Overview

In November 2015, the German legislator passed the Resolution Mechanism Act (Abwicklungsmechanismusgesetz, AbwMechG). The law introduces, among other things, Section 46f (5) et seqq. of the German Banking Act (Kreditwesengesetz, KWG), which requires that claims under certain unsecured debt instruments be subordinated to general senior unsecured obligations in an insolvency proceeding involving a German bank.

As a result, in a resolution of a German bank, these unsecured debt instruments will be bailed-in prior to other senior unsecured liabilities (cf. Section 97 (1) sentence 3 of the German Act on Recovery and Resolution (Sanierungs- und Abwicklungsgesetz, SAG)). The provision will take effect on 1 January 2017 and apply to all insolvency proceedings opened after that date.

Mandatory subordination of certain unsecured debt instruments

The new Section 46f (5) KWG stipulates that, if a bank becomes insolvent (CRR credit institution), claims under certain unsecured debt instruments will be subordinated to general senior unsecured liabilities. The instruments involved are defined in a new paragraph (6) of Section 46f KWG. They include bearer bonds (Inhaberschuldverschreibungen), order bonds (Ordnerschuldverschreibungen) and similar rights which, by their nature, are tradable in the capital markets. They also include promissory note loans (Schuldscheindarlehen) and registered bonds (Namensschuldverschreibungen), as long as they do not qualify as covered or eligible deposits under Section 46f (4) KWG. However money market instruments (Geldmarktinstrumente) within the meaning of Section 1 (11) sentence 2 KWG are excluded. Section 46f (6) KWG also clarifies that the new subordination does not apply to debt instruments under Sec. 91 (2) SAG, which are generally exempted from bail-in.

If a German bank becomes insolvent, this mandatory subordination means the creditors concerned will bear losses prior to others whose claims currently rank pari passu. In the context of a resolution, the bail-in tool will be applied to these unsecured debt instruments before other senior unsecured liabilities. This is the main purpose of the subordination stipulated by Section 46f (5) KWG.

In substance, the new Section 46f (5) in conjunction with (6) KWG will split the currently heterogeneous class of senior unsecured debt and create a new layer of tradable senior unsecured debt, which will serve as a reliable source of loss-absorbing liabilities along with regulatory capital. The subordination is designed to facilitate the application of resolution measures as the bail-in of the debt instruments can be enforced in a legally certain manner and carries a low risk of contagion.

In its Opinion of 2 September 2015 on bank resolution (CON/2015/31 – ECB Opinion), the European Central Bank (ECB) shared the German legislator's view that the new mandatory subordination should enhance the implementation of the bail-in tool.
TLAC and MREL

The new Section 46f (5) KWG is particularly relevant in light of the Financial Stability Board’s (FSB) Principles and Term Sheet on the Total Loss Absorbency Capacity (TLAC) of global systemically important banks, published on 9 November 2015 (TLAC Principles / TLAC Term Sheet). With regard to the instruments eligible for inclusion in TLAC, the Principles exclude certain liabilities (eg any liability that is callable on demand without supervisory approval, or liabilities from derivatives or debt instruments with derivative-linked features, such as structured notes) and requires that eligible instruments absorb losses prior to the excluded liabilities in insolvency or resolution. To ensure this happens, the eligible instruments must principally be either contractually subordinated or junior in the statutory creditor hierarchy to all excluded liabilities on the institution’s balance sheet (cf. TLAC Principle (vii) and TLAC Term Sheet Section 11). Section 46f (5) KWG stipulates the subordination of certain debt instruments in the statutory creditor hierarchy and, thus, might be viewed as a first step in creating, on a statutory basis, instruments eligible for TLAC.

This view is shared by the ECB. The ECB Opinion states that Section 46f (5) KWG ‘introduces a legal feature (statutory subordination) to make existing debt instruments TLAC-eligible, without the need for any action by the issuer’. This gives German banks an advantage as they can use some of their existing debt instruments to meet the TLAC requirements without needing to issue a larger volume of contractually subordinated debt.

Moreover, mandatory subordination might become relevant for all banks that need to meet the minimum requirement for own funds and eligible liabilities (MREL) set by the competent resolution authority. Pursuant to Section 53 (1) SAG (which remains unchanged by the new AbwMechG), the decision on the MREL with regard to an individual institution or group may provide that the MREL is partially met through contractual bail-in instruments. In order to qualify, the instrument will be subject to a binding subordination agreement, under which, in the event of normal insolvency proceedings, it ranks below other eligible liabilities (cf. Section 53 (2) no. 2 SAG). Whether and to what extent the MREL has to be met through contractual bail-in instruments is for the competent resolution authority to decide. From the perspective of the resolution authority and in line with the ECB’s Opinion, there should be good reasons to argue that there is less need to require contractual bail-in instruments where the feasibility of the bail-in tool is strengthened by the creation of a new distinct layer of senior unsecured debt to which the bail-in tool is applied in priority to the remaining (heterogeneous) pool of senior unsecured debt.

Debt instruments exempted from subordination

Pursuant to the new Section 46f (7) KWG, the subordination does not apply to debt instruments for which it has been agreed that: (i) the repayment claim or the amount of the repayment claim will be subject to the occurrence or non-occurrence of an event uncertain at the time of the issuance of the debt instrument, or the claim will be fulfilled by other means than cash payment; or (ii) the interest payment or the amount of the interest payment will be subject to the occurrence or non-occurrence of an event uncertain at the time of the issuance of the debt instrument, unless the interest payment or the amount of the interest payment is subject exclusively to a fixed or variable reference rate and performance is effected by cash payment.

As a result, derivatives (in securitised form), including structured bonds with embedded derivatives, are in principle exempted from mandatory subordination in an attempt to avoid practical difficulties, particularly around the valuation that might arise in the event of a bail-in. Consequently, where there is a mere link between the interest rate and a reference rate which does not raise such valuation difficulties, the bonds are not exempted from subordination.

European law

The subordination of unsecured debt instruments for the purpose of differentiating, in case of a bail-in, these instruments from other senior unsecured liabilities needs to be assessed against Directive 2014/59/EU, which establishes a framework for the recovery and resolution of credit institutions and investment firms (BRRD). The Directive states that creditors of the same class should be treated equally (Article 34 (1) (f) BRRD) and that the bail-in tool is applied to eligible
liabilities in accordance with the hierarchy of claims in normal insolvency proceedings (Article 48 (1) (d) and (e) BRRD). In this context, it should be noted that the new Section 46f (5) KWG does not directly intervene in the order in which the bail-in tool is applied, but only governs the ranking of claims in an insolvency proceeding. In line with Article 10 (2) (h) of Directive 2001/24/EC on the reorganisation and winding up of credit institutions, this is subject to the determination by the law of the home Member State of a credit institution.

German constitutional law

The explanatory note to the draft law explains in detail that the subordination pursuant to Section 46f (5) KWG is required to avoid any systemic risks in the context of a resolution by facilitating a potential bail-in and therefore ultimately for the averting of risks for financial stability. This is certainly a legitimate rationale for the provision from the perspective of German constitutional law, in particular the right to property guaranteed by Article 14 of the German Constitution (Grundgesetz, GG).

The explanatory note further convincingly explains that the mere fact the law also affects existing instruments does not result in a violation of Art. 14 GG. The retroactive effect of a law concerning situations which have not yet been completed (unechte Rückwirkung) can be justified under German constitutional law provided there are public interests that prevail over the legitimate expectations of the persons concerned.

Debt instruments governed by the laws of a foreign jurisdiction

The new provision does not specify whether it applies to debt instruments governed by the laws of a foreign jurisdiction. Section 46f (5) KWG governs the ranking of particular claims in an insolvency proceeding of a CRR credit institution. With regard to insolvency proceedings, the principle of universality (Universalitätsprinzip) applies, ie insolvency proceedings generally extend to all assets of the insolvent entity, including those outside Germany or subject to the laws of a foreign jurisdiction. However, whether the effects of national insolvency proceedings are also recognised in foreign countries (outside the EU) is subject to the applicable foreign laws.

Whether Section 46f (5) KWG applies to debt instruments governed by the laws of a foreign jurisdiction during a bail-in is part of a wider question concerning the application of the bail-in tool to liabilities governed by the law of a third country which is not ultimately resolved. In view of liabilities eligible for bail-in (berücksichtigungsfähige Verbindlichkeiten) established on or after 1 January 2015, Section 55 (1) SAG needs to be considered. This provision requires institutions to include a contractual term by which the creditor or party to the agreement creating the eligible liability recognises that the liability may be subject to the write-down and conversion powers, provided that such liability is governed by the law of a third country. The ECB Opinion does not provide further guidance on this matter but points out the uncertainty connected with debt instruments lacking the required contractual term.

In the context of this discussion it should also be considered that German insolvency law contains a rule that effectively treats creditors unequally in cross-border insolvency proceedings (outside the EU) in order to respect insolvency regimes of foreign jurisdictions. Section 342 (2) sentence 1 of the German Insolvency Code (Insolvenzordnung, InsO) stipulates that an insolvency creditor may keep what he has obtained in insolvency proceedings initiated in another state. With regard to credit institutions, this provision may be relevant in case of insolvency proceedings relating to a foreign branch outside the EU.

Eligibility as ECB Collateral

Early during the legislative procedure the question arose whether unsecured debt instruments mandatorily subordinated by the new Section 46f (5) KWG would be eligible as ECB collateral under the Collateral Framework (Guideline of the European Central Bank of 19 December 2014 on monetary policy instruments and procedures of the Eurosystem, ECB/2014/60). In its Opinion of 2 September 2015, the ECB clarified that "bank debt instruments subject to a statutory subordination of the kind proposed in the draft law would currently no longer be
eligible as collateral for Eurosystem credit operations’. The ECB predicated its view on Article 64 of the Collateral Framework which stipulates that 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.

It remains to be seen whether the ECB will adapt the Collateral Framework at a later stage to address this issue.

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