ALLEN & OVERY

August 2014

Draft of a new regime for the rescuing of banks in Germany

© Allen & Overy 2014

Introduction

The German bank restructuring and resolution regime is approaching its "home stretch". As early as 2008, as a response to the financial crisis, the German legislator started amending bank regulatory provisions to foster the stability of the financial system and to rescue banks in crisis. The legislative framework has been repeatedly readjusted since then.

As the most recent development, the German Federal Government published a legislative package on 9 July 2014 which, among other things, aims to implement Directive 2014/59/EC (*Bank Resolution and Recovery Directive* – **BRRD**) and shall – according to the draft act – for the most part enter into force on 1 January 2015.

Through this, the bank rescue regime applicable today will be amended. Like the BRRD, German law already provides for rules on preparation and planning (cf. 1 below), on early intervention (cf. 2 below) and on resolution (cf. 3 below). Furthermore, Germany has enacted a split-bank regime (*Trennbankenregime*), which will enter into force in the middle of next year. The draft legislation amends parts of these provisions substantively. A summary of the effects is set out below.

1. Preparation and Planning

As the law stands, German banks are obliged to prepare a recovery plan if they are classified by the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – **BaFin**) as posing a potential risk to the stability of the financial system (systemically important). The draft act proposes to extend the requirement to prepare a recovery plan to cover all German banks. However, the general requirement is that the recovery plan will be prepared primarily at group level by the respective Union parent undertaking (in its home Member State). Only in specific cases will a separate recovery plan also need to be prepared for individual German subsidiaries. This particularly affects German subsidiary institutions of European Union groups which up to now have been classified by BaFin as being systemically important. The draft act also suggests that German branches of non-Member State banks (section 53 of the German Banking Act (*Kreditwesengesetz*)) and subsidiaries of non-Member State banks will generally be obliged to prepare a recovery plan, even though (significant) relief can be expected for non-systemically important banks/branches e.g. with respect to the contents of the plan. The draft legislation further provides the potential for banks that belong to an institutional protection scheme (*Institutssicherungssystem*) to be exempted from the obligation to prepare a recovery plan.

In terms of content, the requirements of the recovery plan are provided in fuller detail in the BRRD and accordingly the draft act. Thus, the final draft of regulatory technical standards on the assessment of recovery plans which was published by the European Banking Authority (EBA) on 18 July 2014 e.g. reaches significantly beyond the currently applicable requirements for strategic analysis on the basis of the circular (*Rundschreiben*) regarding the minimum requirements applicable for the design of recovery plans (*MaSan*).

The legislative package further introduces special provisions on the so-called intra-group financial support. Such provisions have been absent from German law to date. Both the agreement and the actual granting of intra-group financial support are dependent on various requirements. The draft does not clarify the relationship of those provisions with the avoidance provisions of insolvency law and, where applicable, with the maintenance of capital provisions of corporate law. There is a current discussion in the market as to whether, based on these requirements and the risks potentially resulting from insolvency law and corporate law, banks will make any use of this provision at all.

Additionally, rules on the ring-fencing of risks will come into effect in Germany on 1 July 2015 (with further transitional periods). Banks and groups which exceed certain accounting thresholds will be prohibited from conducting certain risky,

© Allen & Overy 2014

speculative activities out of CRR credit institutions. These transactions must instead be transferred to a so-called financial trading institution.

2. Early Intervention

The legislative package considerably expands the early intervention powers that already exist under German law. Thus, the supervisory authority in future is entitled to, for example:

- require the management to update its recovery plan or implement one or more of the trading options specified in the recovery plan;
- require the management to convene a shareholders' meeting, with an agenda specified by the supervisory authority, or do so itself;
- require the bank to remove one or more members of the bank's senior management;
- require the management to change the business strategy and the legal and operational structures;
- if these measures are insufficient, order the removal of some or all members of the bank's senior management.

If the removal of some or all of the bank's senior management failed to improve the bank's situation, the supervisory authority will be able to appoint a temporary administrator, who may for a period either replace or work together with the management. Options that already exist today, e.g. the appointment of a special commissioner (*Sonderbeauftragter*), will continue to apply. This will to some extent lead to a doubling of powers.

Alongside this – based on the current draft legislation – the recovery proceedings (*Sanierungsverfahren*) which were introduced in 2011 will also continue to apply. Under this proceeding banks can apply to conduct a recovery on a voluntary basis without, however, being able to unilaterally interfere with creditor rights. Such a proceeding has never been used to date and is widely considered as being unfit for purpose.

3. Resolution

The main goal of the legislative package is reconfiguration and considerable expansion of the resolution tools and mechanisms. At the forefront is the introduction of new provisions on the participation of shareholders and creditors in the losses of a bank, as also contemplated in the BRRD.

Participation of shareholders and holders of other instruments of ownership

Shareholders and holders of other instruments of ownership will in future be required to be the first to "participate" in the resolution by writing down their shares/instruments. While their position may be no worse than if they had been involved in an insolvency proceeding, the probability that this group of persons would not incur extensive losses in insolvency proceedings is, however, usually small. In the event of resolution, writing down of the capital instruments is generally mandatory. According to the wording of the draft legislation, it can already take effect e.g. when so-called extraordinary public financial support is granted from public funds.

© Allen & Overy 2014

Resolution tools

In addition, the framework of available resolution tools will be expanded. A requirement for recourse to these tools is usually the participation of shareholders and holders of other instruments of ownership.

The legislative package provides – as does the BRRD – for the following resolution tools:

- sale of business;
- transfer to a bridge bank;
- transfer to an asset-management vehicle; and
- bail-in (creditor participation).

The tools can generally – if the resolution requirements are met – be applied individually or in combination (only the transfer to an asset-management vehicle requires a combination with other measures).

In a practical sense, the sale of business tool is related to the (partial) transfer order which already applies today; however, the requirements and effects differ. To date, German law has not had an independent tool to transfer legal relationships, assets and liabilities to a bridge bank. However, up to now, the restructuring fund (*Restrukturierungsfonds*) set up by the Federal Financial Stability Authority (*Bundesanstalt für Finanzmarktstabilisierung* – **FMSA**) has been able to establish a bridge bank. It has been possible to transfer parts of the assets liabilities and legal relationships to such bridge bank by issuing a partial transfer order.

German law has so far no equivalent tool to the asset-management vehicle. While generally there has been an option to establish a bad bank (so-called bad bank model) or to transfer a bank's risk positions to an SPV (so-called SPV model), both models require an application being made by the bank and cannot unilaterally be ordered by the supervisory authority.

Side note: the bail-in tool (creditor participation)

The bail-in tool (creditor participation) allows for the participation of creditors by way of a regulatory debt-to-equity swap and (if this is insufficient), if applicable, a partial write-down of their claims. These provisions to a large extent replicate the provisions of the BRRD.

Various claims are exempt from bail-in, e.g. protected deposits and secured claims. Banks will be obliged to maintain a minimum amount of liabilities subject to bail-in. The bail-in tool should be implemented in Germany upon the entry into force of the new provisions on 1 January 2015, i.e. ahead of the 1 January 2016 implementation date required by the BRRD. The goal is to secure the financing of bank rescues primarily through the shareholders and creditors of a bank, i.e. not through public funds.

Reorganisation proceeding (*Reorganisationsverfahren*)

According to the current draft legislation, in addition to these resolution tools, the voluntary reorganisation proceeding established in 2011 will still apply. This proceeding can only be initiated upon application of the bank. It is similar to an insolvency plan proceeding (*Insolvenzplanverfahren*) and has so far never been used. The procedure is widely viewed as being unfit for purpose.

© Allen & Overy 2014

4. Levy-Based Financing (Resolution Fund)

The draft legislation also changes the statutory requirements for financing the rescuing of banks and establishes new responsibilities.

Further development and Europeanisation of the restructuring fund

Already today, a resolution fund financed by the banks can be accessed in Germany for the purposes of resolution. This restructuring fund (*Restrukturierungsfonds*) was set up in 2011.

The fund will be adjusted to reflect the BRRD, and will be integrated into a national resolution fund system of the Member States, which (can) mutually support one another and (can) share the burden of the resolution of a bank among affected Member States.

The "draft legislation on the ratification of the intergovernmental agreement of 21 May 2014" fosters the conversion of the national resolution fund to a single, European resolution fund (of the Eurozone[1], the Single Resolution Fund (**SRF**)). The converted, national resolution fund will initially remain in existence as a section of the SRF; however, even initially it will not provide complete ring-fencing of risks between Member States. Thus, while it is not planned to apply the funds of the individual compartments *pro rata* but primarily to use the funds of the affected compartments, all the other compartments may also be held liable – subject to waterfall provisions. Within eight years, this (partial) protection from liability will further recede, the compartments being subject to a progressive merger and ceasing to exist at the end of the transitional period.

Reconfiguration of the bank levy – exceptions for Sparkassen (savings banks) and Volksbanken (credit unions)

The bank levy that finances the SRF will also be reconfigured, with the goal *inter alia* of reaching the target level of 1% of the protected deposits (estimated EUR 55 billion) by the end of 2024 at the latest. Standard rules will apply for the calculation of fees. However, the amount of contributions can be adjusted with recourse to the risk profile of the affected bank. According to media reports, in this regard the Commission is now proposing in an internal paper significantly less-differentiated risk factors than were originally planned. It is thereby making concessions to France and Spain, because it fears that Spanish and French banks could be economically disadvantaged otherwise. Furthermore, in the internal paper, according to media reports, the Commission is also proposing to grant additional, tiered relief to smaller banks with a balance sheet total of less than EUR 300 million. This provision would particularly benefit (the German) Sparkassen and Volksbanken.

[1] And certain further states which have ratified the agreement.

© Allen & Overy 2014

Use of the restructuring fund only after the participation by the shareholders and creditors

In order to avoid the risk of an "early" intervention of the restructuring fund without the participation of the shareholders and creditors, the means of the restructuring fund shall be available to a bank in resolution only where the shareholders and creditors have "participated" in the bank's rescue achieving the absorption of losses and recapitalisation in an amount of at least 8% of the total liabilities including own funds. From a German legal perspective, this change leads to less-stringent requirements. Upon the introduction of the restructuring fund in 2011, the fund was *per se* prohibited from granting financial support to any bank in resolution. The provision for splitting a bank into a good and bad bank was therefore imposed as a precondition for recourse to the restructuring fund.

However, on the basis of the current draft legislation, it appears unclear in which specific cases the 8% blocking effect should apply. In light of the European legal situation, there is a need for clarification in this respect. The 8% rule shall generally prevent that – without the participation of creditors – other banks would together be liable for the difficulties of one bank and thereby create misguided incentives (in the EU). At the same time, however, the provision impedes the refinancing and recapitalisation of banks via the capital markets.

5. Shifting of Responsibilities

Due to the legislative package (and other parallel developments), BaFin will to a large extent be deprived of its supervisory powers.

The Europeanisation of the rescue of banks will involve a deprivation of powers for BaFin. It has been set for some time that, on 4 November 2014, the European Central Bank (**ECB**) will take over direct supervision of many German banks from BaFin. At the same time, based on the new proposals, BaFin will lose responsibility for bank resolutions to the FMSA, which, however, is supposed to be reintegrated into BaFin "at a later point in time."

However, in the long term, the responsibility for resolutions will only partially remain with the FMSA: the competence to decide on the resolution of a bank (along with the resolution planning) is expected to be transferred on 1 January 2016 to the yet-to-be established "Single Resolution Board" (the **Board**) – an agency of the European Union with independent legal status which will also administer the resources of the SRF. The transfer of the responsibilities and powers to the Board is a component of Regulation (EU) No 806/2014 on the creation of a Single Resolution Mechanism (SRM) (**SRM Regulation**). The SRM Regulation was published in the Official Journal of the European Union on 30 July 2014 and will in our opinion require to be reflected in the wording of the current draft.

Based on the SRM Regulation, the Board, from 2016 onward, will take on the decision-making power with regard to the resolution (i) of all banks under direct ECB supervision, (ii) all banks engaged in cross-border activities and (iii) such banks which receive/require funds from the European Stabilisation Mechanism (**ESM**). The decision of the Board will be binding within 24 hours. Prior to that, the Council may, at the proposal of the Commission, object to a Board decision. The European Parliament generally has no say in this respect.

From 2016 onward, the national resolution authority (in Germany the FMSA) will therefore largely only be responsible for implementing the decisions of the Board. If it does not follow the Board's decisions, the Board can apply the measures itself directly to the affected bank. Thereby, the FMSA will largely lose its planning function and will be reduced to a purely implementing resolution authority. The number of German banks which do not fall within the Board's

© Allen & Overy 2014

responsibility, are systemically important and for whom resolution planning will actually be in Germany is likely to be very limited.

Composition of and decision-making by the Board

The Single Resolution Board will comprise one chairman, four full-time members and the representatives of national resolution authorities. The national resolution authorities in this respect will remain involved in the decision-making process. However, they do not possess any veto right. Thus, for a decision on the resolution of a bank, a plenary session of the Board is generally necessary, if at least EUR 5 billion in capital of the SRF or EUR 10 billion as liquidity aid is to be provided. The decision shall be made by a simple majority, which must, however, represent at least 30% of the affected resources of the SRF. If additional contributions are to be levied to banks (*ex post contribution*), then, until the compartment is completely mutualised, this will require a two thirds majority which must represent at least 50% of the contributions to the SRF. After the eight-year period for the mutualisation of the compartments has expired, decisions will still require a two thirds majority, but this majority must represent only at least 30% of the contributions to the SRF.

6. Expansion of the Options for Extraordinary Financial Support from Public Funds

The legislative package adopted by the cabinet on 9 July 2014 further – on first view, surprisingly – extends the option for rescuing banks by using public funds.

Prolongation of the SoFFin

The current statutory provisions shall be amended so as to keep the Special Financial Market Stabilisation Fund (*Sonderfonds Finanzmarktstabilisierung* – **SoFFin**) fully operational – contrary to the current legal situation – through 2015. Since the use of the SoFFin for rescuing banks, being "extraordinary public financial support", would generally trigger a mandatory write-down of shareholders and holders of other instruments of ownership, this could make it more difficult to use the SoFFin in the current political environment. If necessary, however, it could be used e.g. to close any capital gaps in the context of a stress test, such as the one currently conducted as part of the Comprehensive Assessment. Thus, based on the new proposals, the mandatory participation of shareholders and holders of other instruments of ownership might not be necessary if, at the time of granting the state aid, the bank itself is not in financial distress but rather the entire national economy is in serious disarray. It remains to be seen how this exception will be applied.

Direct bank recapitalisation through the ESM

The SoFFin is expected to be replaced by the ESM in 2016. Thus, part of the legislative package includes the consent of the German legislator to the previously agreed introduction of the new ESM tool of direct bank recapitalisation. The combination of not only the resolution decision and the resolution fund but also the public financial resources seems logical. However, it leads to the possibility of Germany co-financing the rescuing of banks in the Eurozone from public funds through its contributions to the ESM.

© Allen & Overy 2014

Conclusion

The draft legislative package combines multiple measures directed at different focus areas. Whether the resultant joint liability and the transfer of responsibilities to the European Union level will contribute to the stability of the financial sector can hardly be predicted. However, in any event, having centralised procedures at the European Union level is more practical in its application than the coordination of national resolution authorities provided for in the BRRD.

Shareholders, creditors and the affected banks themselves must soon adapt to the changed framework conditions. From the perspective of the affected banks, this requires e.g. planning in regard to the requirement for "liabilities subject to bail-in" and the effects on own funds and their composition. Shareholders, bondholders and other creditors of banks should familiarise themselves with the new risks affecting them and, if necessary, consider adapting relevant contracts.

Contact Information

Dr. Bernd M. Geier
Counsel
Tel +49 69 2648 5965
bernd.geier@allenovery.com

Peter Hoegen
Partner
Tel +49 69 2648 5905
peter.hoegen@allenovery.com

Frank Herring
Partner
Tel +49 69 2648 5310
frank.herring@allenovery.com

Laura Druckenbrodt
Associate
Tel +49 69 2648 5373
laura.druckenbrodt@allenovery.com

© Allen & Overy 2014

© Allen & Overy 2014

FOR MORE INFORMATION, PLEASE CONTACT:

Düsseldorf

Allen & Overy LLP
Breite Straße 27
40213 Düsseldorf

Tel +49 211 2806 7000
Fax +49 211 2806 7800

Frankfurt

Allen & Overy LLP
Bockenheimer Landstraße 2
60306 Frankfurt am Main

Tel +49 69 2648 5000
Fax +49 69 2648 5800

Hamburg

Allen & Overy LLP
Kehrwieder 12
20457 Hamburg

Tel +49 40 82 221 20
Fax +49 40 82 221 2200

Mannheim

Allen & Overy LLP
Am Victoria-Turm 2
68163 Mannheim

Tel +49 621 3285 6300
Fax +49 621 3285 6400

Munich

Allen & Overy LLP
Maximilianstraße 35
80539 Munich

Tel +49 89 71043 3000
Fax +49 89 71043 3800

GLOBAL PRESENCE

Allen & Overy is an international legal practice with approximately 5,000 people, including some 526 partners, working in 44 offices worldwide. Allen & Overy LLP or an affiliated undertaking has an office in each of:

Abu Dhabi
Amsterdam
Antwerp
Athens (representative office)
Bangkok
Barcelona
Beijing
Belfast
Bratislava
Brussels
Bucharest (associated office)
Budapest
Casablanca
Doha
Dubai
Düsseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Istanbul
Jakarta (associated office)
London
Luxembourg
Madrid
Mannheim
Milan
Moscow
Munich
New York
Paris
Perth
Prague
Riyadh (associated office)
Rome
São Paulo
Shanghai
Singapore
Sydney
Tokyo
Warsaw
Washington, D.C.
Yangon

Allen & Overy means Allen & Overy LLP and/or its affiliated undertakings. The term **partner** is used to refer to a member of Allen & Overy LLP or an employee or consultant with equivalent standing and qualifications or an individual with equivalent status in one of Allen & Overy LLP's affiliated undertakings.

© Allen & Overy LLP 2014 I DP1407002-DOC68671 E