control procedure under the applicable regulatory acts, as set out in the preceding section, applies to all German regulated financial institutions, for the acquisition of a bank an additional shareholder procedure related to the so called voluntary deposit guarantee scheme often becomes relevant:

As with all EU banks, German banks are obliged to secure their deposits by way of membership in a statutory deposit guarantee scheme. The statutory deposit protection scheme guarantees the deposits of (most) customers up to an amount of EUR 100,000.

Additionally, the vast majority of private banks in Germany, however, are members of the Deposit Protection Fund (DPF) of the Federal Association of German Banks (Einlagensicherungsfonds des Bundesverbandes deutscher Banken e. V.). In the event of insolvency, the voluntary deposit protection scheme of the DPF guarantees deposits of currently up to 15 percent (8.75 percent as of 2025) of the regulatory capital of the relevant bank. This guarantee generally by far exceeds the level of protection accorded by the statutory deposit protection scheme. As a result, membership in the DPF is by many private banks considered to be vital for refinancing purposes.

Hence, most investors intending to acquire a German bank which is a member of the DPF will be keen on ensuring that the acquisition of the bank will not affect its membership in the DPF.

Continued membership in the DPF, however, requires that:

- Holders of a significant holding (i.e. 10 percent or more of the shares or the voting rights) undergo an additional shareholder control procedure run under the auspices of the Federal Association of German Banks. In this context, investors must, in particular, prove their financial robustness vis-à-vis the Federal Association of German Banks, whereby the level of scrutiny is considerably increased in the case of a majority shareholding; and
- Holders of a direct or indirect majority holding and investors which may otherwise exercise a controlling influence on the bank must additionally issue a declaration of indemnification in which they indemnify the Federal Association of German Banks against any losses it may incur as a result of rendering assistance to the bank. In practice, this requirement regularly poses particular challenges for private equity funds. Therefore, individual solutions have to be agreed upon with the DPF.

From the purchaser's point of view, it is advisable that the purchase agreement provides approval of the Federal Association of German Banks to the continued membership of the target in the DPF as a condition precedent to the closing of the transaction.

PUBLIC LAW RULES OTHER THAN FINANCIAL REGULATION

In addition to financial regulatory rules, general rules applicable to the acquisition of companies must be considered in the context of the acquisition of a financial institution, in particular merger control rules and foreign trade rules.

MERGER CONTROL

The acquisition of shares, voting rights, or financial institution assets either in part or in their entirety, may require merger control review by antitrust and competition law authorities.

Generally, the requirement of a merger control notification does not depend on the degree of product overlap between the merging parties, but on the group turnover of the acquiring company/ companies on the one hand and the acquired business on the other hand. The turnover of financial institutions is the sum of: (i) the interest and similar income, (ii) the income from securities, (iii) commission's receivables, (iv) net profit on financial operations and (v) other operating earnings (after deduction of VAT and other taxes directly applied to these earnings). It should be noted that while in most jurisdictions only the acquisition of control is subject to clearance, in Germany the acquisition of a minority stake may also require prior notification and clearance.

If a notification is required, the competent authority needs to be determined. This can either be the European Commission in Brussels or a national antitrust authority, in case of Germany the German Federal Cartel Office (*Bundeskartellamt*) in Bonn. Again, this depends on the turnover. Broadly speaking, the greater the turnover of the merging companies in the EU is the more likely the European Commission has to be notified.

Once notified, the antitrust authorities examine whether the transaction significantly impedes effective competition in the relevant product markets. The authorities can be expected to

analyze a transaction in more detail if, inter alia, the merging parties combine market shares of more than 35 – 40 percent in a given market. Amongst others, consumer banking, business banking, asset management, factoring, investment banking, and money market and securities business are considered separate product markets. Further segments (e.g. deposit and loan business) may also be examined. From a geographic perspective the authorities normally define national markets. Exceptions are certain investment banking or money markets and securities business activities where the territory of the community may be deemed to be the relevant geographic market.

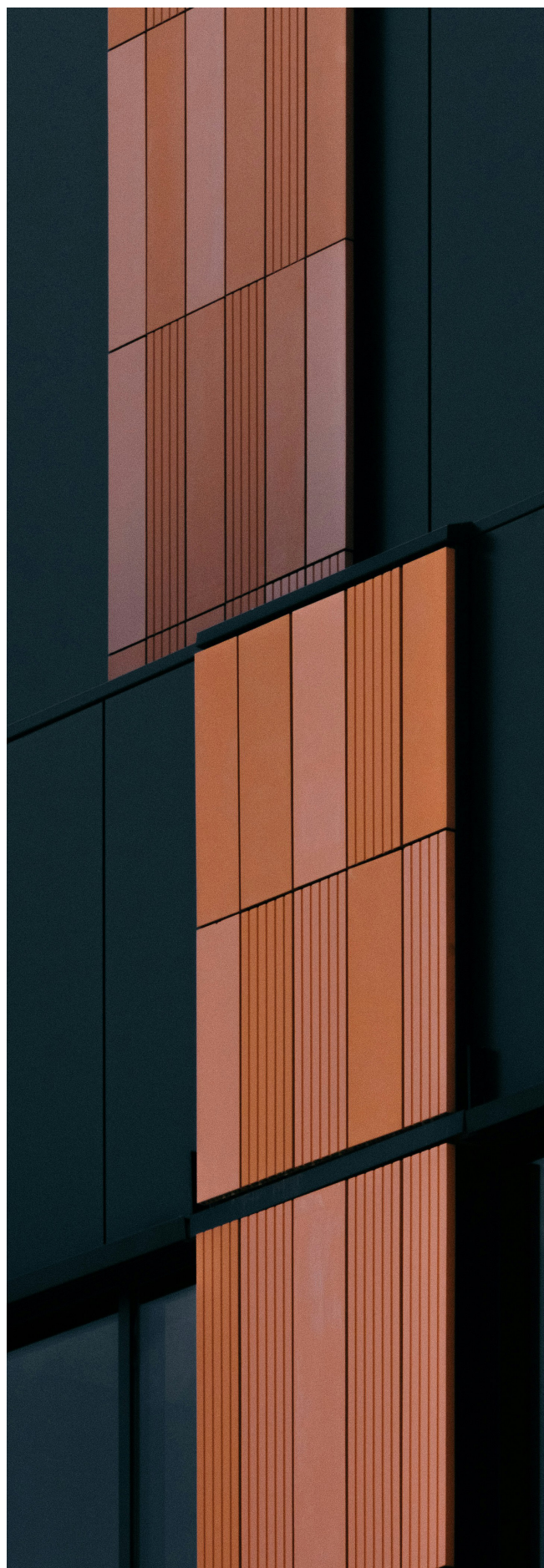
Notifications to the competent authorities are typically made after signing of agreements, but prepared well in advance. In all EU member states, the merging parties are not allowed to implement the transaction prior to clearance. Clearance is therefore generally made a condition to closing. In most countries, including in the EU, the notification becomes public.

In simple cases, after formal notification to the competent authority, the clearance process does not take longer than a few weeks at the EU level (25 working days) or in Germany (one month). However, transactions that raise serious antitrust concerns will be assessed in-depth, and the process takes much longer (a few months). Such deals potentially require the merging parties to offer remedial measures in order to win the desired clearance decision.

FOREIGN INVESTMENT RULES

The Federal Ministry for Economic Affairs and Climate Action (*Bundesministerium für Wirtschaft und Klimaschutz – BMWK*) may prohibit the acquisition of German companies if, following the transaction, (i) 25 percent or more of the voting rights of the target will directly or indirectly be held by a non-EU purchaser and (ii) it is necessary to do so for reasons of public order or security. In such cases the BMWK may also apply other (less severe) measures than a prohibition of the transaction. This power of the BMWK applies regardless of the sector of the target company and therefore also applies to financial sector companies. There might even be an obligation to file for approval when acquiring only 10% or more of the target if the target offers financial services that are considered critical infrastructure and such services exceed certain volume-based thresholds.

Up to two months after the authority becomes aware of the transaction (e.g. by a press release), it is allowed to start the review procedure. To avoid the related uncertainty, purchasers should, and often do, file a notification and apply for a certificate of non-objection (*Unbedenklichkeitsbescheinigung*) from the BMWK. The BMWK will then either grant such a certificate or will notify the purchaser of its decision to investigate the transaction. In many cases where the purchaser applied for such a certificate the BMWK just remains silent, in which case a certificate is deemed to be granted two months after receipt of the application.



TRANSACTION PARTICULARITIES

TRANSACTION STRUCTURING

The acquisition of a financial institution can be effected as a share deal or as an asset deal. In some cases, it can be advisable to first separate the business that will be sold into a separate entity, which is subsequently sold to the purchaser (spin-off structure).

SHARE DEAL

The advantage of a share deal is that the license of the target entity remains unaffected, i.e. an entity with an existing license is acquired. The purchaser must, however, undergo the shareholder control procedure(s), as described above. All agreements of the target generally also remain unaffected. However, agreements can contain change-of-control clauses which can lead to their termination or to termination rights. This is particularly relevant for financing agreements and must be thoroughly analyzed in the legal due diligence.

ASSET DEAL

An asset deal allows the purchasers to select the assets (and liabilities) which they want to buy. However, the purchaser must ensure that the purchasing entity possesses the license which is required to conduct the purchased business at the time of the closing. If entire agreements shall be transferred, including outstanding obligations of the seller, the contracting party must approve of the transfer. If loans are transferred, additional approval requirements can result from data protection and bank secrecy requirements. Obtaining such approvals can be difficult and time consuming if a large number of third parties are involved. In such cases, synthetic transfers and sub-participations can offer solutions.

Employees whose employment relates to the transferred business transfer to the purchasing entity by operation of law. Their employment cannot be terminated because of the transfer. Employees can, however, object to the transfer and thus remain with the transferring entity. If a purchaser wants to ensure that certain key employees transfer, it is advisable that the purchaser talks to these employees while purchase agreements are being negotiated.

SPIN-OFF STRUCTURES

In some cases, the parties wish to transfer only a specific part of a business or a business which is spread over a number of different legal entities. In this case, it can be advisable to separate the business that will be sold to a newly established entity (first step) and to subsequently transfer that entity to the purchaser (second step). The first step can be achieved through an asset deal, which, however, may require the approval of contracting parties. The German Reorganization of Companies Act (*Umwandlungsgesetz*) offers the possibility to spin-off all assets and liabilities pertaining to a certain business from one legal entity to another by way of partial universal succession. The advantage is that approvals of contracting parties are generally not required. As a result, a business can easily be transferred to a NewCo which is subsequently sold to the purchaser. If a license is required for the transfer- red business, the NewCo can be structured as a limited partnership which is ultimately merged into the purchaser so that an existing license of the purchaser can be used (so called collapse merger). On the flip side, transactions under the Reorganization of Companies Act result in joint liability of the NewCo for liabilities of the transferring entity; therefore,

purchasers will regularly request a guarantee from the seller to protect them from such risk. Ultimately, the risk associated with this for the purchaser depends on the financial strength of the seller.

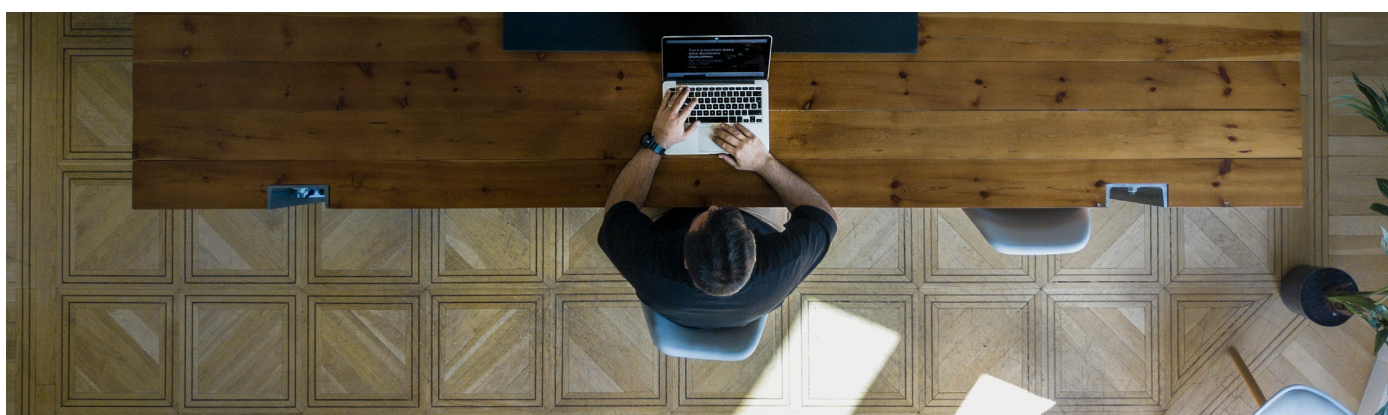
Which structuring alternative is best suited in a specific situation depends on a variety of factors, such as the nature of the business involved, license requirements, number of agreements pertaining to the business, number of employees and necessity of a post acquisition restructuring, tax aspects, financing aspects, time constraints, etc. It is important to analyze advantages and disadvantages of the different alternatives at an early stage. This allows efficient allocation of resources and a smooth transaction implementation.

TRANSACTION AGREEMENTS

Required transaction agreements depend on the specific transaction structure. In addition to a share purchase agreement, a shareholders agreement can be required if several purchasers act together, or if one of the sellers retains a minority stake. In the case of an asset deal, servicing agreements with the seller may be required at least for an interim period. If a spin-off structure is used, a framework agreement can be put in place which describes the entire transaction structure and the different steps to be undertaken by the parties.

Typical issues in agreements are:

- The scope of warranties depends very much on the individual situation in which the negotiation takes place and of course on the target. The purchaser will typically request warranties regarding (i) the validity of all required regulatory licenses, (ii) completeness of disclosed information in correspondence with regulatory authorities, and (iii) regulatory capital.
- Closing of agreements is typically subject to (i) successful statutory shareholder control procedure, (ii) agreement on continued membership in the DPF and (iii) merger control clearance. Obtaining clearances under (i) and (ii) can be time consuming, which results in a relatively long time between signing and closing. The purchaser will seek protection against a downturn in the business. This can be achieved by a "material adverse change" clause entitling the purchaser to walk away in certain defined situations. However, this is often difficult to negotiate. A purchaser may also wish to be involved in major decisions regarding the target in the interim period. This is legally limited by merger control rules which generally do not allow a factual transfer of control before clearance.
- In the case of an asset deal, closing can be made subject to approval of contracting parties to transferred agreements. Alternatively, a mechanism is agreed which puts the purchaser economically in a position as if all required approvals had been obtained.



DUE DILIGENCE

Particularities of the legal due diligence devoted to the financial regulatory regime include an assessment of licenses, of correspondence with supervisory authorities and of auditors' reports. For a bank, a credit portfolio may have to be reviewed. This is done hand-in-hand with the financial due diligence undertaken by the auditors.

Due to German bank secrecy and data protection requirements, target companies normally prepare a green and a red data room. Only the red data room will contain data allowing for the individualization of customers and will therefore only be accessible by persons that are by law subject to confidentiality obligations, such as lawyers and auditors. Persons with access to the red data room are typically not allowed to share customer data with their respective clients. Reporting from the red data room must undergo scrutiny by the target. This makes the process more time consuming than other due diligence processes.

OTHER CONSIDERATIONS

Further particularities due to financial sector rules must be taken into account when structuring the acquisition of a regulated entity, including:

- Regulatory rules generally provide for consolidated supervision. Therefore, it must be considered what effect the acquisition of a regulated entity has on other parts of the group of the acquirer.
- If the acquisition is financed by a third party, a structure must be found which allows the grant of sufficient security to the financing third party while at the same time observing regulatory restrictions.
- If the purchaser wants to nominate members of the management or supervisory board of the target company, the individuals must undergo "fit and proper" tests of BaFin.



TAX ASPECTS

VAT

As with any other company, a bank is subject to VAT in regard of its financial services except for its lending business which is VAT-exempt. Other activities, such as asset management or financial advisory services, are subject to VAT. As a consequence of the VAT-exempt part of the business, the bank is unable to deduct VAT which is charged to the bank by third service providers and other suppliers to the extent the services and supplies relate to the non VAT-exempt business of the bank. In many cases the bank has agreed with their tax auditor on a certain percentage of the input-VAT to be allocated to the VAT-exempt business of the bank. In a tax due diligence situation, it has to be carefully reviewed whether such VAT arrangements with the auditor are still up to date or can create an issue for the upcoming next tax audit because the circumstances upon which the percentages have been agreed upon have changed.

TRADE TAX

Similarly, banks are subject to trade tax like other companies that carry out commercial activities. Under trade tax, law only 75 percent of the interest on any kind of debt raised for the refinancing of the business of a company is tax deductible. There is an exemption made for banks under which the bank can fully deduct the remuneration for debt which it has raised to refinance its banking business. This trade tax privilege for banks has been introduced in light of the fact that already on the bank customer

level the interest deductibility for interest on the bank loan is limited to 75 percent. If there was a limitation of interest deductibility to 75 percent also on the level of the bank, that would result in an over-taxation of the banking industry and would result in a significant increase of tax costs of the financing of a company by way of a bank loan. On the other hand, to the extent the bank refinances its fixed assets, it will be treated like a regular company and would in this regard be limited to a tax deductibility of its costs for refinancing to 75 percent. In an M&A situation, the buyer ought to diligently review whether the bank has in accordance with these rules correctly allocated its refinancing costs between the banking business (interest fully deductible) and the refinancing of its fixed assets (75 percent deductible).

FOREIGN BRANCHES

As compared to companies from other industry sectors, banks more often use, for regulatory reasons, branches than subsidiaries to organize their foreign activities. There is a set of transfer pricing rules stipulating the income and asset allocation between the bank's head office and foreign branches. One of the objectives of these rules is to determine whether a foreign branch of a bank is sufficiently or even over-capitalized in relation to its banking activities carried out in Germany through the head office. In respect of banks, this equity portion is called dotation capital. If dotation capital is shifted between the head office and its foreign branches this could result in an increase or decrease of the debt portion attributable to the head office, which can significantly affect the German taxable income.



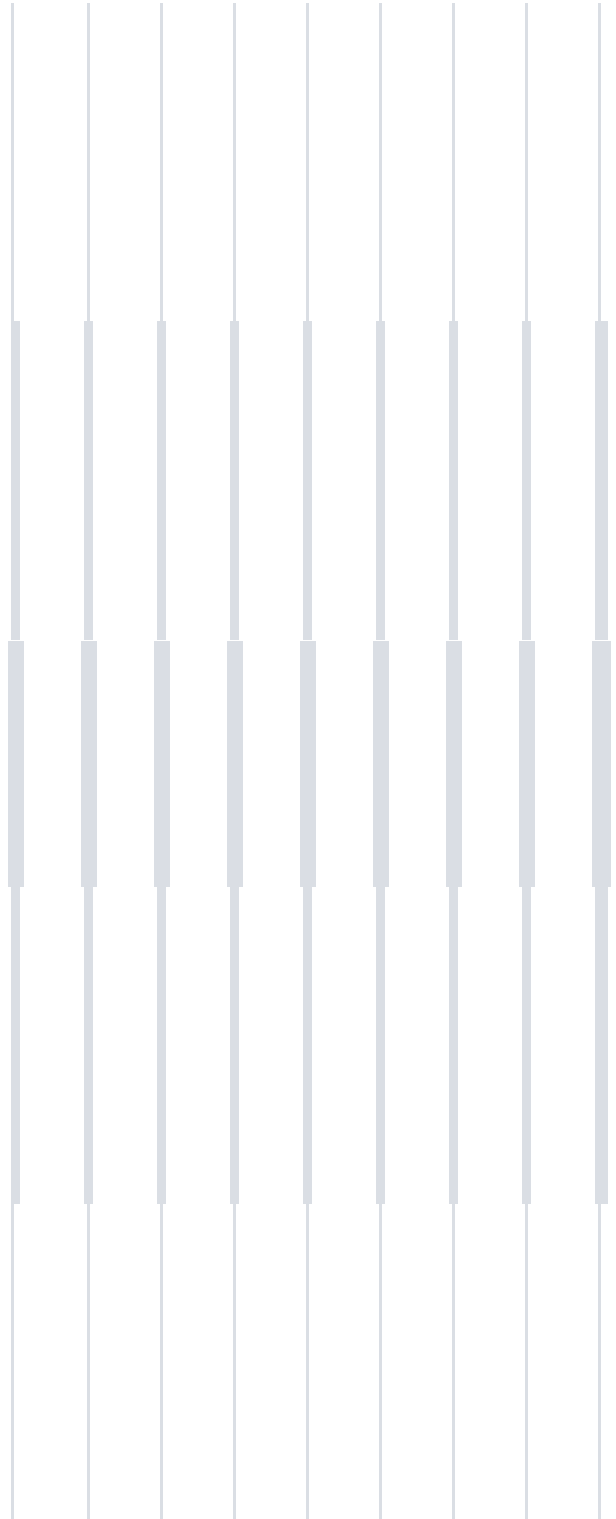
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