



A study of the lending market – September 2010

How is the upturn being financed?



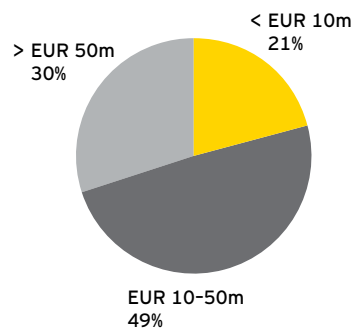
About this study

Ernst & Young conducted its second survey of 120 banks and 570 companies in Germany in August 2010. The first survey was carried out in September 2009. This telephone survey was conducted by an independent polling firm (Valid Research, Bielefeld) on behalf of Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft.

The companies surveyed represent a cross-section of the German economy.

The sample of participants from the banking sector was assembled based on their shares of total loans in Germany.

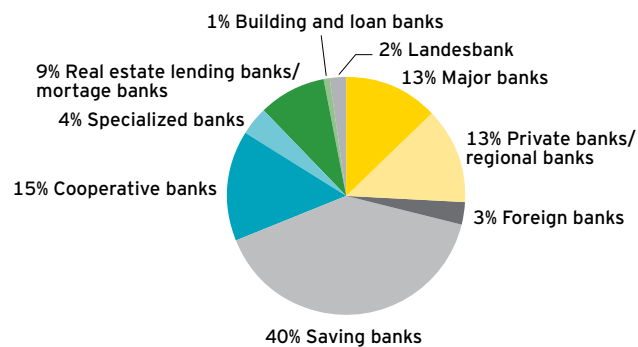
Revenue distribution (annual revenue)



Number of companies surveyed

Breakdown by sector	Number
Services	227
Trade	143
Construction	80
Processing industry/heavy industry	70
Automotive	10
Energy	10
Financial institutions (excluding banks) and insurance	10
Renewable energies	10
Telecommunications	10

Types of bank surveyed



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The author



Ana-Cristina Grohnert

Partner, EMEA Financial Services

Ernst & Young GmbH
Wirtschaftsprüfungsgesellschaft
Rothenbaumchaussee 78
20148 Hamburg
Germany
Office: +49 40 36132 11979
Fax: +49 181 3943 11979
ana-cristina.grohnert@de.ey.com



The real economy is gaining steam

The economy is recovering at a faster pace than originally expected. The automotive, mechanical engineering, chemicals, steel and electronics industries - Germany's most important sectors - are reporting sharp increases in orders received and rising production and capacity utilization. The main drivers behind this growth are the strong export situation and a surge in domestic demand for capital goods. In a globalized economy, Germany's supplier countries are also profiting as imports increase at a similar pace.

The EU Commission anticipates economic growth of 3.4% in 2010, three times its

estimate in May 2010. The German Finance Minister has also upped his forecast to more than 3%. The financial journal Handelsblatt has already reported that "Germany is taking off." However, our survey of 570 companies and 120 banks in Germany shows that both groups are still not quite ready to hail the end of the financial market and economic crises.

The real economy is booming and companies are achieving a lot under their own steam. Nevertheless, signals from sectors such as mechanical engineering suggest that significant expansion investments are still required.

The growing need for finance does not stop here either. Very soon, there may be an even greater need to fund materials and working capital requirements. Sectors with relatively high throughput times, such as mechanical engineering and plant construction, are having to pre-finance their mounting order backlogs. It is certain that companies will be unable to shoulder both of these burdens, especially after four years of crisis have weakened some companies' financial standing significantly. How will the long-awaited upturn be financed?



Will the refinancing situation hamper the recovery?



The further progress of the upswing will ultimately hinge on the availability of sufficient loans with reasonable terms. Who will provide these loans? Will their terms and conditions suit companies' capabilities? And what alternatives to traditional bank loans are available to companies?

Without doubt, the challenge will be to finance the recovery. Banks and companies alike will have to dedicate more time and effort to providing and obtaining the necessary funds as banks scale back their lending in response to the ongoing constraints on refinancing. This situation is compounded by the still-sluggish financial

markets. High numbers of credit defaults have reduced the willingness to take on new risks.

It remains to be seen whether the crisis-hit companies will be able to fight back. Explicit requests were made to the banks in June, when the German Engineering Federation VDMA made a joint appeal together with the metalworkers' union IG Metall. Their collective request was that "due to the weakened financial position of companies, in 2010 banks must grant loans based on sustainable future concepts and viable and long-term business strategies." It also said "fair conditions are crucial. This applies

not only to interest and fee payments [...], but also to the provision of collateral." In September, the economic research institute ifo reported that the credit constraint indicator had continued to fall and German companies' access to loans was improving again. In spite of this, the task at hand is to prevent a financing squeeze. As our study shows, this is a very real concern in some sectors.

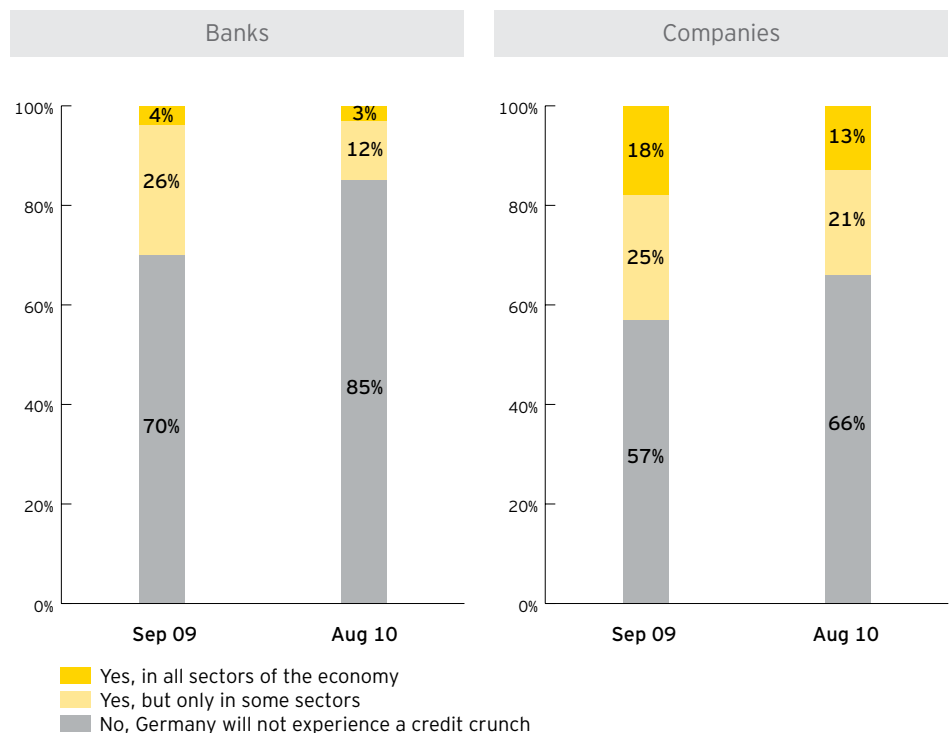
No widespread credit crunch expected

The credit squeeze remains a real threat for large sections of the German economy. Nevertheless, fears of a credit crunch have subsided. Only 15% (2009: 30%) of German banks believe a crunch may occur. A large number of these banks (12% of survey participants) believe such a situation will materialize in only

some sectors. While companies are considerably more skeptical in this regard (34% anticipate a credit crunch and 13% expect it to be widespread), these results also indicate a noticeable improvement compared with the prior year (43% and 18%, respectively).

No widespread credit crunch expected

“Do you think Germany will suffer a credit crunch in the next 12 months?”

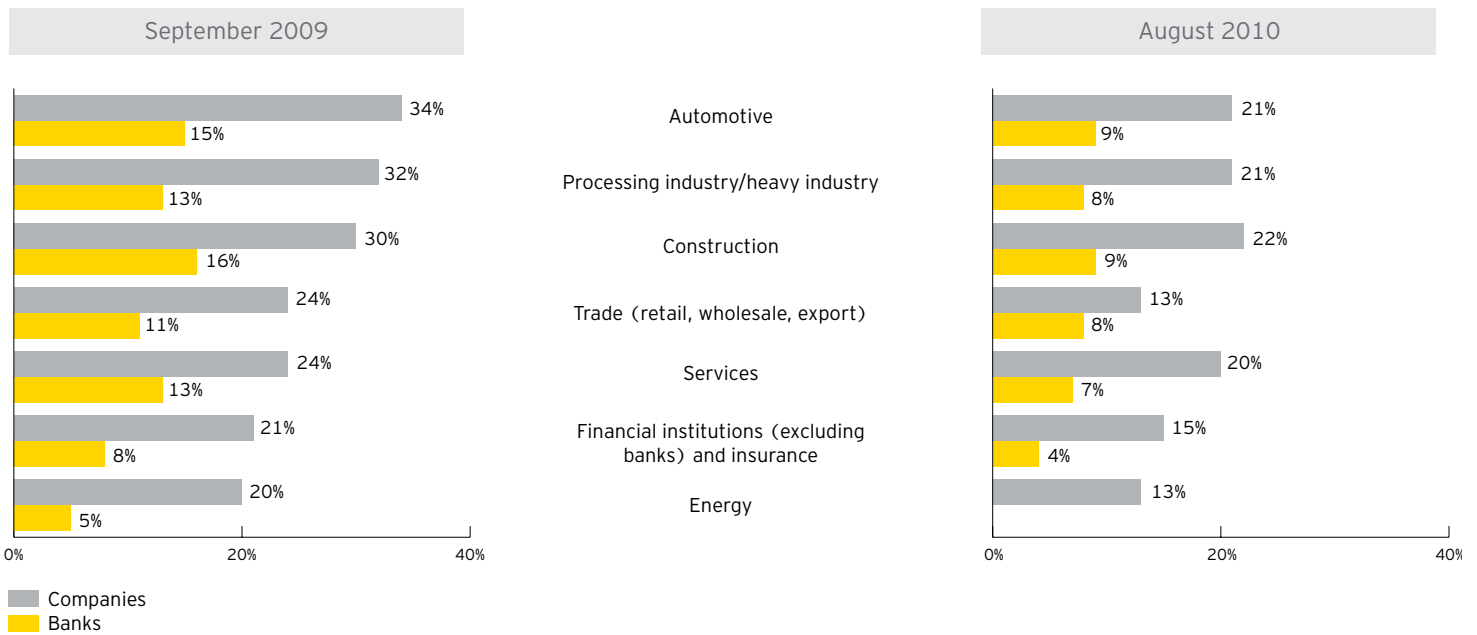


In terms of which industries - if any - could be impacted by a liquidity squeeze, banks in particular are much more confident this year than they were in 2009. As few as one in ten banks expect the construction industries and industrial sector, including the automotive industry, to fall victim to a credit crunch. The same applies

to companies with trade and service operations. Companies are still significantly more skeptical on the whole, although the acute risk of a credit crunch features less prominently in their forecasts. At present, only one in five foresees difficulties for the industrial and construction sectors, compared with almost one in three in 2009.

Participants continue to view the industrial and construction sectors as hit hardest

“In what industry do you expect a credit crunch to occur?”



Slight increase in demand for loans

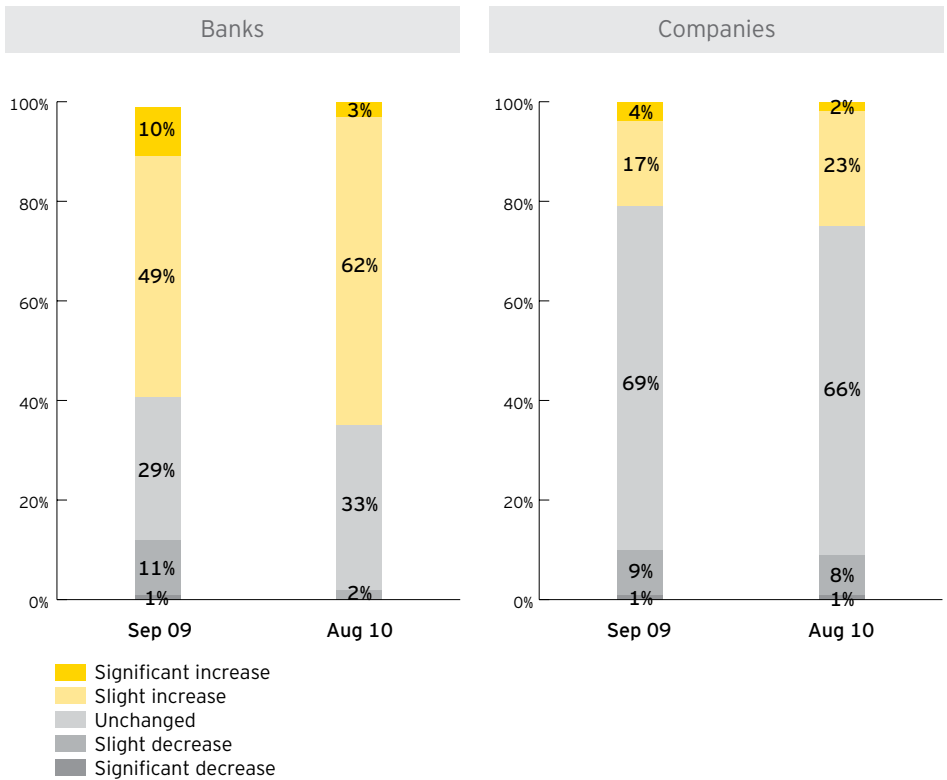
Generally speaking the credit crunch, i.e., shortage of loans to the economy, has become less of a problem. Does this mean that companies should no longer be treating financing issues as a top priority? Companies today are complaining about the current deterioration in lending conditions, but the real challenges are yet to come.

A surge in demand on the credit market is inevitable because key industries are operating at high capacity earlier than they had either hoped for or expected. Banks and companies alike are more aware of growing borrowing requirements than a year before. However, it is not yet apparent whether the opportunities available will be sufficient when demand becomes acute.

The expectations of both groups differ widely. The banks are clearly hoping for considerably more than companies have budgeted for. Two thirds of banks but only one quarter of companies expect only a slight increase in demand for loans in the coming 12 months. Consequently, banks and businesses are appreciably more confident than in the prior year.

Slight increase in demand for loans

“How will demand for loans develop in the coming months?”



Is an increase in new loans expected?

The current level of confidence at banks and companies is well substantiated. Key sectors of industry, such as mechanical engineering, automotive, electronics and - as a proven early indicator of economic development - the chemicals industry, are once again reporting sharp increases in the number of orders received. Against this backdrop, project and working capital (pre-) financing requirements will increase significantly, at which point the lending ability and willingness of the credit industry will be tested.

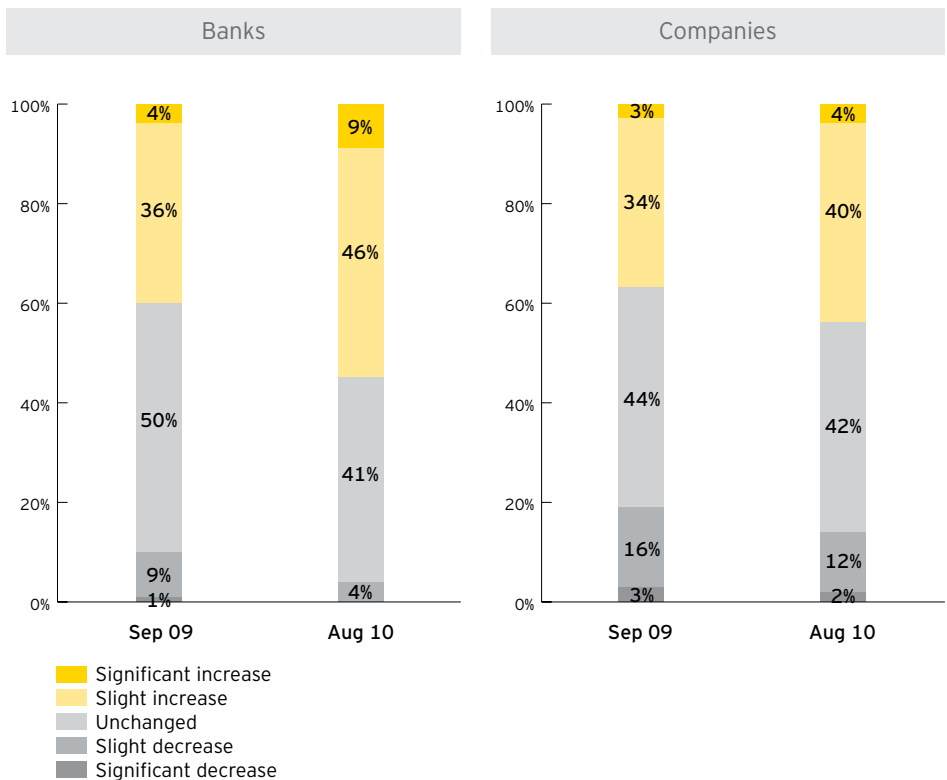
Our survey showed that the tendency of banks to issue new loans has increased overall. While only 40% of banks forecast an increase in new lending business in 2009, this year shows a clear majority of 55%; 9% even believe that expansion will be strong. Even companies who tend to view business with banks with a certain degree of skepticism are now confident that they will be able to obtain new loans. Following 37% in the prior year, 44% of companies now expect to raise additional loans from the banks.

The facts do not yet substantiate whether banks' forecasts are consistent with their intentions. Contrary to our expectations following the prior-year survey, the Bundesbank reported that the total volume of loans to companies and self-employed persons in Germany has declined overall since the second half of 2009.

The lending volume in the second quarter of 2010 was down by 1.9% year on year. According to calculations of the German

More new loans expected

"In your opinion, how will the volume of new loans issued by your bank/the banks develop in the coming months?"

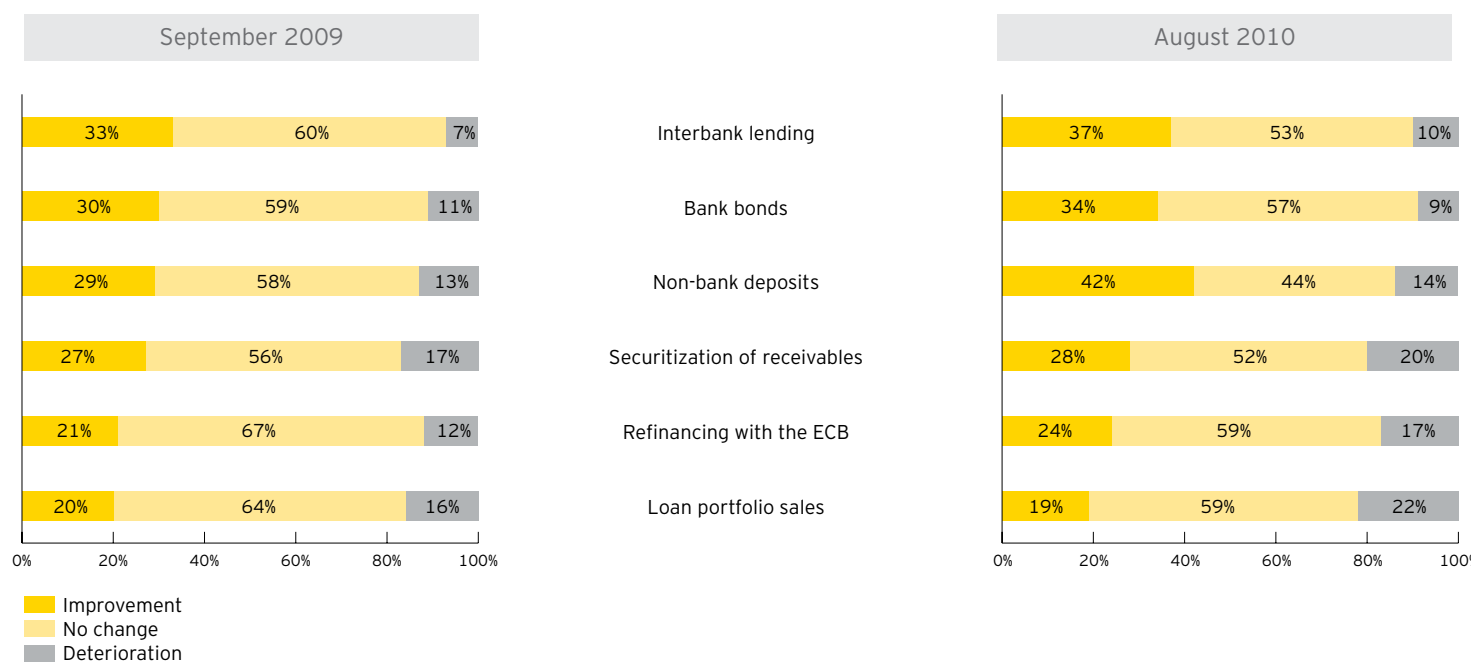


Development Bank KfW, new lending business is also almost 8% lower than it was a year ago. At the beginning of the year, this figure was just under 17%. According to the KfW's estimates, by the end of 2010 new lending business is even expected to overtake the prior-year figures.

Trust is still a key issue

Banks only expect the refinancing situation to improve slightly

“How do you expect refinancing opportunities to change in the next 12 months?”



The reasons for the current reduction in loans granted are plain to see: ongoing high aversion to risk and pervasive problems in connection with bank refinancing. Our survey confirms both. A shift in risk awareness is the key issue this year for 57% of banks and consequently the main reason for the restraint seen with respect to new lending. In 2009, 45% of participants ranked this shift as the second

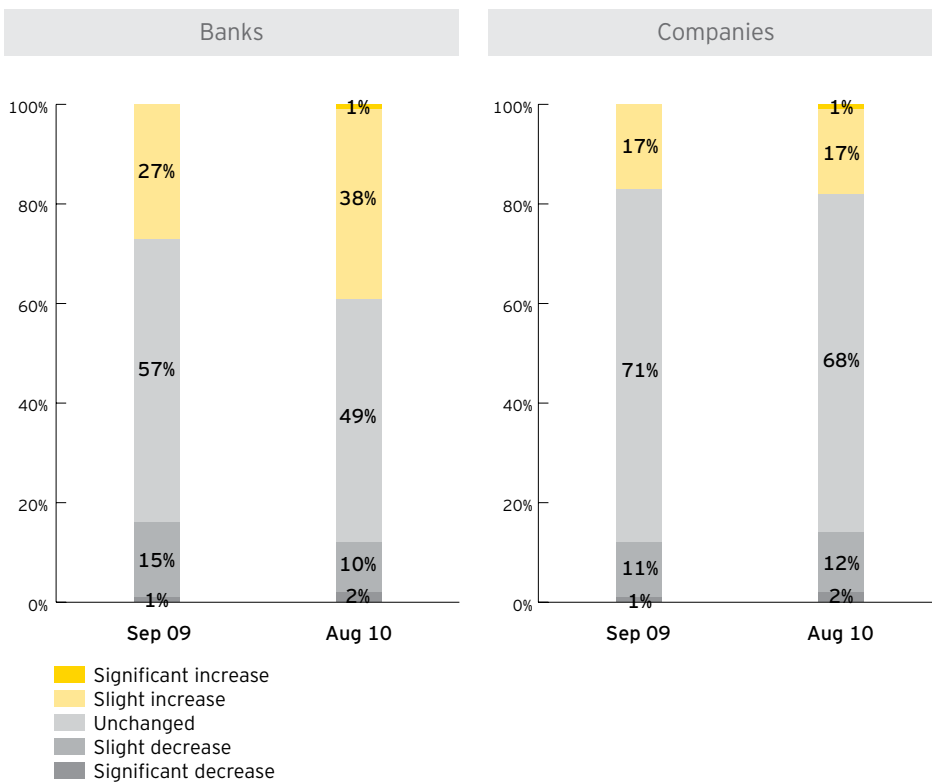
most important issue behind changes in companies' credit ratings.

The impact of refinancing opportunities is also evident. At most, banks are expecting a slight improvement and their hopes lie in particular in non-bank deposits and the issue of bank bonds. As regards interbank trading - once the industry's mainstay but weakened since the financial crisis - the

number of optimists has increased roughly in line with the number of pessimists. Interbank lending remains at a low level, which is affecting banks' borrowing ability and therefore the volume of loans being granted to businesses.

Banks see a slight improvement on the securitization market

“In your opinion, how will the securitization market develop for banks over the next 12 months?”



Bankers see light at the end of the tunnel in the securitization market, which temporarily collapsed in the wake of the financial crisis. Turbulent financial markets put a stop to all kinds of securitizations. Securitization was a good way for banks to refinance their lending activities, allowing small loans to SMEs and private customers to be bundled and sold on the capital market.

39% of those surveyed now expect the securitization situation to improve, compared with 27% in the prior year. No figures are available at present. A new quality standard presented recently by the Federal Association of German banks and the True Sale International (TSI) securitization platform may bolster this trend. It is hoped that the German securitization standard will emphasize the

hallmark qualities of German securitization products, in particular their low default rates, and set them apart from other products on the international market.

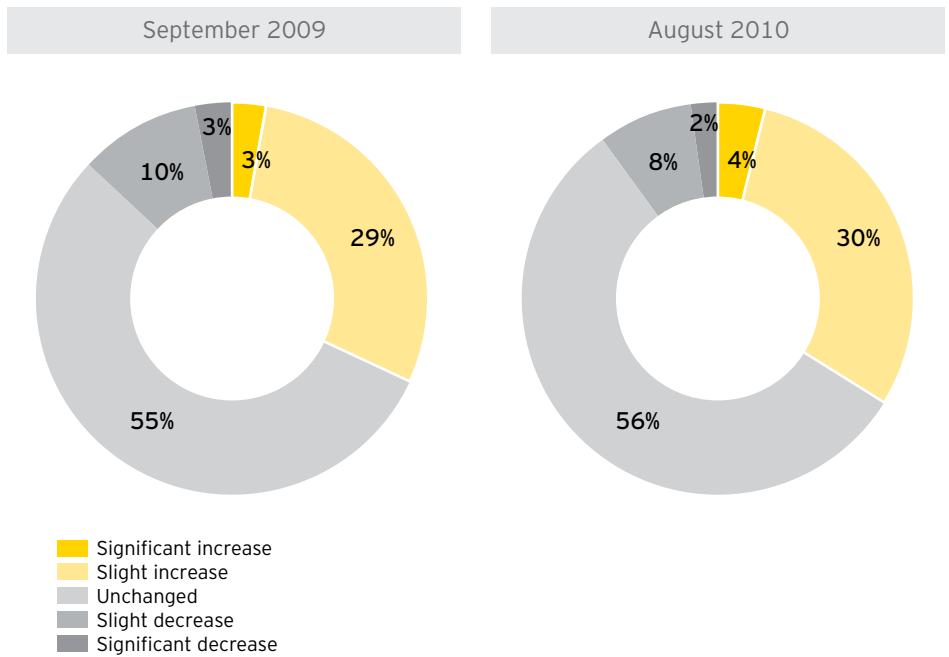
Companies still reluctant to invest

Our study shows that companies are still fairly reluctant to invest. As in the prior year, only one in every three companies intends to make further investments, the majority of which are relatively immaterial. The percentage of companies who wish to investment significantly remains in the low single digits. A lack of appetite for additional investments is justified by the utilization of technical capacities, which was still weak in the spring.

Consequently, the recovery is not yet reflected in investment planning. However, this could change in the near future given that the German economy's gross capital expenditure rose in the second quarter of 2010, up 24% on the first quarter and 7% higher than in the prior year.

Companies remain reluctant to invest

"How will your company's capital expenditure develop in the next 12 months?"

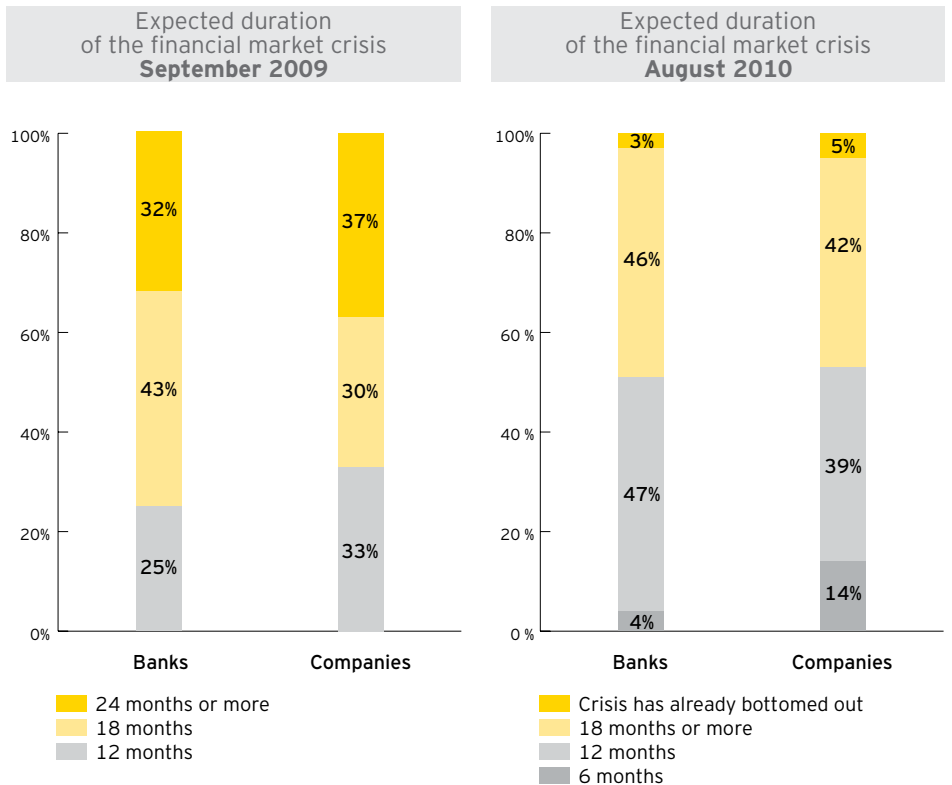


Expected duration of the financial market crisis

Can the caution exercised by both groups suddenly shift into long-term optimism? At the moment, it seems skepticism is prevailing. The fact that 46% of banks and 42% of companies believe the crisis on the financial markets will continue for at least another 18 months underpins this statement. In the prior-year survey almost 12 months ago, only 32% of banks and 37% of companies shared this belief.

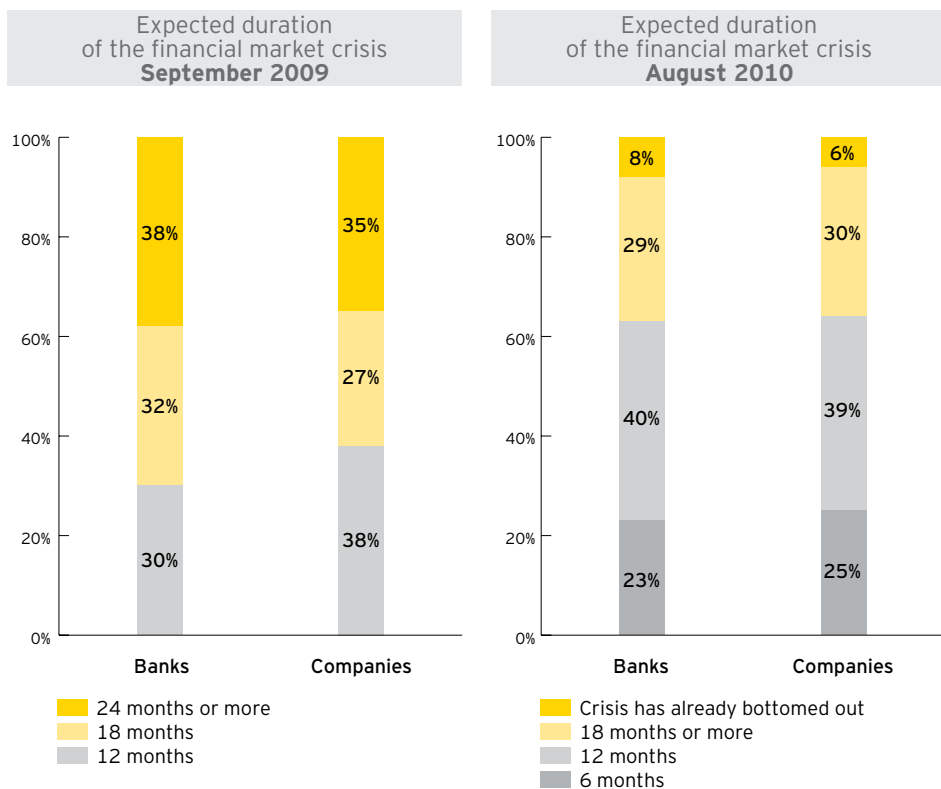
Although a narrow majority expects the financial crisis to continue for just another 12 months, it should be noted that a year has passed since the last study. Last year, around two thirds of both groups surveyed expected the financial market crisis to continue for a further 18 months at most. Currently only 4% of banks and 14% of businesses anticipate the crisis being overcome within 6 months at the latest. With the exception of 3% of banks and 5% of businesses who think the crisis has already bottomed out, all of those surveyed believe it will be a while before we see the end of the crisis.

Participants expect the financial market crisis to continue



Survey participants viewed the course of the economic crisis more positively, albeit only slightly. If these expectations had been rolled forward, 30% of banks and 38% of businesses - both groups having stated last year that the crisis will only last for another 12 months - ought to now view the situation as having stabilized. In reality, however, a mere 8% of banks and 6% of companies believe the economic crisis has been overcome. By contrast, 29% of banks and 30% of companies predict that the economic crisis will continue for at least another 18 months and almost two thirds of both groups anticipate the crisis will continue for a further 12 months.

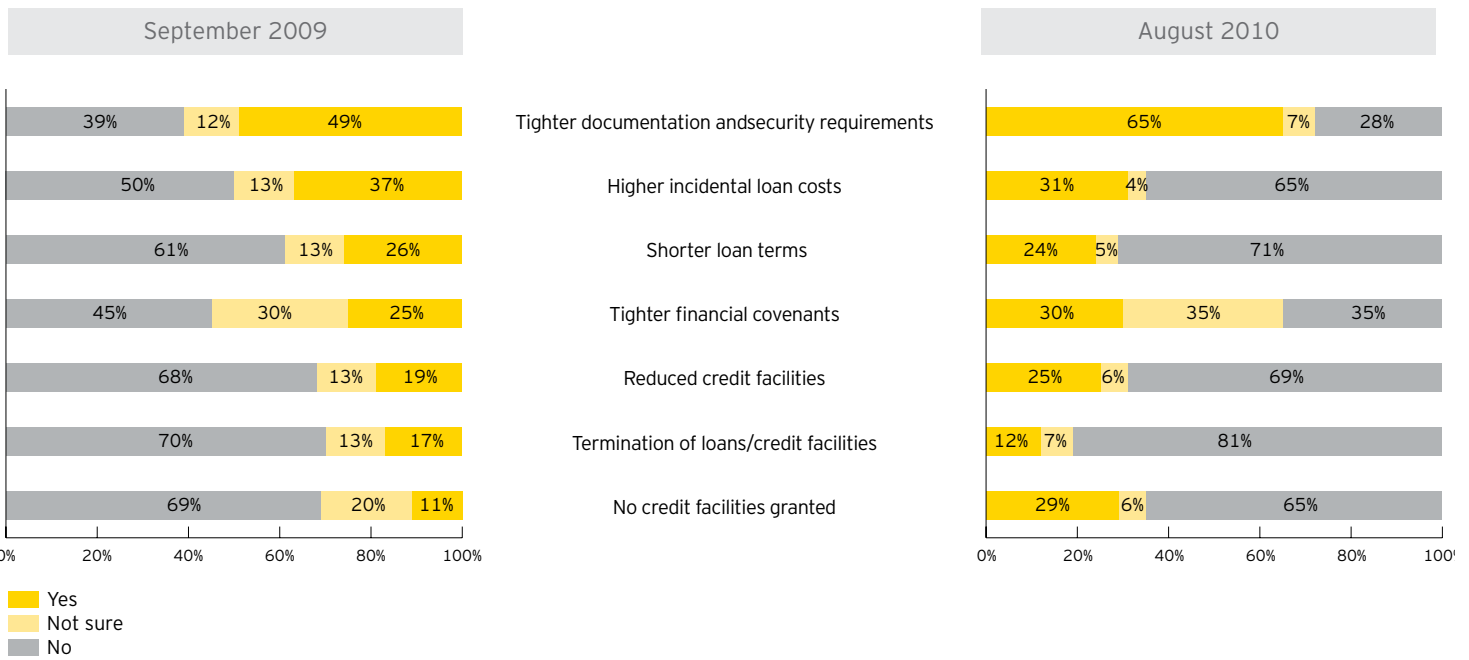
Majority predicts the economic crisis to end within 12 months



How are lending conditions changing?

Lending conditions may become more stringent

“What will your bank change about new loan issues in the next 12 months?”



There are several signs that the recovery is well established, a view clearly shared by most banks and the Bundesbank, which expects GDP growth of 3% in 2010, while the German Chamber of Industry and Commerce even anticipates an increase of 3.4%. The recovery is expected to continue throughout 2011.

Two in three banks intend to increase documentation and security requirements. Last year, this intention was only shared by almost every second bank. 30% of banks (2009: 25%) intend to tighten financial covenants and 25% (2009: 19%) intend to shorten existing credit facilities.

Finally, 29% are refusing to grant new loans - more than two and a half times as many as in the prior year (11%).

Fewer problems with renewals

In terms of loan renewals, the number of banks stating that they are willing to make it easier to extend existing facilities doubled from 7% to 14%. The group in favor of further regulation has fallen at a similar rate to one third (2009: 38%).

Skepticism shown by companies regarding banks' plans has also lessened. The share of participants expecting major difficulties with loan renewals has dropped from two thirds to 54%.

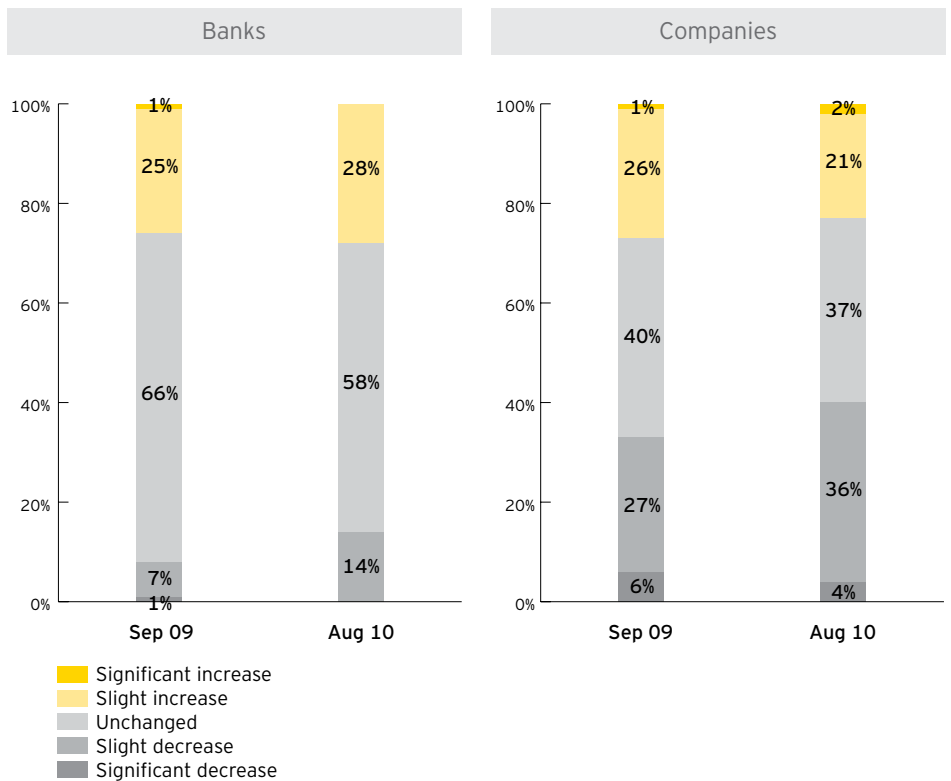
How are lending conditions developing?

Simple extensions of existing agreements will be the exception. Usually all terms of an agreement are renegotiated when a loan is up for renewal. For this reason, all counterparties in the credit market share the same expectation that the terms and conditions for loans will continue to worsen slightly in the coming 12 months.

Again, the discrepancy between the opinions of companies and banks is striking: only 14% of banks expect conditions to worsen, whereas 40% of companies believe this will happen. 4% even anticipate a significant deterioration. The trend observed as regards both groups is visible: in the prior year, only 8% of banks and 33% of companies forecast a deterioration in terms and conditions.

Loan conditions expected to worsen slightly

"How do you expect loan conditions to change in the next 12 months?"

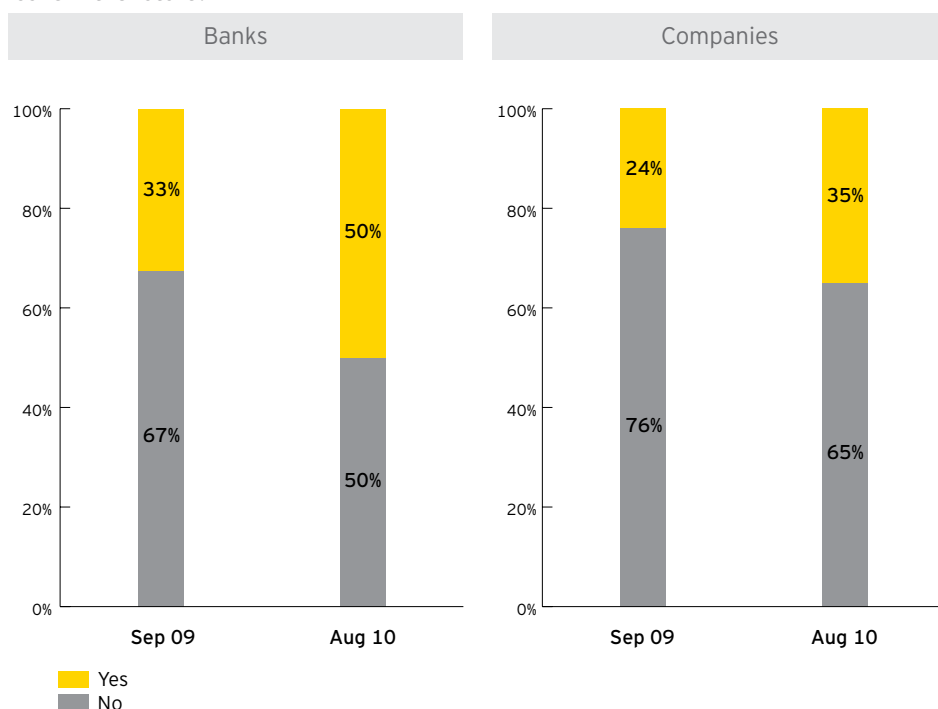


Significance of innovative refinancing products in the future

In 2009, just under a quarter of companies viewed bonds and promissory notes as appropriate substitutes for traditional bank loans. This year, a good third of businesses share this opinion. These kinds of structured credit products are also becoming increasingly important for banks. Following one third in the prior year, half of banks now view bonds and promissory notes as credit substitutes.

Bonds and promissory notes becoming more important

“Do you think that corporate bonds and promissory notes are suitable alternatives to bank loans in the future?”



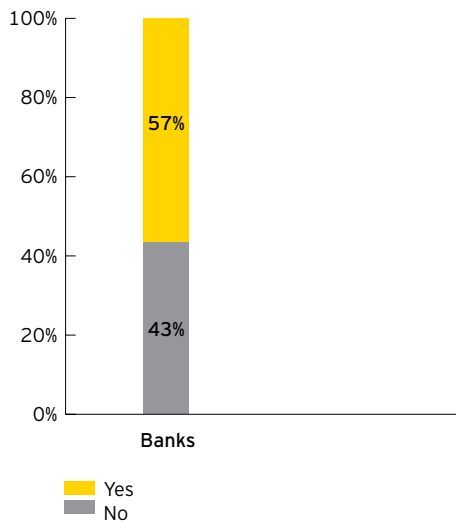
Conflicting opinions on the role of the government

Last but not least, we asked how the government's various influences and interventions impact the way in which the credit markets function. For example, 57% of banks fear that the planned German bank levy will have a negative impact on lending, while the remaining 43% do not share this view.

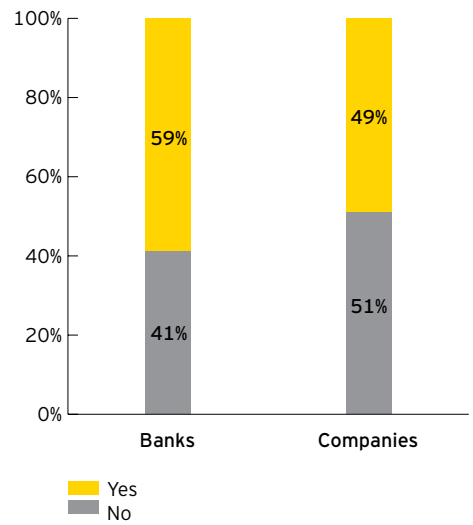
There is only a narrow majority opinion on the impact of the increase in VAT to 25%, with 59% of banks expecting demand for loans to drop as a result. Around half of companies believe that the tax increase will have an effect on their credit requirements, while the other half thinks the opposite.

The opinion is at least clearer among banks regarding the introduction of the financial market transaction tax. Almost three quarters expect the tax to have no impact on loan issues. Companies' opinions on this issue are more or less evenly divided. 47% fear that there will be negative effects, while 53% are not concerned. Only the effects stemming from the debt crisis facing a number of EU countries are more controversial. Two thirds of banks do not believe this will impact loan issues and conditions, while three quarters of companies fear the opposite.

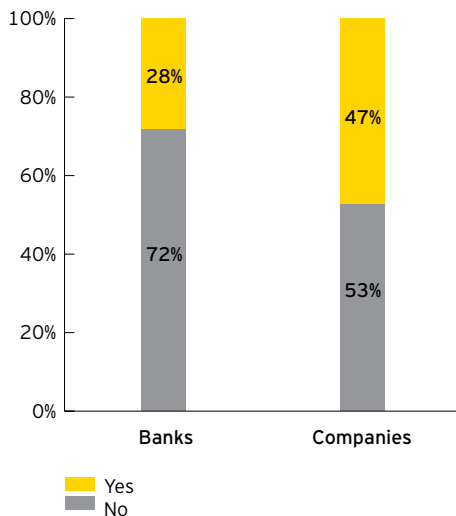
"Do you think the planned German bank levy will affect loan issues in the future?"



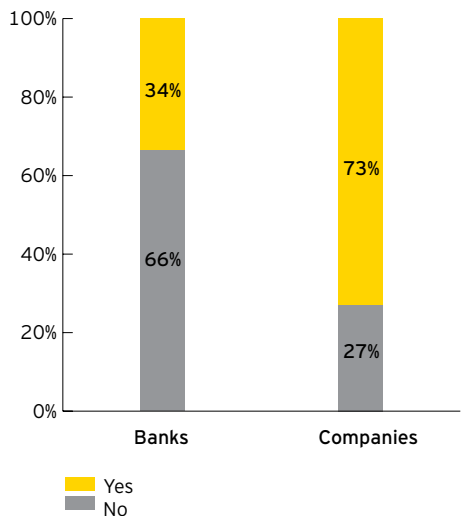
"Given Germany's current budget deficit, do you believe an increase in VAT to 25% will affect (your) demand for credit?"



"Do you believe the introduction of the financial market transaction tax will affect loans granted by your bank/the banks?"



"Do you believe the debt crisis in euro countries will have a negative effect on the lending policies and conditions of your bank/the banks?"



Conclusion



In terms of financing, the recovery is not yet safe. Worries remain, despite a broad majority of decision-makers at banks and companies believing there is no danger of a wide-scale credit crunch.

The stricter requirements for loan issues announced by a majority of banks and the trend towards deteriorating lending conditions do not suggest that companies' respective financing situations will improve in the foreseeable future.

The ongoing shortage of credit and high prices are primarily attributable to the state of the financial system. Interbank trading, traditionally the cornerstone of refinancing, still lags behind pre-crisis levels. Due to the fact that it is difficult to raise funds using alternative methods and the capital base of many banks has contracted during the crisis, the overall funds available for lending have shrunk. This pressure also means that banks have little room to take on risk

as they still face significant challenges in terms of restructuring loans and securities.

To ensure a sufficient supply of credit to the economy in the long term, banks will have to optimize their balance sheets. In addition, the new Basel III regulations require a higher level of equity to protect against potential losses. The problem now, however, is that banks' growing capital requirements are meeting with a still-dysfunctional refinancing market.

As a result, the interests of lenders and borrowers have moved further apart and will need to converge. Our study shows in many places that companies continue to view banks with a certain level of skepticism.

Both borrowers and lenders have had little success in finding alternative means of financing so far. The tried and tested concept of leasing remains the preferred

option. Only the corporate bond market is attracting more and more companies. Aside from this, innovation takes a back seat and most companies still prefer to meet their requirements with bank loans.

Consequently, the overall situation remains uncertain. A financing gap continues to pose a threat to all companies who fail to comply with the future borrowing requirements.

Sooner or later this means that banks will have to ease their lending conditions. However, this has the potential to become a vicious circle as banks will only ease their conditions if their ability to refinance improves, i.e., if the important securitization market recovers. One thing is clear - refinancing remains one of the toughest challenges ahead for banks and companies.

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