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ALERT MEMORANDUM

BaFin and FMSA Issue Guidance on Ranking of Bank Bonds in Insolvency

August 9, 2016

On November 6, 2015, the German Resolution Mechanism Act (*Abwicklungsmechanismusgesetz* – "Act") entered into force.[1] Among other things, the Act modified the ranking in insolvency of certain senior unsecured debt instruments (*Schuldtitel* – "Debt Instruments") issued by German banks. The reason behind the modification which will apply from January 1, 2017 was to facilitate the application of the bail-in tool introduced by the Bank Recovery and Resolution Directive, or BRRD (Directive 2014/59/EU), to Debt Instruments without the risk of violating the no-creditor-worse-off principle.[2] On August 5, 2016, the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – "BaFin") and the Federal Agency for Financial Market Stabilization (*Bundesanstalt für Finanzmarktstabilisierung* – "FMSA") issued joint interpretive guidance with respect to the relevant provisions of the Act ("Guidance").[3] The Guidance provides helpful clarification regarding the ranking of certain types of bank debt.

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[1] See our previous alert memorandum "Beyond Bail-in" on the draft bill of the Act published on April 30, 2015.
[2] See article 34(1)(g) BRRD, according to which *"no creditor shall incur greater losses than would have been incurred if the institution or entity ... had been wound up under normal insolvency proceedings."*
[3] BaFin and FMSA, Joint interpretative guidance on the treatment of certain liabilities of CRR institutions pursuant to Sec. 46f(5) to (7) of the German Banking Act (*Gemeinsame Auslegungshilfe zur insolvenzrechtlichen Behandlung bestimmter Verbindlichkeiten von CRR-Instituten nach § 46f Abs. 5 – 7 KWG n.F.*), August 5, 2016.

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I. The Resolution Mechanism Act and the Modified Ranking of Bank Bonds

Captured Debt Instruments. Pursuant to the Act, within the class of senior unsecured debt, any senior unsecured debt *other than Debt Instruments* ranks senior to Debt Instruments in an insolvency of the issuer. Hence, the Act established a priority regime whereby Debt Instruments would rank junior to all other outstanding unsecured unsubordinated obligations, while ranking senior to contractually or statutorily subordinated debt. Debt Instruments comprise bearer bonds (*Inhaberschuldverschreibungen*), negotiable registered bonds (*Orderschuldverschreibungen*) and similar 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.

Exempted instruments and products. The Act exempts certain bank debt, including money market instruments and "Structured Products", from the definition of Debt Instruments. Bank debt so exempted ranks senior to Debt Instruments. Structured Products are defined as financial instruments (i) the repayment (or the repayment amount) of which depends on the occurrence or non-occurrence of an event which is uncertain at the time of their issuance or which are not repayable in cash or (ii) the payment of interest (or the interest amount payable) on which depends on the occurrence or non-occurrence of an event uncertain at the time of their issuance, except that applicable interest rates or interest amounts tied to a fixed or floating reference interest rate and payable in cash are not sufficient to qualify bank debt as Structured Products.

II. Joint BaFin and FMSA Guidance

The Guidance specifies the instruments and products falling under the above-mentioned exemption and, thus, ranking senior to Debt Instruments as follows:

Exemption for money market instruments. In line with general market practice, the Guidance describes money market instruments as claims of a kind that are typically traded on the money market (with the exception of payment instruments) and that provide for a maximum term of 12 months. Pursuant to the Guidance, the term of an instrument is determined based on its *initial term* rather than its residual term in the case of instruments with an initial term of more than 12 months.

Exemption for Structured Products. The Guidance distinguishes between products that feature certain structured elements but are not captured by the exemption, *i.e.,* constitute Debt Instruments (see 1) below), and products that fall under the exemption, *i.e.*, do not constitute Debt Instruments (see 2) below).

1) Products that constitute Debt Instruments

   Although providing for certain structured elements, the following products are not exempted from the scope of the definition of Debt Instruments:

- Fixed rate (including 0% interest) and zero coupon instruments
- Floating rate instruments
  - Payable interest is linked to the performance of a "common and straightforward" reference interest rate such as EURIBOR, EONIA or LIBOR (but not, *e.g.*, Constant Maturity Swap ("CMS")). This includes cases where the terms and conditions of the instrument ("Ts&Cs") provide for (i) the addition of a spread or factor to the reference interest rate, (ii) an explicit or implicit 0% floor, or (iii) an inverse relationship of the applicable interest rate and the reference interest rate (inverse floater)
  - See 2) below for certain floating rate instruments qualifying as Structured Products
- Instruments with a schedule of pre-defined interest rates/amounts over the term of the instrument

    This applies irrespective of whether the interest rates/amounts are

expressed as percentage points or nominal amounts

- Foreign currency instruments
  - Repayment and interest rate must be "certain and evaluable"
  - See 2) below for certain foreign currency instruments qualifying as Structured Products
- Instruments providing for put *or* call rights
- Instruments providing for a combination of one or more of the above elements over the term of the instrument
  - *E.g.,* first year: floating rate linked to EURIBOR, second year: certain pre-defined interest amount
  - Ts&Cs must not provide for additional element of uncertainty (such as, *e.g.*, option right of creditor or debtor)

2) <u>Products that do not constitute Debt Instruments</u>

The following products qualify as Structured Products and are, thus, exempted from the scope of the definition of Debt Instruments:

- Instruments the repayment amount of which or interest payable on which is based on a derivative instrument
- Indexed products

  Payment of principal or interest is linked to the performance of an index (*e.g.*, inflation-linked bonds or stock exchange index-linked bonds)
- Floating rate instruments
  - Instrument entails an additional structured element, *e.g.*,

    the interest payable is subject to one or more of the following features: floor (presumably other than 0% floor, see under 1) above), cap or collar.
  - Interest payable is linked to the performance of an *alternative* reference interest rate, such as CMS.
- Foreign currency instruments

  Instruments denominated in a currency different from the repayment and/or interest coupon currency and the repayment amount and/or interest amounts are calculated based on a future currency exchange rate.
- Instruments providing for an option right of the creditor or the debtor with respect to the applicable interest coupon
- Instruments providing for a combination of elements under 1) and 2) above over the term of the instrument

III. Outlook

The Guidance clarifies a number of questions regarding the ranking of certain bank debt under the Act and, ultimately, under the BRRD. Pursuant to media reports, however, the European Commission is currently reviewing the different concepts regarding the ranking of bank debt adopted by EU Member States for the purpose of facilitating the application of the bail-in tool. As a result of such review, the BRRD may be amended implementing a concept for the ranking of bank debt different from that reflected in the Act.[4] Hence, while helpful for the application of the Act, in the medium term, the Act and the Guidance may be superseded by revisions to the BRRD which would have to be implemented into German law.

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[4] Pursuant to media reports, the European Commission favors the "French concept" which is based on a new class of (contractually) „sub-senior" or "non-preferred senior" debt. The French concept avoids re-classifying outstanding senior unsecured debt but rather requires the issuance of a new class of „sub-senior" or "non-preferred senior" debt going forward.