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KIRKLAND **ALERT**

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Subordination of Senior Financial Creditors in German Bank Resolutions

Executive Summary

- From 1 January 2017 onwards, certain senior liabilities of German banks are subordinated by law to facilitate "bail-ins" under the Single Resolution Mechanism (SRM).
- Those liabilities are carefully selected to target non-bank lenders, with the aim to contain a bank's distress and not have it spread onto the financial markets.
- When purchasing senior liabilities issued by German financial institutions, careful consideration will have to be given to the terms of the instrument, as seemingly *pari passu* instruments could receive materially different treatment in a "bail-in" scenario.
- These instruments will also not be eligible anymore as collateral in the ECB's Eurosystem.
- This newsletter explains the background to the new legislation, which also applies retroactively to already issued and outstanding instruments and to instruments not governed by German law.

1. The Emergence of a "European Banking Union"

As a result of the financial crisis starting in the fall of 2008, when many national European governments had to rescue failing financial institutions often overnight based on national legislation, with sometimes heavy litigation emanating from these hastily implemented *adhoc* actions (e.g., in the case of the bail-in of creditors of former Austrian bank Hypo Alpe Adria,[1] split-up of Portuguese bank Banco Espírito Santo,[2] the bail-in of deposits of Bank of Cyprus and Laiki Bank[3] or the litigation of bondholders against the exit consent in the Anglo Irish Bank rescue[4]), the European Union introduced a new set of legislation to establish a "European Banking Union."

2. Single European Bank Resolution Framework for "CRR Institutions"

Resolution of banks governed by uniform European rulebook

One of the three[5] pillars of the European Banking Union is the harmonization of the legal framework for the reorganization and liquidation of financial institutions, which are now uniformly governed by Regulation (EU) 806/2014[6] (Single Resolution Mechanism Regulation "SRM") and Directive 2014/59/EU (Bank Recovery and Resolution Directive ("BRRD")). These rules apply to CRR Institutions, which is defined in Article 4 para 1 no. 1 and 2 of Regulation (EU) 575/2013[7] (Capital Requirements Regulation ("CRR")). It applies to:

- "credit institutions" — i.e., undertakings which take deposits or other repayable funds from the public and grant credits for their own account —; and
- "investment firms" — i.e., legal entities whose regular business is to provide one or more investment services for third parties and/or to perform one or more investment activities on a professional basis.

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Creditor Participation in Bank Resolutions; "No Creditor Worse Off"

Creditor impairment under new rules subject to "absolute priority" and "best interest" test.

CRR Institutions are thus subject to special insolvency, resolution and restructuring rules. These rules aim at a restructuring of banks in financial distress to avert their liquidation and bankruptcy in order to avoid the burden on the taxpayer and a contagion of the financial system as a whole through such a bankruptcy.

The main element is the so-called "bail-in" of creditors, before any public money or bank resolution funds are used to "bail-out" a failing institution. The "bail-in" tool gives the resolution authority broad powers to modify debt obligations of the CRR Institution, or to swap into equity or even impose a total or partial write-off without compensation.

The overarching principle for application of the new bank resolution rules is the "*No Creditor Worse Off*" Principle: in any case a resolution authority applies resolution tools on a CRR Institution, it has to ensure that the impairment of shareholders' and creditors' rights still treats those stakeholders better than they would be treated in hypothetical insolvency proceedings. If a creditor can prove that the resolution tool results in worse results than a liquidation, that creditor cannot demand that the resolution will be unwound, but can claim compensation. This principle has apparently driven the German legislator to modify the ranking of certain liabilities in a CRR Institution's insolvency proceedings (as explained in the following paragraphs), so that the "no creditor worse off principle" can still be met even if seemingly *pari-passu* claims are disproportionally treated. This was not foreseen in the SRM and BRRD, and it remains to be seen whether other member states will follow suit.

3. Ranking of Liabilities in German CRR Institutions' Insolvency

Under German law until 31 December 2016, all senior unsecured liabilities rank *pari passu*, except for deposits.

Under the general rules of the German Insolvency Code (*Insolvenzordnung*, "InsO"), all unsecured debt ranks *pari passu* pursuant to §38 InsO (so-called "§38-Creditors"), unless such claims are subordinated by law (e.g., post-commencement interest) or contract. However, to protect retail and other unexperienced investors in bank insolvencies, certain deposit-like claims enjoy special protection. Under §46 f para. 4 of the German Banking Act (*Kreditwesengesetz*, "KWG"), within the group of §38-Creditors, the following liabilities rank senior to other §38-Creditors ("Protected Deposits"):

- covered deposits, i.e., deposits, including fixed and savings deposits, up to Euro 100,000 deriving from funds held in an account or from individual positions in the course of normal banking transactions, which the CRR Institution must repay under the applicable legal and contractual conditions;
- deposits of small and medium-sized companies (i.e., companies that have less than 250 employees and an annual turnover of no more than EUR 50 million and/or assets not exceeding EUR 43 million) eligible for compensation; and
- deposits with institutions based in the EU that would be eligible for compensation if they had not been received by branches outside the EU.

Creation of New Junior Ranking for Certain Senior Financial Liabilities

From 1 January 2017, certain senior liabilities ("§46f(6) KWG Instruments") are subordinated to all other senior unsecured liabilities in a German bank insolvency.

Effective as of 1 January 2017, the German Single Resolution Mechanism Act (*Abwicklungsmechanismusgesetz*, "AbwMechG") amends the priority of §38-Creditors in a German CRR Institution's insolvency by amending §46 f para 5-7 KWG. The AbwMechG in particular aims at facilitating a "bail-in" and therefore subordinates certain debt instruments issued by CRR Institutions to all other §38-Creditors. As a result, these creditors will only rank senior to subordinated debt, but junior to all other general unsecured debt.

§46 f para 6 sentence 1 KWG expressly subordinates the following unsecured instruments ("§46f(6) KWG Instruments") to all other §38-Creditors:

- bearer bonds (*Inhaberschuldverschreibungen*);
- negotiable bonds (*Orderschuldverschreibungen*);
- rights comparable to these instruments, which by their nature are tradable on the capital markets; and
- promissory note loans (*Schuldscheindarlehen*) and non-negotiable registered bonds (*Namensschuldverschreibungen*), unless these qualify as Protected Deposits (see above).

except for

- instruments issued by public institutions which cannot become subject to insolvency proceedings;
- money market instruments;
- instruments exempted from a "bail-in" under Art. 44 para. 2 BRRD; or
- debt instruments for which it has been agreed (so-called "structured financial products") that:
    - the repayment or the amount of the repayment depends on the occurrence or non-occurrence of an event which is uncertain at the point in time when the debt instruments are issued or settled in a way other than by monetary payment (no. 1); or
    - the payment of interest or the amount of the interest payments depends on the occurrence or non-occurrence of an event which is uncertain at the point in time when the debt instruments are issued unless the payment of interest or the amount of the interest payments solely depends on a fixed or floating reference interest rate and is settled by monetary payment (no. 2).

In summary, it seems that debt instruments issued by banks typically held by other banks will enjoy a more senior ranking, whereas instruments typically held by asset managers and other non-bank investors will be subordinated and therefore likely be treated worse in a bail-in scenario (because they would be subordinated in an insolvency

and therefore have less protection under the "No creditor worse off" principle). The German legislator has very openly confirmed this rationale in the official reasoning of the draft law and argues that senior liabilities held by non-banks should be bailed in first in order to avoid spreading contagion through the financial system.[8]

Certain §46f(6) KWG Instruments are exempted from subordination.

Guidance from German Banking Regulator

The German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin) issued a joint guidance with the Financial Market Stabilization Authority (*Bundesanstalt für Finanzmarktstabilisierung,* FMSA) and the German National Bank on 5 August 2016[9] on the interpretation of these amendments, and in particular on the features that debt instruments must have to fall under one of these exemptions to subordination.

Money Market Instruments Exemption

"Money market instruments" are defined as all types of receivables that are usually traded on the money market, except for payment instruments. According to the BaFin guidance, the distinction between capital markets and money markets is based on the original maturity of the instrument. A debt instrument is attributed to the money market if its original maturity does not exceed 12 months. This exemption privileges mainly the banking sector, since it will mainly be banks who buy these money market instruments, but not asset managers looking for long-term investments.

Instruments with original term under 365 days are exempted from subordination.

Structured Financial Products Exemption

Another significant exemption is the exemption for structured financial products. This provision particularly aims at excluding credit derivatives and other structured debt instruments from the subordination and is based on the assumption that uncertainties in determining the value of these instruments in the context of a "bail-in" could occur. According to the BaFin guidance, the following features will *not* result in a debt instrument being considered a structured financial product:

"Structured financial products" are exempted from subordination.

- The interest rate is fixed, or floating, but defined by reference to EURIBOR, LIBOR or EONIA;
- (solely) a contractual acceleration right or a right of early repayment is granted (based on the assumption that the maturity date, taken in isolation, does not cause difficulties regarding the aforementioned valuation);
- the respective debt instrument is a zero-coupon instrument (since the compounding of interest — paid in a lump sum at maturity — is fixed, no uncertainties occur); or
- the principal has to be repaid in a foreign currency.

Fixed, floating rate and zero coupon instruments are not exempt from subordination.

No Grandfathering Rules

The new rules have no grandfathering provisions, which means they not only apply to debt instruments to be issued in the future, but also to unsecured debt instruments already issued and still outstanding. The government draft points out that this retroactive effect is justified by common public welfare considerations which shall be given priority

Issued and outstanding notes are subject to new rules.

over the investor's legitimate interest. Investors whose debt instruments are treated worse than those of §38-Creditors in future bank resolutions could seek to challenge that argument in litigation under constitutional law aspects. Under the German procedural rules, investors would first have to exhaust all ordinary legal appeals available; i.e., in an appeal against the "bail-in," the relevant court would consider whether the investor's constitutional rights were impaired. If the court finds that the new rules are in breach of constitutional rights, it will refer the case to the German Federal Constitutional Court (*Bundesverfassungsgericht*) for review of the constitutionality of the new law. Only once all ordinary legal appeals have been exhausted without a referral, investors could seek to appeal directly to the German Federal Constitutional Court (*Bundesverfassungsgericht*). Investors could also (after exhausting all legal remedies under German law) seek to appeal to the European Court of Human Rights.

Relevance of Governing Law of Debt Instrument

New rules apply regardless of the governing law of debt instrument.

As the new rules amend the priority of liabilities in insolvency proceedings, they will be applicable if German insolvency law applies. As Article 4 of Regulation (EC) 1346/2000 on Insolvency Proceedings[10] stipulates that the law governing the insolvency proceedings will also govern the priority of liabilities and has to be recognized within the EU, European courts will enforce the new German rules. This means that in a "bail in" scenario, investors who would have to bring claims under the instrument before a court in a member state of the European Union will not be able to argue that they would be treated better in a liquidation. For debt instruments governed by the laws of non-EU member states, investors could seek to challenge the recognition of the new rules[11] if they can establish jurisdiction in their home courts or other non-EU courts, and those courts would find that the subordination of certain senior liabilities (with retroactive effect) while not subordinating others breaches their public policy.

4. Consequences for the resolution and restructuring of German CRR Institutions

§46f(4) KWG-Liabilities will be "bailed in" before any other general unsecured creditors.

As mentioned above, the new rules aim at facilitating the resolution of CRR Institutions by supporting the bail-in of debt instruments issued by them.[12]

If the requirements of a CRR Institution's resolution are met, the resolution authority is entitled to apply the "bail-in" tool. The waterfall of liabilities to which to apply a "Bail In" follows their priority in an insolvency. As a consequence of the new law, after having written down equity and subordinated debt, holders of §46f(6) KWG Instruments will have to face haircuts or equitization in a German bank resolution before any other §38-Creditor. Ultimately the amendment creates of new type of "mezzanine debt."

Instruments constituting §46f(4) KWG-Liabilities cease to be eligible for collateral in the ECB's Eurosystem.

Because §46f(4) KWG-Liabilities will cease to rank *pari passu* with other debt instruments of a CRR Institution, they will not be eligible as collateral for participating institutions in the ECB's Eurosystem[13] as of 1 January 2017.[14]

Criticism; Alternative Models

The new rules were criticized for not fairly aligning the burdens with the causes of the banking crisis, since pension funds and other investors who mainly invest in unsecured senior debt instruments are disadvantaged in comparison with investment banks, for example. Senior unsecured funding could become less available to issuers since investors could step away from this asset class as the probability of bail-in proceedings increases. This could ultimately result in an increase in price for these debt instruments. Furthermore, the amendment discourages efforts of institutions to build up capital reserves from equity or other regulatory capital, since TLAC buffers can be filled with senior unsecured debt instruments.[14]

An alternative model discussed and considered preferable is the so-called comprehensive approach whereby in case of a bail-in of senior unsecured debts, losses shall be spread over as many senior liabilities as possible. In contrast to the German approach, this would lead to lower losses each senior creditor has to face instead of discriminating selective instruments and creditors. It remains to be seen how other members states implement the European laws in this respect, and whether the German approach will find suitors.

5. How Can Investors Protect Themselves?

As the new rules apply to instruments that are already outstanding, there is little that can be done legally prior to an actual bank resolution, in which affected creditors might consider challenging the constitutionality of the new rules in the litigation for compensation. When purchasing debt instruments issued by a German CRR Institution, its terms should be carefully reviewed to determine its precise ranking in a "bail-in" scenario. In sales of those positions, that risk will likely be priced in.

With respect to newly issued debt instruments, investors should seek that they fall under one of the exemptions, and/or in addition, that the law governing the instrument is that of a non-EU member state. In particular, investors should look for the following terms:

- Original maturity shorter than 12 months;
- No fixed or floating rate interest where the reference interest rate is EURIBOR, LIBOR or EONIA;
- Floating interest rates with floor (other than 0% floor), cap or collar; and
- Repayment amount in different currency than original principal amount, based on future exchange rate.

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1 *Landgericht* München I, Judgment of 8 May 2015 (Az. 32 O 26502/12) — *Bayerische Landesbank AöR ./. HETA Asset Resolution AG (f/k/a Hypo-Alpe-Adria Bank International AG)*; Landgericht Frankfurt am Main, Order for Referral to CJEU of 21 June 2016 (Az. 2-12 O 114/15) — *FMS Wertmanagement AöR ./. HETA Asset Resolution AG.*

[2] *In re: Goldman Sachs International v Novo Banco S.A.*, High Court of England and Wales, Judgment of 7 August 2015, [2015] EWHC 2371 (Comm).

[3] Court of Justice of the European Union (CJEU), Judgments dated 20 September 2016 in Joined Cases C-8/15 P (*Ledra Advertising v Commission and ECB*), C-9/15 P (*Eleftheriou and Others v Commission and ECB*) and C-10/15 (*P Theophilou v Commission and ECB*) and in Joined Cases C-105/15 (P Mallis and Malli v Commission and ECB), C-106/15 P (*Tameio Pronoias Prosopikou Trapezis Kyprou v Commission and ECB*), C-107/15 (*P Chatzithoma v Commission and ECB*), C-108/15 (*P Chatziioannou v Commission and ECB*) and C-109/15 (*P Nikolaou v Commission and ECB*).

[4] *In re: Assénagon Asset Management S.A. v Irish Bank Resolution Corporation Limited (f/k/a Anglo Irish Bank Corporation Limited)*, High Court of England and Wales, Judgment of 27 July 2012, [2012] EWHC 2090 (Ch)

[5] The other two pillars are a single supervisory mechanism and a single deposit protection framework; see European Commission, http://ec.europa.eu/finance/general-policy/banking-union/index_en.htm.

[6] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010.

[7] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council.

[8] Begr RegE BT-Drs. 18/5009, page 44

[9] See https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Fachartikel/2016/fa_160805_Auslegungshilfe_46f.html.

[10] To be replaced with effect from 26 June 2017 by Regulation (EU) 2015/848 on Insolvency Proceedings, which in its Article 7 also provides for recognition of the law of the member state on priority of liabilities.

[11] Under Art. 55 BRRD, CRR Institutions are obliged to include a clause in newly issued debt instruments governed by laws other than those of an EU member state a clause that any bail-in instrument will be recognized. If the instrument contains such a clause, a challenge of the recognition will become more difficult.

[12] An important side effect for German banks is that §46f(6) KWG-Instruments will in future also be eligible to fall under the definition of TLAC instruments and hence make it easier to for struggling German banks to comply with their regulatory capital ratios. TLAC (“Total Loss Absorbing Capacity”) Instruments are instruments which can be equitized or written down rapidly and without legal difficulties in order to recapitalize the institute. Therefore not all debts are suitable for TLAC (e.g., covered deposits or credit derivatives do not meet these requirements due to their priority or the aforementioned difficulties).

[13] See Para. 3.3 of the Opinion of the European Central Bank of 2 September 2016 (CON/2015/31), (https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2015_31_f_sign.pdf)

[14] See e.g., Rabobank's position paper on the new rules (https://www.rabobank.com/en/images/2015-05-position-paper-german-legislative-proposal-senior-unsecured-debt.pdf)

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