NABARRO
CLARITY MATTERS

TransAtlantic

Welcome to the November edition of *TransAtlantic*, where we look at a number of issues impacting on US companies doing business in the UK and Europe.

Following on from Andrew Inkester's appointment as Nabarro's new Managing Partner in the summer, I have taken over the reigns of the North American Group. My clients include a number of North American investors and property owners.

One of our Alliance partners at GSK Stockmann + Kollegen, Andreas Dimmling provides a special report on the current economic climate in Germany.

Andrew McLean gives an overview of the Independent Commission on Banking's final report; Sharon Piert outlines the risks of investing in groups with UK defined benefit pension plans; Alasdair Steele comments on a panel discussion the firm held in September on the future of London as a global financial centre and Peter Williamson explains the intricacies of US companies floating on AIM.

This bulletin also gives you an update on my colleagues' forthcoming trips to the region. If you would like to know more about a topic covered in this bulletin or any other aspect of our work please feel free to contact me.

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Special report: Germany's economy at a glance

Germany is better off than it has been for decades: more economic growth, less unemployment and less structural state deficit. After the 2008/2009 recession, Germany recovered better than any other G7 economy. Nevertheless, there is still some scepticism, fuelled by the European financial crisis and the bruised US economy.

Back to its best

Coming from a spectacular GDP decrease in 2009 (GDP minus 4.7% – a historical figure in Germany), 2010 was a boom year with an overall GDP growth of 3.6 per cent. Whilst some recovery was expected, experts were surprised at the extent of the economy's resurgence. Forecasts predict further GDP growth of up to two per cent in 2012. Given that Germany is generally seen as a sluggish economy with minor assistance from private consumers, such statistics are almost sensational – in particular, when compared to countries like France, UK or Italy where recovery takes place at a much more reluctant level. Germany is at the forefront of economic growth in Europe once again. As a result, unemployment is less threatening in particular to young professionals. After the German reunification, unemployment was the dominating social and economic challenge in Germany with a peak of 12 per cent in 2005. In comparison, fewer than three million Germans (approximately seven per cent) will be unemployed at the end of 2011.

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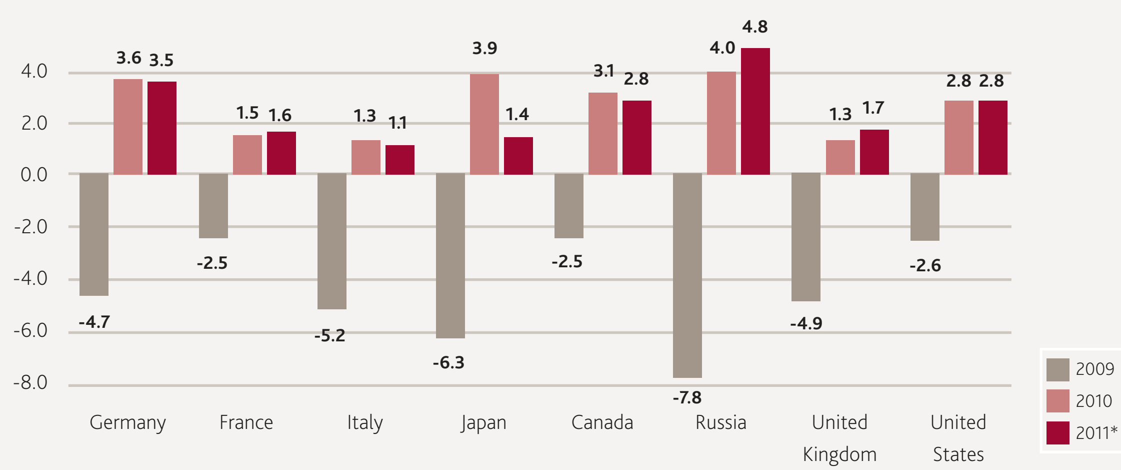
Germany (2010)	
World Economy Rank	4
GDP	$ 2,497.6 bn
GDP growth	3.6 %
Unemployment	3,244,000 (8.6%)
Inflation	1.1 %
Export	€ 959.5 bn
Import	€ 806.2 bn

Source: German Federal Statistical Office

Economic growth in the G8 industrial nations
% change of the gross domestic product



Data sources: IMF, IW (Aug. 2011) *expected

Fears of another crisis

Whilst Germany's economy is still looking rosy, dark clouds are looming. Those clouds do not originate in Germany however, but from the European and US horizon. The US economy seems to have converted from triple A to a double dip scenario resulting in reduced export opportunities for German "Mittelstand" hidden champions and German global corporations like Siemens. Economic growth in emerging markets is also slowing down. At the same time, German analysts have observed that the European finance crisis is affecting states, governments and the banking sector at the same time. Will Germany continue to bail out the Greek and soon Italian, Spanish and French over-indebted governments? And who will pay for this if not the German taxpayer? Will banks cease lending again? Will my savings be safe? Should I stop investing money in business and park my money in commodities? Fears like these (sometimes not based on hard facts but rather on rumours and panic) escalate in a traditionally sceptical German society. In particular, German consumers and German companies are refraining from starting major investments due to the growing uncertainty regarding unstable governments in Greece and Italy.

Could Germany be the saviour of Europe?

As an economically strong nation, Germany cuts a lonely figure in Europe. There are fears that the worsening debt crisis in Greece could spread to Italy, Spain and eventually France, causing the Eurozone house of cards to collapse. If this were to happen, there would be insurmountable debts, growing deficits and stalling economies, together with the potential collapse of the single currency in Europe. European leaders recently met at an emergency summit in Brussels to thrash out a plan to prevent other nations from being sucked into this crisis and, as the financial powerhouse of Europe, all eyes are now on Germany to lead a way out.

Where have all the high potentials gone?

At the moment, there is another pressing issue for German manufacturers – a lack of sufficiently educated professionals. Some expect that in 2020 between 2.4m and 6.1m jobs will not be manned by educated staff. In particular, in the boom regions of Munich and Stuttgart in southern Germany, employers find it very difficult to hire new, sufficiently qualified employees. Historically, Germany had been reluctant to hire overseas staff whereas such potential employees are highly sought after today. For small and mid-sized companies, it is difficult to find such specifically skilled employees – particularly in the mechanical engineering industry as well as the metal and electronics, medicine technology and automotive industries. Accordingly, companies and universities are eager to copy the US model where a constant flow of workers from emerging countries such as India, China and Russia are coming to the US. Germany has worked hard to become more attractive to such people.

Other factors

Renewable energy and the US prosecution of German corporations are two business topics we have specifically highlighted because of their major impact on global German corporations:

Renewable energy – the magic word

Firstly, Germany's decision to stop producing nuclear power until 2022 will result in an uncontrolled meltdown for the big four German electricity companies RWE, E.ON, EnBW and Vattenfall Europe. Renewable energy is the magic word of 2011 but some of the electricity dinosaurs are still undecided as to what it means to them. So as not to become extinct, they have worked quickly to expand their portfolio so that many new offshore wind parks, solar panels, biomass power plants and water power plants are in the pipeline. Investments of over US$50 bn per year until 2020 have been forecasted in this sector (NB: US$ 34bn in 2010). German companies are world market leaders for their renewable energy products. German consumers, however, will have to pay their share for the energy turn with a considerable rise in energy costs expected over the next few years.

GSK Stockmann + Kollegen is advising the Compliance Monitor, the ex- Federal Minister of Finance, Theo Waigel appointed by the SEC.

US prosecution of German corporations

German corporations do excellent business in the US (for example, the automotive industry is constantly celebrating all-time selling records). Nonetheless, the US government (the US Department of Justice and the SEC) continue to monitor some German companies, such as Siemens AG. Daimler AG also had to pay US$185m because of corruption reproaches by the US government. Currently, Deutsche Bank (among several other banks) faces a US mortgage suit. Whilst Deutsche Bank calls the suit unfounded, the US government has asked for payment of up to US$14 bn. Improvement in compliance systems, anti-bribery provisions and good business rules thus become even more vital to all German companies when operating in the US.

Good times ahead?

Undoubtedly, Germany is prosperous in 2011. After the Lehman shock, the German economy recovered more rapidly and to a greater extent than expected. However, difficult times are ahead. The debt crisis in Europe and the US, the lack of sufficiently educated professionals and rising energy costs could become barriers to economic development for the rest of 2011 and into 2012. Whilst these challenges have to be observed and accounted for, Germany should also respect an old American motto: "everything is possible".

The Vickers report

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Summary and implications

The Independent Commission on Banking (ICB) lead by Sir John Vickers was set up over a year ago to formulate policy recommendations with the aim of promoting stability in Britain's banking system and boosting competition between lenders. On 12 September 2011 the much awaited final report was published with the following main recommendations:

- British banks must separate their retail and investment banking operations so that a ring-fence is placed around all deposits from individuals and SMEs and any overdrafts provided to them.
- The ring-fenced business must maintain equity capital equivalent to 10 per cent of its risk weighted assets (RWAs). In addition, as a whole banks must also maintain loss absorbing capital of at least 17–20 per cent of RWAs (e.g. bail-in-bonds, contingent convertible bonds).
- Banks must be more transparent and provide greater detail on charging structures and products to customers and price comparable websites.
- A new industry-wide switching service to enable customers to move providers within seven days.

It is difficult to summarise general sentiment for the recommendations which range from those that say the report has not gone far enough to avert another financial crisis to a belief among others that the measures will destroy British banks' competitiveness and inhibit short-term growth.

Much lobbying lies ahead as the Chancellor decides exactly how to implement the proposals. In what is seen as a concession to banks the implementation has been delayed until 2019 although it is likely the main proposals will be legislated for during this Parliament. It is hoped that the extended period for implementation will help mitigate the impact of the costs of reform, although there is the risk that banks will in fact be under pressure to start restructuring sooner – placing pressure on their ability to lend.

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It remains to be seen if this blueprint and the reforms that are proposed will prevent the British taxpayer from having to bail out failing banks in the future, and if the costs (including the potential loss of economic output) outweigh the benefit of a more stable banking system.

Ring-fencing

While banks must ring-fence their retail from their investment banking operations, they have been given a degree of flexibility as to where this line is drawn. Banks will be able to choose which side of the fence to place big corporate deposits and trade finance. This is seen as an important concession by some as it allows banks to adapt the rules to suit their own models.

The ring-fenced entity must have its own board of directors and be governed independently from the rest of the bank.

Capital requirements

The regulatory capital requirements proposed under Basel III are more lenient at seven per cent of RWAs against the 10 per cent being proposed by the ICB. There is a concern that going further than the agreed international standards, would put British banks on the back foot and damage their ability to compete globally. The proposals could increase the costs of borrowing for UK businesses and thereby also make them less competitive than their foreign counterparts who have access to their local banks which are not similarly burdened in terms of capital adequacy.

It is thought that the further layer of loss-absorbing capital should not cause too many problems, as banks typically already hold the equivalent of between 15 and 25 per cent of RWAs in loss-absorbing debt.

Disadvantages of ring-fencing

According to the report, costs to the banking industry are estimated at between £4bn and 7bn per year, much of which comes from higher funding costs largely in the non-ring-fenced business. Therefore it is anticipated that corporates, largely medium-sized companies reliant on debt, will be hit the hardest. Ernst & Young Item Club (a group of economic forecasters) have estimated the cost of lending will rise by up to 150 basis points for large UK companies as a direct consequence of ring-fencing.

There are concerns that these measures will create an uneven playing field and place the UK at a competitive disadvantage since they will only affect UK banks. Share prices of Barclays, RBS, Lloyds and HSBC fell between one and three per cent on the day of the ICB report, although these falls were much smaller than those experienced by many of their European counterparts troubled by the ongoing Eurozone crisis. However, since the report's publication date senior bankers and representatives of the big UK banks have made positive comments and in fact welcomed the main aspects of the report.

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There are also fears that the proposals will not only affect the competitiveness of UK banks but will be detrimental to ordinary savers, borrowers and companies as well. While banks and their shareholders will have to share the burden of the ring-fencing and adequately capitalising the respective banking operations, it is inevitable that some of the costs will be passed on to customers. In the current economic climate this could be further damaging for the UK economy and businesses.

An abiding worry for the UK economy is that the ICB's recommendation might encourage UK banks to incorporate abroad and others to leave the UK.

The risk to British taxpayers is on a different scale to those in other countries.

Advantages of ring-fencing

In the midst of all these concerns, the main driver behind the proposals should not be forgotten: to promote stability in our banking system and avert another crisis where failing banks are bailed out by taxpayers.

The ICB estimates the financial crises cost taxpayers an average of £40bn a year and when contrasted with the £4bn–£7bn cost of reforms to the industry, many would argue it is well worth it.

There is also an argument that as the value associated with the British banking system is close to 500 per cent of the country's GDP (significantly higher than most countries), international reform and regulation is not and does not go far enough. The risk to British taxpayers is on a different scale to those in other countries (although that argument is losing ground as at mid-October of this year as Dexia's bail-out challenged French, Belgian and Luxemburg governments) and therefore deeper reforms are necessary to ensure stability.

The hope is that the protection of the ring-fence will keep wholesale funding costs on the retail side down so that lending to households and small companies should not be hampered.

It will be interesting to see if the UK's move to create a more stable environment in which the banks it regulates operate will trigger similar measures around the world.

The risks of investing in groups with UK defined benefit pension plans

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Summary and implications

The Pensions Regulator (the Regulator) has launched an investigation into the acquisition by the Carlyle Group, one of the world's largest private equity firms, of the UK carpet manufacturer, Brintons, in September 2011, following a "pre-pack" administration. The Regulator may seek to exercise its anti-avoidance powers in relation to Carlyle and require it to make a payment, likely to be substantial, to Brintons' underfunded defined benefits pension plan.

Detail

The Regulator's anti-avoidance powers give it the ability to issue a financial support direction or a contribution notice in certain circumstances but only to persons who are "connected" or "associated" with the plan employer.

In this case, Carlyle was the senior debt holder, and the pension plan, the largest unsecured creditor. Following the pre-pack, the pension plan has entered an assessment period and may, in time, enter the Pension Protection Fund, which is the "lifeboat" for UK pension plans with an insolvent employer.

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However, it is difficult to see how the Regulator could exercise its anti-avoidance powers in relation to Carlyle (or any other senior debt lender/investor) unless the Regulator can demonstrate that Carlyle was connected or associated with the plan's sponsoring employer. The test is usually satisfied if there is some form of share ownership or one party controls the other as a result of common directors or shadow directors.

It is possible for a company to be a shadow director but there would need to be evidence that the company's directors were accustomed to acting on the instructions of the shadow director. This is a question of fact. One possible option in these circumstances would be for the Regulator to argue that the lender took control of the debt in order to exercise control over the insolvency of the target company and that overall the process is sufficient to meet the connected or associated test.

However, we think such an argument would be a significant extension of the Regulator's powers and likely to be strongly challenged by Carlyle.

It is not known when the Regulator will conclude its investigations and we will report on the outcome once it has been announced.

Financial sector: Cautious optimism amidst the gloom

Summary and implications

In September, Nabarro hosted a panel discussion looking at London's future as a global financial centre. The panel was chaired by Anthony Hilton, City Editor of the London Evening Standard and was made up of:

- Oliver Hemsley, CEO of Numis Corporation, a leading brokerage house;
- Duncan Smith, Adviser to the Chairman of Kuwait-based The Investment Dar; and
- Ruth Lea, the respected economist.

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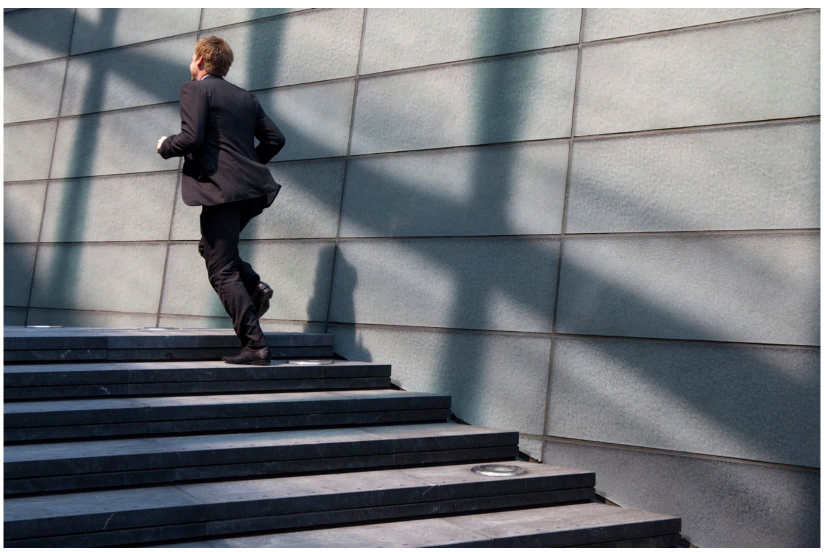

Background

The background to the discussion saw more and more people starting to compare the remainder of 2011 with the latter months of 2008, leaving little cause for optimism. The Euro saga still runs on, putting Italy and the major French banks firmly in the firing line, and there is continuing inaction and lack of leadership from the ECB and major Eurozone governments. Our own government in the UK is sending out conflicting messages: a "Britain is Great" campaign has been launched while at the same time the Business Secretary launched another attack on executive pay, the very high-achievers we will need to grow the UK economy.

In addition, just a few days before the event, the Independent Commission on Banking released its much trailed report without any significant surprises.

The discussion

Despite the doom and gloom, the atmosphere was generally optimistic about London's future. Yes, there are a lot of challenges from other financial centres but the overall view seemed to be that London's innovative attitude will allow us to respond to the challenges and develop new products and solutions to keep London at the forefront of the international financial services sector.

Core to London's position is differentiating itself from the competition: what is it that makes global financial firms and global businesses seeking finance come to London?

Core to London's position is differentiating itself from the competition: what is it that makes global financial firms and global businesses seeking finance come to London? How do we remain attractive? London's geographical position between Asia and the US and between the US and Europe is an undoubted attraction, coupled with a robust legal and regulatory system which is generally well regarded and respected.

The threats and risks to London's position were generally regarded as the frequently repeated ones of over-zealous regulation and high personal tax rates. EU regulation was also seen as posing a danger, particularly if the UK government is not prepared to fight its corner (coincidentally, the UK government had just launched a legal action against EU legislative proposals which would have prevented UK clearers from clearing certain trades within Europe). From the overseas perspective, Duncan Smith raised the concern over the lack of additional capacity in London's airports, potentially restricting its reputation as a hub-centre.

London's ability to innovate and develop new products and solutions within whatever regulatory framework prevails was seen as key to London's future. With a lack of bank finance generally accepted as being a concern for business at least for the short to medium term, filling the gap with non-bank finance was seen as a major opportunity. In the US, the proportion of funding provided to business from non-banks is several times larger than the UK where banks are the default lenders to business. A number of regulatory changes are making direct lending by insurance companies and the like to businesses much more attractive, and this is one area where we can expect to see major developments over the next 12 to 24 months.

So, as we headed off into the darkness of winter, buffeted by economic headwinds and curve-balls from our political masters and the Eurozone, there was cause for cautious optimism that London will ultimately prevail. Just don't tell the competition!

Round-up

NABARRO IN NORTH AMERICA

- **Kevin Stimpson**, **Ciaran Carvalho** and **James Trundle**, all real estate partners at Nabarro will be visiting clients in Boston and New York between 10 and 13 January 2012.
- **Glen Flannery**, a restructuring and insolvency partner at Nabarro will be speaking at the International Bankruptcy Course at Columbia Law School in New York in February 2012.
- **Andrew Wylie**, an investment funds partner at Nabarro will visit New York in February 2012.
- **Neal Gibson** and **Karen Denny**, both dispute resolution partners at Nabarro will be visiting clients in New York and Washington DC between 27 and 29 February 2012. Neal Gibson will also be attending the ABA White Collar Crime Seminar in Miami between 29 February and 3 March 2012.

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