Beyond Bail-in -

German and Italian Proposals Affecting Bondholder Rights

I. Introduction

Both Germany and Italy have brought forward legislative proposals that are of interest to market participants in connection with the application of the bail-in tool under the Bank Recovery and Resolution Directive, or BRRD, and the proposals of the Financial Stability Board ("**FSB**"), as currently under discussion, to introduce the so-called "total loss absorbing capacity" ("**TLAC**") for global systemically important banks ("**G-SIBs**").

In Germany, where the BRRD has already been implemented and has become effective since 1 January 2015 (including the bail-in tool), the legislature proposes to subordinate bank bonds in insolvency. In Italy, in contrast, the legislature has proposed, in connection with the implementation of the BRRD, to make deposits that are not covered by the statutory deposit protection "super senior." In doing so, both proposals amend the waterfall in insolvency, going beyond BRRD requirements into the territory of insolvency law, an area in which harmonization at EU level is limited. Also note that, although TLAC will apply to G-SIBs only, both German and Italian proposed rules would apply to all banks.

II. The German Approach

1. Bank Bonds Subordinated by Operation of Law

In order to make the changes necessary to conform German law with Regulation No. 806/2014 on the establishment of a Single Resolution Mechanism and a Single Resolution Fund (the "**SRM Regulation**"), the German Federal Government on 30 April 2015 published a draft bill of the so-called Resolution Mechanism Act (*Abwicklungsmechanismusgesetz*) (the "**Draft Bill**").[1] The Draft Bill, however, in certain respects goes beyond adapting German law to the SRM Regulation and also BRRD requirements.

In particular, the Draft Bill provides for the statutory subordination of certain senior unsecured debt instruments issued by German CRR institutions (*i.e.*, CRR credit institutions and CRR investment firms) (the "**Relevant Debt Instruments**"). According to the proposed new sections 46f(5) through (8) of the German Banking Act (*Kreditwesengesetz*), Relevant Debt Instruments are by operation of law subordinated in insolvency to other unsecured bank debt. Relevant Debt Instruments, however, would continue to rank senior to any debt that is otherwise statutorily or contractually subordinated. The statutory subordination applies to

[1] http://dip21.bundestag.de/dip21/btd/18/050/1805009.pdf

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bearer bonds (*Inhaberschuldverschreibungen*), 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. In contrast, the statutory subordination does not apply to money market instruments and structured products such as derivatives. Structured products have been excluded from the proposed statutory subordination because, in a resolution scenario, their valuation might be practically difficult and, consequently, their bail-in fraught with uncertainty. Thus, the expectation of market participants and the Federal Government was that such structured products are likely to be excluded from the application of the bail-in tool on a case-by-case basis pursuant to the German rules implementing article 44(4) BRRD.

The main reason for the proposed subordination of Relevant Debt Instruments according to the legislative materials is to facilitate the application of the bail-in tool by creating a class of eligible liabilities that can be easily and quickly determined because such liabilities are neither complex nor related to critical functions or core business lines. Pursuant to the legislative materials, the bail-in of the Relevant Debt Instruments would be legally secure due to their statutory subordination and bear only little risk of contagion for the stability of the financial markets (as opposed to, *e.g.*, trying to bail-in structured products). Moreover, the proposed subordination of the Relevant Debt Instruments would practically eliminate the risk of potential violations of the "no creditor worse off"-principle,[2] while simultaneously creating a potentially large loss-absorbing base of liabilities.

2. <u>TLAC Eligibility of Relevant Debt Instruments</u>

As acknowledged by the ECB in its opinion on the Draft Bill (the "**ECB Opinion**"),[3] "*under the draft law, German banks will be able to use some of their already-issued debt instruments to meet the TLAC requirements as the statutory subordination applies to existing senior unsecured bank debt instruments*." Accordingly, the proposed statutory subordination might facilitate the implementation of the proposals by the FSB as currently under discussion, regarding the TLAC for G-SIBs without the need, or reducing the need, for G-SIBs to issue new (subordinated) debt. Pursuant to the FSB's proposals, to be eligible for TLAC, debt instruments are required to be contractually, statutorily or structurally subordinated to operational liabilities.[4]

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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 https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2015_31_f_sign.pdf

4 While debt instruments to be eligible for purposes of the "minimum requirement for own funds and eligible liabilities" requirement (MREL) under BRRD do not need to be subordinated, the proposed subordination of Relevant Debt Instruments would as a practical matter facilitate their inclusion in eligible liabilities as a class of debt ranking junior to other debt that may be bailed in, *see* also II.1 above.

3. Eligibility as Collateral for Eurosystem Credit Operations

One of the downsides, as noted by market participants and the ECB, is that Relevant Debt Instruments would as a result of their statutory subordination not be eligible as collateral for Eurosystem credit operations. The statutory subordination would conflict with article 64 of the ECB guideline on the implementation of the Eurosystem monetary policy framework ("**ECB Guidelines**"),[5] which requires that eligible debt instruments shall not give rise to rights to the principal or the interest that are subordinated to the rights of holders of other debt instruments of the same issuer. While the German Central Bank (*Deutsche Bundesbank*) viewed such potential non-eligibility as "unproblematic" from a monetary policy perspective, market participants have voiced strong concerns in this respect. Accordingly, pursuant to recent media coverage, the German legislature is planning to revise the Draft Bill such that Relevant Debt Instruments continue to be eligible as collateral for Eurosystem credit operations. One possible solution would be to treat any other senior unsecured debt preferential to Relevant Debt Instruments, which would be similar to the Italian approach discussed below and was suggested by market participants.[6]

4. Consequences for Bank Funding

The proposed statutory subordination of Relevant Debt Instruments might also have adverse impacts on the ratings of Relevant Debt Instruments and, consequently, on the funding of the operations of German banks leaving them disadvantaged *vis-à-vis* their European and overseas competitors, as stated by the ECB and market participants. Given that certain types of investors such as insurance companies and investment funds are bound by strict investment guidelines, the statutorily subordinated Relevant Debt Instruments may no longer or to a lesser extent be eligible for certain investors. This may reduce the potential investor base for Relevant Debt Instruments and, consequently, raise the financing cost of banks.

5. Protection of the Right of Property

Finally, the statutory subordination proposed in the Draft Bill raises the question whether it is in conformity with the right to property as guaranteed in the German Basic Law (*Grundgesetz*), the Charter of Fundamental Rights of the European Union ("**CFEU**") and the 1st Additional Protocol to the European Convention of Human Rights ("**ECHR**"). According to the Draft Bill, the subordination would also apply to any Relevant Debt Instruments already outstanding. Such retroactive effect, given the adverse impact of the statutory subordination on the value of such outstanding Relevant Debt Instruments, has been considered as a violation of the right to property and, more specifically, the prohibition on retroactivity (*Rückwirkungsverbot*). However, this is far from clear. While a creditor position is generally protected by the right to property, the present case involves an interference by a public authority

[5] http://www.ecb.europa.eu/ecb/legal/1002/1014/html/index-tabs.en.html

[6] This was suggested, amongst others, by the umbrella association of the various German banking associations, Written Statement of *Deutsche Kreditwirtschaft*, p. 19.

into an ongoing process which does, pursuant to constitutional doctrine, not result in retroactivity within the stricter sense (*unechte Rückwirkung*). Rather, such interference into an ongoing process, pursuant to case law, is generally permissible. This was confirmed in 2014, when the Federal Court of Justice (*Bundesgerichtshof*) held that the German legislature, by way of a change to the German Bond Act (*Schuldverschreibungsgesetz*), may incorporate collective action clauses into the terms and conditions of bonds including bonds outstanding at that time.[7]

III. The Italian Approach

1. BRRD Implementation and "super seniority" of other unsecured bank debt

On 10 September 2015, the Italian Government approved the text of two Legislative Decrees aimed at implementing the BRRD in Italy.[8]

The Italian implementation of the BRRD generally mirrors the text of the directive. However, with respect to the implementation of article 108, it went one step further, although choosing a different path from that proposed in the German Draft Bill. Rather than providing for the statutory subordination of senior unsecured bank debt, the Italian rules modify the creditors' hierarchy in bank insolvency proceedings (*liquidazione coatta amministrativa*) making "other deposits" (*i.e.*, deposits that are not covered by article 108 BRRD) senior to other unsecured debt of the bank.

It appears that the rationale behind the new provision lies in the lower risk profile undertaken by depositors *vis-à-vis* that undertaken by investors in bank debt and by counterparties in derivatives. In case of insolvency, other deposits (including those held by corporate clients) shall rank senior to other unsecured debt, right after covered deposits, deposit guarantee schemes, and the part of individuals' and SME's eligible deposits exceeding EUR 100,000, which all benefit from the preferential treatment under article 108 BRRD.[9] The

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7 Federal Court of Justice, Judgment of July 1, 2014, II ZR 381/13.

8 While the first decree (the "**Resolution Decree**") is aimed at implementing mostly the BRRD provisions on resolution, the second decree (the "**Amending Decree**" and together with the Resolution Decree, the "**Decrees**") amends relevant provisions of the Italian Banking Act (Legislative Decree No. 385 of 1 September 1993) and the Italian Securities Market Law (Legislative Decree No. 58 of 24 February 1998). At the date of this memorandum, the text of the Decrees approved by the Government was not yet publicly available. The analysis of relevant provisions of the Decrees presented herein is therefore based on the latest draft of the Decrees that was available to us at the date of this memorandum. Although we do not expect that such texts will differ from the final texts of the Decrees in any material respect, we cannot exclude that the final texts of the Decrees will include changes to provisions of the Decrees that may be relevant for the analysis presented herein. The most recent drafts of the Decrees publicly available may be found at http://www.dt.tesoro.it/it/consultazioni_pubbliche/consultazioni_pubbliche_online_storico/consultazione_pubblica_dirett_2014_59_ue.html

9 *See* article 91(1-*bis*) of the Italian Banking Act as proposed by the Amending Decree: "*By derogation to article 2741 of the Italian Civil Code and article 111 of the Bankruptcy Act, in distributing the assets liquidated pursuant to paragraph 1 above:*

a) *the following creditors rank senior to other unsecured creditors: 1) the part of individuals, microenterprises, small and medium enterprises' deposits eligible for reimbursement and above the amount provided for under article 96-*bis*(5); 2) the deposits under 1) above, at non-EU branches of banks incorporated in Italy;*

ranking of certain unsecured debt below "other deposits" should also facilitate the bail-in of such unsecured debt as it makes easier to comply with the "no creditor worse off"-principle.

2. TLAC Eligibility of G-SIBs' Senior Unsecured Debt

It is likely that the new provision was drafted taking into account the discussions on the TLAC currently pending at the FSB, and the German draft rules implementing the BRRD, summarized above. Indeed, the draft Italian rules on creditors' hierarchy in insolvency proceedings may facilitate the application of the bail-in tool with respect to banks' senior unsecured debt and, thus, help compliance with the upcoming TLAC requirement, since banks' senior unsecured debt will be more likely to be TLAC eligible as it would not rank *pari passu* with deposits that may be considered "excluded liabilities" (*i.e.*, liabilities that cannot be included in the external TLAC requirement) at least to the extent they are callable on demand.

However, the Italian approach - unlike the German - seems to fall short from making senior unsecured debt issued by Italian G-SIBs (which, as of today, consists only of Unicredit) automatically eligible under the TLAC requirements (as they currently stand). Indeed, although subordinated to deposits, senior unsecured debt would still rank *pari passu* with other excluded liabilities under point 12 of the FSB TLAC term sheet of 10 November 2014 (*e.g.*, liabilities arising from derivatives or structured notes). Therefore, further contractual or structural subordination would likely be needed for an Italian GSIB to issue senior unsecured debt that qualifies for TLAC purposes.

The need of such further subordination may have been subject to consideration in the drafting of the Decrees. However, the choice to revise the ranking of claims in insolvency rather than providing for a statutory subordination was probably suggested, among other things, by the fact that TLAC requirements are not yet defined. They may change as a result of the discussions currently pending at the FSB level on the eligibility of certain instruments, such as structured notes, as well as of the outcome of the quantitative impact study by the FSB. The choice to subordinate senior unsecured debt to other bank liabilities might have proved overreaching in light of what will be the final content of TLAC requirements.

3. Impact on MREL Requirement

It is unclear whether the priority in insolvency accorded to "other deposits" may have an impact on the eligibility of such deposits to meet the MREL requirement applicable to the bank. Under the Decrees, the Bank of Italy (which has been designated as the Italian resolution authority and is also the supervisory authority for Italian less-significant banks that are not subject to the ECB's direct supervision under the single supervisory mechanism) is required

b) *the following rank senior to the creditors indicated under a) above: 1) covered deposits; 2) credits by the deposit guarantee schemes subrogated to the rights and obligations of covered depositors;*

c) *other depositors at the bank rank senior to other unsecured creditors, but junior to creditors under letters a) and b) above.*"

to identify the MREL requirement applicable to Italian banks, as well as the requirements that liabilities need to meet to be MREL-eligible.

4. Eligibility as Collateral for Eurosystem Credit Operations

Since the Decrees provide merely that deposits rank senior to other unsecured debt in insolvency (rather than certain unsecured debt is subordinated to other unsecured debt instruments of the bank), senior unsecured debt issued by Italian banks should still be eligible as collateral for Eurosystem credit operations (unlike senior unsecured debt issued by German CRR Institutions if the subordination rules were enacted as proposed, as noted in the ECB Opinion).

5. Consequences on Bank Funding

The priority of other deposits in insolvency may have an impact on the pricing and ratings of Italian banks' senior unsecured debt. However, such impact should be lighter than the effects on German banks cost of funding of the proposed German statutory subordination. Indeed, as noted in the ECB Opinion, the German subordination regime may have an impact on (a) pricing and capital requirements for institutions holding other banks' senior unsecured debt; (b) investment mandates; and (c) relevant ratings and, thus, refinancing costs for issuers.

6. Protection of the Right to Property

Another consideration that may have suggested the choice of a revision of the insolvency ranking over the provision of an express statutory subordination may relate to issues relating to the conformity of such subordination with creditors' property rights. Article 1 ECHR and article 17 CFEU, as well as article 42 of the Italian Constitution ("**Constitution**") protect the right to property (including all pecuniary rights assigned to the individual in her/his private interest and as an exclusive entitlement) from sovereign interferences. Although challenges on the basis of an alleged breach of property rights cannot be ruled out, the risk that the proposed changes to insolvency ranking are deemed a violation of rights protected under the aforementioned provisions of the ECHR, CFEU and the Constitution should be less significant than the risk that would have resulted by a statutory subordination similar to that proposed by the German Draft Bill.

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