New law on the implementation of the Single Resolution Mechanism in Germany passed

The German Parliament (*Bundestag*) has resolved on a revised law implementing the Single Resolution Mechanism. As reported (see our Newsletters of May 2015 and of March 2015), the former drafts included a proposal on the subordination of senior unsecured bonds in bank insolvency. Now, under the Act, senior unsecured debt instruments are not automatically subordinated by law but are treated separately when distributing the assets to the creditors of the estate. The Act now also contains a clarification on the treatment of repo or securities lending transactions covered by master agreements under the bail-in tool as implemented by the German Recovery and Resolution Act (*Sanierungs- und Abwicklungsgesetz*, "**SAG**").

Introduction

On 23 September 2015, the German Parliament resolved on a law amending national banking resolution laws with respect to the Single Resolution Mechanism ("**SRM**") and the European law requirements on bank levy (*Abwicklungsmechanismus*gesetz) (the "**Act**") based on a revised proposal of the German Parliament's Financial Committee.[1] Please refer to our Newsletters of March 2015 and May 2015 for further information on the initial drafts and further considerations. In the following we focus only on some substantial changes compared to the initial drafts, i.e.

- the treatment of senior unsecured debt instruments in an insolvency of a German CRR Institution, (i.e. CRR Credit Institutions and CRR Investment Firms),
- the contractual recognition of rights of suspension of the resolution authority, and
- the treatment of certain financial transactions under the bail-in tool of the SAG.

The Act is now with the German Federal Council (*Bundesrat*) which has a right to object and enters into force upon publication. The German Federal Council will likely decide on the Act on 16 October 2015.

Changes concerning the ranking of senior unsecured bonds

The Act is, in particular, aiming at supporting the bail-in of bank debt instruments. The German Federal Government originally proposed an automatic statutory subordination of senior unsecured debt instruments issued by German CRR Institutions. Now, under the Act, the revised section 46f of the German Banking Act (*Kreditwesengesetz*, "**KWG**") stipulates that senior unsecured debt instruments are not automatically formally subordinated by law as such legal subordination would have adverse effects on those debt instruments which were not intended by the legislator. Rather, in a CRR Institution's insolvency, senior unsecured debt instruments are satisfied after the claims of all other creditors which are not subordinated creditors have been satisfied. Therefore, even though such debt instruments are not formally subordinated by law, but rather preserve their original seniority, these debt instruments are from a commercial point of view treated junior to all other obligations of the insolvent debtor, but senior to all subordinated obligations (irrespective whether the subordination applies by law

[1] *See* http://dip21.bundestag.de/dip21/btd/18/060/1806091.pdf.

or contract). It appears as if the new proposal still achieves its originally intended purpose in facilitating bail-in of senior unsecured debt (in particular coping with the "no creditors worse off"-defence) and helping German CRR credit institutions in meeting MREL and TLAC requirements..

The Act contains further clarifications on the scope of the debt instruments affected and now explicitly clarifies that all debt instruments which are *per se* not eligible for bail-in under the SAG are not subject to such "allocation rule". Likewise, debt instruments issued by banks established under public law which are not subject to insolvency proceedings are now excluded. While the SAG would be applicable (and hence they would be subject to bail-in), some banks established under public law are not subject to the German Insolvency Code (*Insolvenzordnung*) and would, therefore, have to be liquidated by a specific law to be enacted by the relevant competent Federal State (*Land*) which may then deal with the ranking of creditors.

The new section 46f SAG is intended to become effective in all insolvency proceedings opened on or after 1 January 2017. Please find a comparison between the draft version of 46f SAG of May 2015 and the final version (English translation) at the end of this Newsletter.

Changes concerning the contractual recognition of resolution measures

Upon implementation of the SAG it turned out that the recognition of the suspension of certain contractual rights including termination upon resolution measures being taken was not entirely clear for financial contracts (*Finanzkontrakte*) governed by the laws or subject to the jurisdiction of a third country. Therefore, the Act now provides for an additional obligation of CRR Institutions and their group companies to ensure the effectiveness of resolution measures including suspension of termination rights. Pursuant to the new section 60a SAG, CRR Institutions and their group companies must include provisions into their financial contracts governed by non EU-law by which the counterparty recognises and agrees to be bound by resolution measures including the suspension of termination and enforcement rights. The resolution authority can, however, consider the specifics of the institution when enforcing such duties, in particular it can take the systemic relevance of an institution into consideration. It is to be noted, though, that this does not lead to not systemically relevant German entities being excluded from the application of the Act; neither is there any way to apply for an official confirmation of the inapplicability. This obligation does not cover financial contracts entered into prior to 1 January 2016 unless financial contracts entered into prior to such date are subject to a netting agreement that also covers obligations incurred after 1 January 2016.

It was initially proposed that parent companies are obliged to monitor compliance of all financial contracts entered into by their subsidiaries (within the meaning of section 10a paras 1 and 2 KWG). The Act now only provides for an obligation of the parent company to monitor those financial contracts that are guaranteed or secured by any other means by one of the group entities having their seat in Germany.

Clarification regarding the application of the bail-in tool to repos and securities lending transactions

Under the currently applicable version of the SAG the treatment of repo or securities lending transactions in a bail-in is unclear, as the exemption for derivatives transactions (which allows a bail-in only after close-out on the basis of the net settlement amounts) is likely not applicable and it is also not entirely clear to what extent these transactions would qualify as secured liabilities. The Act now contains a clarification with respect to the applicability of the bail-in tool under the SAG with respect to repo or securities lending transactions. While the SAG did not exclude that the bail-in tool may be applied to individual repo or securities lending transactions even if governed by a master agreement, section 93 para 4 SAG now provides that section 93 SAG also applies to repo or securities lending transactions if they are subject to a master agreement (such as GMSLA, GMRA or the German master agreements for repurchase or securities lending transactions). This means that only the net settlement or close-out amount is subject to bail-in but not each single obligation under any underlying transaction. The new provision therefore reduces the risk that the application of the bail-in tool under the SAG adversely affects the effectiveness of contractual netting provisions for repo or securities lending transactions.

A comparison between the draft version of 46f SAG of May 2015 and the final version reads in an English convenience translation as follows:

The following paras 5 to 7 are added to section 46f:

~~(5) In insolvency proceedings over the assets of a CRR Institution claims arising from uncollateralised debt instruments within the meaning of para 7 shall be satisfied as if they were subordinated claims senior to any claims ranking pursuant to section 39 para 1 no. 1 of the Insolvency Code and, in case of claims of the same rank, proportionate to their notional, provided that no further subordination is contractually agreed or stipulated by law. In case a contractually agreed subordination provides for subordination immediately junior to non-subordinated insolvency creditors, it shall be deemed to have been agreed that the claims shall rank immediately junior to the claims under sentence 1.~~

~~(6~~(5) Of the claims within the meaning of section 38 of the German Insolvency Code (*Insolvenzordnung*), initially all claims are served which are not debt instruments pursuant to para 6 sentence 1.

(6) Debt instruments in the meaning of this sentence are bearer bonds (*Inhaberschuldverschreibungen*) and negotiable registered bonds (*Orderschuldverschreibungen*) and rights comparable to these instruments, which by their nature are tradable on the capital markets, as well as promissory notes (*Schuldscheindarlehen*) and non-negotiable registered bonds (*Namensschuldverschreibungen*) which do not qualify as deposits pursuant to para 4 nos. 1 or 2. Debt instruments that within the range of section 91 para 2 of the German Recovery and Resolution Act (*Sanierungs- und Abwicklungsgesetz*) and debt instruments issued by institutions established under public law that cannot become subject to insolvency proceedings as well as money market instruments are not considered as debt instruments within the meaning of sentence 1 hereof.

(7) Para ~~5~~6 sentence 1 does not apply to debt instruments for which it has been agreed that

1. 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; or
2. 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.

~~(7) Debt instruments within the meaning of para 5 are bearer bonds (*Inhaberschuldverschreibungen*), negotiable registered bonds (Orderschuldversichreibungen) and rights comparable to these instruments, which by their nature are tradable on the capital markets, as well as promissory notes (*Schuldscheindarlehen*) and non-negotiable registered bonds (*Namensschuldverschreibungen*) which do not qualify as deposits pursuant to para 4 nos. 1 or 2. Money market instruments are not considered as debt instruments within the meaning of para 5.~~

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