

Recovery and Resolution of Banks – German Legislative Developments

In December 2012, the German Federal Ministry of Finance (*Bundesministerium für Finanzen*) started a consultation among market participants regarding the initial Draft Bill on Recovery and Resolution Planning for Credit Institutions and Banking Groups (*Entwurf eines Gesetzes zur Sanierungs- und Abwicklungsplanung von Kreditinstituten und Finanzgruppen*) (the “Draft Bill”). The Draft Bill deals with recovery plans and resolution planning for banks and banking groups. The introduction of a requirement to prepare recovery plans and resolution plans forms part of a series of regulatory measures intended to reduce the risk that in the event of a crisis systemically important financial institutions have to be bailed out by the government using taxpayers’ money, thus addressing the “too big to fail” problem. The Draft Bill is modeled on the requirements applicable to recovery plans and resolution planning set forth in the “Key Attributes of Effective Resolution Regimes for Financial Institutions” published by the Financial Stability Board on November 4, 2011,¹ and preempts in part the implementation into German law of the European directive establishing a framework for the recovery and resolution of credit institutions and investment firms (“RRD”), a draft of which was published by the European Commission on June 6, 2012.²

The Draft Bill is not the only regulatory initiative in Germany dealing with recovery plans. Already in November 2012, the German banking regulator *BaFin* (*Bundesanstalt für Finanzdienstleistungsaufsicht*) published its draft release on Minimum Requirements for Recovery Plans (*Mindestanforderungen an die Ausgestaltung von Sanierungsplänen*) (the “Draft Release”). The recovery plan requirement provided for in the Draft Release is based on the general requirement to maintain an adequate risk management system and would apply only to banks of systemic importance in Germany.³ It is currently unclear whether *BaFin* will finalize the Draft Release and how exactly it will fit into the framework of the Draft Bill.

¹ http://www.financialstabilityboard.org/publications/r_111104cc.pdf. In the meantime, the European Parliament’s Economic and Monetary Affairs Committee published a vast number of proposed amendments to the draft RRD. See <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+PE-502.084+02+DOC+PDF+V0//EN&language=EN>. On January 13, 2013, the Council of the European Union published a compromise proposal which is dated November 15, 2012. See <http://register.consilium.europa.eu/pdf/en/12/st16/st16258.en12.pdf>.

² http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm.

³ See our Alert Memorandum of November 2012 on the Draft Release. http://www.cgsh.com/ba_fin_starts_consultation_on_recovery_plans_for_banks/

Overview

The Draft Bill deals with the preparation, annual update and content of recovery plans and resolution plans of banks and banking groups which are of systemic importance in Germany or globally. Although not expressly set out in the Draft Bill, in line with the general principles on the territorial application of German law, a bank of “global” systemic importance will only become subject to the German recovery and resolution planning requirement if it has at least business activities in Germany. The Draft Bill leaves open the question of whether it will apply to (German) banks which are members of a non-German banking group that is of global systemic importance if the German bank is not of systemic importance for the German market.

“Recovery plans” within the meaning of the Draft Bill are plans setting out measures which enable a bank to take early action to restore its long-term viability in a situation of financial distress. The requirement to adopt a recovery plan, which includes potential recovery measures to address a situation of financial distress, is intended to strengthen a bank’s resilience in the case of crisis.

The Draft Bill further provides for the establishment of a special unit (the “Resolution Unit”) within *BaFin* which, in consultation with the German Federal Agency for Financial Market Stabilization (*Bundesanstalt für Finanzmarktstabilisierung*), will be responsible for resolution planning. According to the Draft Bill, “resolution planning” comprises the preparation and annual update by the Resolution Unit (rather than the relevant banks) of resolution plans for banks which are of systemic importance in Germany or globally. In addition, the Resolution Unit must assess continuously, but at least annually, whether it will be possible to resolve such banks in general insolvency proceedings or utilizing the special tools provided for in the German Banking Act (*Kreditwesengesetz*). According to the Draft Bill, such special tools comprise, in particular, *BaFin*’s power to dissolve banks as a result of a so-called transfer order. Transfer orders are orders requesting the transfer of a distressed bank’s viable business to another bank including a bridge bank for the purpose of dissolving the failing bank. In our view, the power to issue a transfer order is the only special “resolution tool” currently available under the German Banking Act. Therefore, in this memorandum we refer to the issuance of transfer orders where the Draft Bill talks more broadly about special resolution tools. Finally, the Resolution Unit may request the timely removal of impediments to a bank’s or banking group’s resolution.

What institutions are affected?

Only banks of systemic importance at least for the German financial market will be subject to the recovery plan requirement and resolution planning by the Resolution Unit. *BaFin*, in consultation with *Deutsche Bundesbank* will identify, on a case by case basis, what banks are considered as systemically important within the meaning of the Draft Bill. According to the legislative materials accompanying the Draft Bill, any bank which cannot

be resolved as a result of a transfer order pursuant to the German Banking Act without the use of substantial funds from the German Restructuring Fund (*Restrukturierungsfonds*)⁴, constitutes a systemically important bank. According to press reports published at the time of the publication of the Draft Release, in more “normal” financial markets conditions, *BaFin* would consider about 15 German banks (including subsidiaries of non-German financial institutions) as systemically important for the German financial market. In the current environment, however, the number is higher, and according to the press, Deutsche Bank, Commerzbank, at least the major Landesbanken, and UniCredit Bank are among the group of banks which are of systemic importance for the German market.

The recovery and resolution planning requirement also applies to banking groups subject to consolidated supervision by *BaFin*. As far as recovery plans are concerned, the bank which is the parent company of the group will be responsible for the preparation of a single recovery plan on a consolidated basis, and no stand-alone recovery plans would be prepared for the parent company or any other systemically important bank within the banking group. The consolidated recovery plan must include all group companies and branches irrespective of whether they are of systemic importance on a stand-alone basis. The Draft Bill does not provide for any specific rules applicable to the preparation of recovery plans by systemically important banks which are members of non-German banking groups. This raises the question of whether and how a recovery plan for a relevant German bank can be harmonized with non-German group recovery plan requirements where the German bank is a member of a non-German banking group.

As far as resolution plans are concerned, in the case of a German banking group, the Resolution Unit will prepare a single resolution plan for the banking group only; resolution plans for group companies on a stand-alone basis are not required. In addition, the Resolution Unit will assess the banking group’s resolvability. In contrast to the recovery plan requirement, the Draft Bill explicitly provides that the Resolution Unit must coordinate its resolution planning efforts with any non-German resolution authorities if the banking group or bank concerned has operations outside Germany and the group’s or the bank’s failure could jeopardize the stability of financial markets (also) outside Germany. The Resolution Unit may even decide not to prepare a resolution plan for a systemically important bank if such bank is a member of a non-German banking group and the Resolution Unit determines, in particular on the basis of its participation in any resolution colleges (which are colleges comprised of the relevant non-German resolution authorities and *BaFin*), that a resolution plan prepared by a non-German authority sufficiently deals with the failure of the relevant German bank.

⁴ The German Restructuring Fund is a cash pool funded by contributions from banks which has been established to finance, *inter alia*, bank resolutions.

Recovery plans

The provisions of the Draft Bill dealing with recovery plans are much less detailed than the Draft Release. Therefore, it is well possible that the Draft Release will be finalized and will serve as interpretative guidance for the Draft Bill once in effect. Each recovery plan prepared pursuant to the Draft Bill has to include the principal elements described below, in each case taking into account the size, complexity, and interdependencies of the bank or banking group, as the case may be, as well as the type, scope and complexity of the relevant business model. Generally, the recovery measures proposed in the recovery plan must be suitable to restore the financial strength of the troubled bank in a sustainable manner and must be feasible in a crisis.

Organizational structure; business model; interdependencies. The recovery plan must describe the organizational structure of the bank or banking group, as the case may be, the relevant business model, including its or their principal business activities (*i.e.*, activities having a major impact on the bank's or banking group's financial condition or results of operations) and its or their systemically important business activities (*i.e.*, activities, the termination or unwinding of which would have a material adverse effect on other enterprises in the financial sector, the financial markets at large, or the general trust in the functioning of the financial system in Germany). The recovery plan must also describe the legal, economic and operational interdependencies within the banking group (internal interdependencies) and of the bank or banking group concerned with third parties (external interdependencies).

Recovery measures. The recovery plan must set forth a set of potential measures which the bank or banking group, as the case may be, could potentially adopt to foster or regain its financial strength in a situation of financial distress. According to the Draft Release, such measures may include recapitalization measures, suspension of dividend payments, securing refinancing sources, liquidity measures, asset sales, or voluntary debt rescheduling programs. Also, as further detailed in the Draft Release, the bank must analyze the impact of the potential recovery measures on the bank or banking group concerned, the continuation of systemically important business activities, as well as on other market participants, creditors and shareholders. The analysis of the potential recovery measures must finally address the feasibility, timing and chances of success of, and risks involved in, their implementation.

Stresstesting. In connection with the preparation and each update of a recovery plan, each relevant bank has to perform stress tests reflecting the scope, complexity and risk profile of its or its group's business activities and involving different stress scenarios. Such stress scenarios have to cover enterprise- or group-specific (internal) stress factors, market-related (external) stress factors, or a combination of both. As part of the stress-testing, each relevant bank has to analyze the impact of the stress scenarios on the bank or banking group, as the case may be, and, according to the Draft Release, identify the principal or

systemically important business activities which may come under stress in a stress scenario. In addition, each relevant bank shall identify early warning triggers, based on suitable indicators, such as its capital, risk capacity, liquidity, earnings, risk profile, and other external and internal factors, which enable it to adopt the appropriate recovery measures in a timely manner and restore the bank's financial strength without recourse to taxpayers' money.

According to the Draft Release, for each stress scenario, each relevant bank must designate and describe specific recovery measures in the recovery plan, including concrete steps for their implementation. Similar to the analysis of potential recovery measures outside a stress scenario (see "Recovery measures" above), the impact of these specific measures on the bank concerned (and potentially also the relevant banking group), as well as the feasibility, timing and risks involved in the implementation of such measures, must be analyzed and described in the recovery plan. As part of its recovery plan, each relevant bank must prepare a communication plan covering internal and external communication, including with respect to the adoption of recovery measures.

To the extent the recovery plan has identified difficulties or impediments regarding the implementation of recovery measures in a stress scenario, *BaFin* may request that the bank concerned take steps to resolve such difficulties and eliminate such impediments within a certain period of time. However, *BaFin* may not issue any orders interfering with the bank's business activities (such as a request that the bank adopt de-risking measures) solely based upon deficiencies of the submitted recovery plan.

Resolution planning

The Draft Bill puts the Resolution Unit in charge of preparing transfer orders pursuant to the German Banking Act and reorganization plans pursuant to the German Credit Institution Reorganization Act (*Kreditinstitute-Reorganisationsgesetz*). In addition, the Resolution Unit will have the following major responsibilities:

Preparation of resolution plans. The Resolution Unit has to prepare for each bank (or banking group, as the case may be) that is of systemic importance in Germany or globally a resolution plan with the aim, *inter alia*, to resolve, where necessary, the bank (or banking group, as the case may be) without jeopardizing the financial system (*i.e.*, other enterprises in the financial sector, the financial markets at large, or the general trust in the functioning of the financial system in Germany) and to continue any systemically important business of the bank or banking group, as the case may be. "Resolution" within the meaning of the Draft Bill is the power to dissolve banks as a result of a transfer order pursuant to the German Banking Act or to institute insolvency proceedings. The resolution plan may provide for financing of the resolution – within certain limits – by the German Restructuring Fund and has to provide for an appropriate sharing of losses by shareholders and creditors and avoid moral hazard.

The Draft Bill specifies certain information about the bank or the banking group, as the case may be, which has to be included in the resolution plan. The information requirements applicable to resolution plans are more detailed than those applicable to recovery plans. The information requirements applicable to resolution plans focus on the description of the legal, economic and operational structure (including the systemically important business) of the relevant bank or banking group. This focus reflects the consideration that complex legal structures, as well as the organization of business activities without a clear allocation to specific legal entities of a banking group may constitute an impediment to resolution because such structures may prevent the separation and transfer of any systemically important business. This focus on resolvability, as well as the required description of possible resolution steps, development of a communication plan and coordination with non-German authorities, if necessary, clearly shows the legislator's intention to make the power to issue a transfer order for the purpose of dissolving a failing bank more effective and, at the same time, no longer dependent on government funds.

The Resolution Unit must consult with the German Federal Agency for Financial Market Stabilization and *Deutsche Bundesbank* in connection with the preparation of any resolution plan. Similarly, where a relevant bank or banking group conducts business activities outside Germany, the resolution plan has to be prepared by the competent resolution college, if any. Finally, while the banks and banking groups concerned are obligated to co-operate with the Resolution Unit for purposes of preparing the resolution plan (which obligation goes beyond the mere provision of information), the resolution plan itself is confidential and will not be shared with the relevant bank or banking group, as the case may be.

Assessing resolvability. The Resolution Unit, in coordination with the German Federal Agency for Financial Market Stabilization and any competent resolution colleges, must continuously, but at least annually, assess whether any relevant bank or banking group, as the case may be, can be resolved in insolvency proceedings or as a result of a transfer order pursuant to the German Banking Act. The Draft Bill specifies the criteria to be considered in this respect, again focusing on the description of the legal, economic and operational structure (including systemically important businesses and the allocation of business activities to legal entities) of the relevant bank or banking group, as the case may be. In addition, the resolvability analysis focuses on the transferability of contracts and the ability to maintain business operations in a crisis. Finally, the Resolution Unit must consider whether it has the necessary power to resolve the bank or banking group, as the case may be, whether such resolution is feasible without jeopardizing the financial system, and what potential impact the resolution would have on creditors, counterparties, employees, financial market infrastructures and other market participants. If the Resolution Unit identifies impediments to a bank's or banking group's resolution, such impediments would be set out in the resolution plan, and the bank or banking group, as the case may be, needs to take steps to eliminate the impediments identified.

Eliminating resolution impediments. If the Resolution Unit comes to the conclusion that a bank or banking group cannot be resolved, or that there are impediments to resolution, the Resolution Unit notifies the relevant bank or banking group's parent company of the specific impediments, provided that such impediments are within the control of the relevant bank or banking group. The bank or parent company must then propose and, within an appropriate period of time, take the required steps to eliminate the impediments identified. If the Resolution Unit determines, after consultation with the German Federal Agency for Financial Market Stabilization and *Deutsche Bundesbank*, that the proposed steps are insufficient to eliminate the impediments, the Resolution Unit may request that alternative measures be adopted.

The Resolution Unit may in particular request the sale of assets, the termination or reduction of business activities, or changes to the legal or operational structure of the bank or banking group, as the case may be. However, the Resolution Unit may order such intrusive measures only if, in the absence of such measures, (i) the resolution (or uncontrolled insolvency) of the bank or banking group would jeopardize the financial system, or (ii) the resolution would not be possible or be at least significantly more difficult, provided that, in either case, the Resolution Unit has notified the bank or parent company of its intention to order such measures and given it the opportunity to adopt alternative measures. In our view, the power to order the elimination of resolution impediments, in particular impediments resulting from the legal and operational structure of banks and banking groups, constitutes one of the most important new features proposed by the Draft Bill, and can significantly interfere with a bank's business operations. The consequences for banks and banking groups may be severe due to the fact that any such order (similar to the order to prepare a recovery plan) can be appealed only before the competent higher administrative court, the decision of which is not appealable.

Outlook

The Draft Bill is intended by the legislator as a further step towards a comprehensive crisis management regime for German banks. Like the Draft Release, it needs to be seen in the context of existing legislation regarding the crisis-related reorganization of German banks set forth in the German Credit Institution Reorganization Act or specific crisis-related mechanisms to resolve banks as a result of a transfer order pursuant to the German Banking Act. The preparation and annual update of recovery plans and the co-operation with *BaFin* in connection with the preparation of resolution plans, as well as the compliance with related organizational requirements can be expected to require considerable resources on the part of the banks concerned. In light of its fairly high-level and abstract nature, the Draft Bill leaves ample room for interpretation, and it will be interesting to see how recovery plans and resolution planning will shape up in practice.

If you have any questions in regard to the issues addressed herein, please feel free to contact Dr. Gabriele Apfelbacher (gapfelbacher@cgsh.com) or Michael Kern (mkern@cgsh.com) at the Frankfurt office of Cleary Gottlieb or any of our partners and counsel listed under “Germany”, “Lawyers in this Practice”, under the “Practices” section, “Regions”, of our website at <http://www.clearygottlieb.com>.

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