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Germany plans to subordinate senior unsecured bonds in bank insolvency

The German Federal Government has published a draft law implementing the Single Resolution Mechanism. It includes a proposal to subordinate senior debt instruments in the insolvency of German banks. The subordination is designed to enable the bail-in of senior debt instruments before other unsecured claims and to help German banks meet the loss absorbency requirements of new European bank resolution frameworks.

Introduction and background

On 10 March 2015 the German Ministry of Finance published a draft law on the implementation of the Single Resolution Mechanism (**SRM**), including a number of amendments to other resolution and regulatory laws. The draft law[1] is open for consultation until 27 March 2015. Following consultation, an official government draft will be published and the normal parliamentary procedure begins.

The SRM is the second pillar of the "Banking Union". The SRM Regulation (**SRMR**) was adopted in April 2014 together with the EU Bank Recovery and Resolution Directive (**BRRD**). For the most part the change proposed by the draft law will apply as of 1 January 2016. The SRM creates an EU level resolution 'Board' with centralised resolution responsibilities and creates a (gradually) mutualised resolution fund. For banks that are directly supervised by the ECB, the effect of the SRMR will be to move most of the resolution responsibilities under the BRRD from the national level to the Board and the ECB, although the resolution authority in the relevant Member State would retain responsibility for implementing the resolution decisions of the Board.

Subordination of senior bank debt

Most notable are changes to the German Banking Act (*Kreditwesengesetz*; **KWG**) aiming at implementing a regime which facilitates the bail-in of senior unsecured bank debt under the SAG by adding a new para 5 to section 46f KWG.

Pursuant to the draft law, in the insolvency of a CRR institution claims arising from unsecured debt instruments are treated as subordinated obligations senior to

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[1] See *http://www.bundesfinanzministerium.de/Content/DE/Downloads/Gesetze/2015-03-10-bankenabwicklungsrecht-srm.pdf?__blob=publicationFile&v=2*

Overview

- Germany implemented the BRRD in full in January 2015 and has published a new draft law to implement the SRM.
- The draft law proposes that claims under unsecured senior debt instruments issued by German banks are subordinated in insolvency, enabling those liabilities to be bailed in during resolution and reducing the possibility of "no creditor worse off" claims by affected creditors.

  If the draft law is adopted, senior unsecured debt instruments issued by German banks will rank junior to deposits and derivatives claims but senior to contractually subordinated debt such as Tier 2 capital.

Key issues

Market participants should be considering the following issues ahead of any change in law:

- Any impact of the subordination on *pari passu* provisions in existing bond terms
- Whether the change would have impact on deliverability of affected bonds in credit default swap transactions.
- Potential capital implications for regulated banks / investment firms holding the affected bonds.
- Effect on investment mandates – will the bonds remain eligible assets?
- Any possible ratings impact.

any subordinated obligations pursuant to section 39 para 1 no. 1 of the German Insolvency Code (*Insolvenzordnung*; **InsO**) and, in case of obligations ranking pari passu, on a pro rata basis. The subordination does not apply to debt instruments for which the repayment or the repayment amount depends, according to their terms, on the occurrence or non-occurrence of an event which at the time of the issuance of the debt instrument was not certain or which is discharged in a way other than by a money payment.

CRR institutions are credit institutions under Article 4 (1) no. 1 of Regulation 575/2013 (CRR) and investment firms under Article 4 (1) no. 2 CRR, so not every bank in Germany would be affected by this new insolvency provision. Debt instruments are defined in the draft section 46f (5) KWG by reference to section 11 (3) no. 3 KWG and include participation bonds, bearer bonds, negotiable registered bonds and other comparable instruments, which are tradable on the capital markets. The debt instrument does not need to be listed and money market instrument are not affected. There is a carve out for structured instruments thereby ensuring that structured instruments do not necessarily rank junior to derivatives.

While the ranking of obligations in an insolvency is not only addressed in the InsO, the obligations under section 39 (1) InsO which will be junior to unsecured debt instruments include, inter alia, (1) unpaid and default interest accrued after the opening of the insolvency proceedings, (2) costs incurred by individual insolvency creditors due to their participation in the proceedings, (3) fines, regulatory fines, coercive fines and administrative fines, as well as such incidental legal consequences of a criminal or administrative offence requiring the insolvency debtor to pay money (4) claims against the insolvency debtor for performance without consideration and (5) claims for restitution of a equity replacing loan.

While parties may agree on the seniority of any obligations arising under an agreement, section 39 (2) InsO clarifies that such obligations shall be satisfied after the obligations mentioned in section 39 (1) InsO if the agreement does not provide otherwise. Hence, obligations subject to section 39 (2) InsO are the most junior obligations and only senior to equity.

To summarise, and also with regard to the scope of the bail-in tool under section 91 SAG or respectively Article 44 BRRD, obligations under unsecured debt instruments issued by German CRR institutions would rank junior to deposits and obligations arising under derivatives but generally senior to contractually subordinated debt such as Tier 2 capital. As contractual arrangements on the ranking of obligations are enforceable under German law, as long as they do not affect any other party's rights, it remains to be seen whether the ranking of any future subordinated debt instrument issued by German credit institutions will be determined by referring to the senior unsecured debt instruments, if the draft law is adopted.

Cross border application

The draft law is silent on the question whether it is intended to apply only to debt instruments governed by German law, but since section 46f (5) InsO is a procedural insolvency law provision the question to be answered is to what extent German insolvency proceedings are recognised in foreign jurisdictions. Insolvency proceedings under German law apply universally to all assets of the insolvent debtor, irrespective of the location of such assets, subject to recognition under applicable foreign laws where such assets are from a German law perspective deemed to be located outside Germany.

As a result of the implementation of Directive 2001/24/EC of April 2001 on the Reorganisation and Winding-Up of Credit Institutions (**WUD**), the opening of secondary or territorial insolvency proceedings is excluded in respect of CRR credit institutions and in respect of certain entities subject to a resolution order or certain resolution measures. So within the EEA the question can be answered without any reference to the governing law. If the debt instrument is governed by the laws of a jurisdiction outside the EEA, the requirement under Article 55 BRRD may be applicable pursuant to which member states require institutions to include a contractual term by which the counterparty recognises that the liability may be subject to the write-down and conversion powers (which in particular in respect to third country jurisdictions may need to be supported by legal opinions).

Pari passu clauses and default

As regards *pari passu* clauses under German law issuances, the subordination contemplated by the draft law should not be considered to be a default, as the subordination would be imposed by operation of law.

In effect, the issuer is powerless to stop the subordination, hence it would be a case of impossibility which should give no room to characterise the change as a default.

Effects on CDS

One aspect for consideration is whether the change to the insolvency hierarchy could affect the deliverability of affected bonds for credit default swap deliverability purposes. While in principle priority rankings effected by law tend not to be taken into account for these purposes, this is something for further examination in specific transactions.

Effect on investment mandates

Market participants will also need to consider whether subordination has any impact for investors under investment mandates. Some investment mandates may preclude an investor from investing in subordinated instruments.

Capital consequences

Other banks and investment firms holding the senior bank debt of German banks will need to consider carefully the potential regulatory capital consequences of the draft law.

a starting point, the subordination under the draft law would have an impact on the Loss Given Default figure in the regulatory capital calculation under the foundation IRB approach and would give rise to higher risk weightings under the Basel Committee's recent proposal for a revised standardised approach.

ECB eligibility

In order to be eligible as collateral for Eurosystem credit operations, marketable assets must comply with the eligibility criteria as laid down in the applicable Guideline of the European Central Bank (ECB) on the implementation of the Eurosystem monetary policy framework. Under such Guidelines eligible debt instruments shall not give rise to rights to the principal and/or the interest that are subordinated to the rights of holders of other debt instruments of the same issuer. Accordingly, the draft law raises questions as to eligibility of the affected bonds as ECB collateral.

No creditor worse off

In presenting the draft law, the Ministry of Finance explains that the subordination of senior debt will support the bail-in tool under the SAG. By subordinating unsecured debt instruments in case of an insolvency, the resolution authority can use such debt instruments as a priority when applying the bail-in tool: If they were not subordinated in an insolvency proceeding, they would, in a resolution, have to be used alongside any other obligations (save for any obligation excluded from bail-in) in a proportion which would also apply in an insolvency proceeding, sections 68, 97 SAG.

By allowing using unsecured debt instruments before using any other unsecured claims, the resolution authority is, according to the view of the Ministry of Finance, in a position to use such obligations that provide for the most reliable source for a bail-in. Bailing in other unsecured claims might present practical or legal problems which, in the view of the Ministry of Finance, justifies the use of unsecured debt instruments in the first instance.

An important consequence of the subordination is that it will likely exclude any compensation claims of the affected debt holders under the "no creditor worse off" principle (**NCWO**). In an actual insolvency, the recovery of subordinated noteholders would potentially be close to zero. Yet in a resolution involving bail-in under the SAG, it is only when post-resolution valuations determine that the resolution left a creditor *worse off* than in insolvency that they would have any entitled to compensation from the German bank restructuring fund (Restrukturierungsfonds) (section 147 SAG or Article 75 BRRD).

TLAC and MREL

One of the primary benefits of the change in the legislation would be to facilitate existing senior debt instruments of German banks qualifying towards a bank's requirement for Total Loss Absorbing Capacity (TLAC) under the recent proposals of the Financial Stability Board (FSB) and its Minimum Requirement for Own Funds and Eligible Liabilities (MREL) under the BRRD . Although the FSB proposal does not require full conformance with the TLAC requirements before 1 January 2019, the EU MREL requirements will come into effect as from 1 January 2016. The EBA has proposed that this requirement might initially be set (effectively) at zero, with a phase-in period, but there is currently considerable uncertainty as to what the implementation period within the EU will be.

There is no requirement in either BRRD or the FSB proposal that eligible instruments must be subordinated. However, authorities have suggested that instruments which are not subordinated (either explicitly on their face or structurally through being issued through a "clean" holding company) may face restrictions on their eligibility for use as TLAC or MREL. This is because instruments which rank pari passu on insolvency with excluded claims (such as deposits) will have the benefit of NCWO protection, and may therefore be limited in the amount by which they can be written down. This is why (inter alia) the FSB proposal suggested that non-subordinated non-holdco issues should only be permitted to be classed as TLAC up to a relatively low limit (2.5 % of Risk Weighted Assets). Subordinated bonds do not pose this difficulty for resolution authorities, and can be included in TLAC/MREL without limit.

Retrospective effect

As outlined in the explanatory material accompanying the draft law, challenges to the subordination on the basis that it violates the human right to private possession (Article 14 German Constitution, **GG**) are unlikely to succeed. The right to private possession may be lawfully limited in pursuit of a reasonable public purpose. As the legislator points out, there is no other way to cater for a quicker and more reliable resolution, which is in the reasonable interest of the public (*Gemeinwohlinteresse*). The reason given is that if other creditors were explicitly exempted from the bail-in in the specific case pursuant to section 92 SAG, they would also not have to bear any costs of the resolution procedure which is not to be justified. Furthermore, it might be a difficult and lengthy process to use such other debt for a bail-in where the main objective should be that the resolution is enacted quickly.

Another constitutional law problem is the retrospective effect. Once in force, section 46f (5) KWG determines the seniority for all debt instruments irrespective of whether they have been issued before or after the date in which this law entered into force. In line with the draft reasoning of the Ministry of Finance the draft law might have a retrospective effect, even though the effect is dependent on a future event. Under German constitutional law, such an "uneven retrospective effect" (*unechte Rückwirkung*) is usually valid and binding, provided that a reasonable interest of the public (*Gemeinwohlinteresse*) exists – which the German government argues in their reasoning being the necessity for a sustainable resolution of CRR institutions.

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