

Fundamental features of the German Bank Restructuring Act

One of the key lessons learned from the recent crisis is that the existing legal basis for the orderly recovery or resolution of a systemically important bank (SIB) that has become distressed has proven to be insufficient. The specific contents of a framework for improved crisis management and orderly bank resolution are therefore currently being discussed and developed at the international and European level along with ways of both strengthening the capital and liquidity base of systemically important institutions and intensifying the supervision to which SIBs are subject, thus reducing the danger of their collapsing.

German legislators have already taken action at the national level with the Act on the Restructuring and Orderly Resolution of Credit Institutions, on the Establishment of a Restructuring Fund for Credit Institutions and on the Extension of the Limitation Period for the Liability of Governing Bodies under Company Law (*Gesetz zur Restrukturierung und geordneten Abwicklung von Kreditinstituten, zur Errichtung eines Restrukturierungsfonds für Kreditinstitute und zur Verlängerung der Verjährungsfrist der aktienrechtlichen Organhaftung*), hereinafter referred to as the Bank Restructuring Act. According to the Federal Government's bill (Bundestag printed paper 17/3024), the desired legislative aim is to deal with a distressed SIB without jeopardising the stability of the financial system. In developing the German solution, however, care was taken to ensure that the new instruments are compatible with the European Commission's existing ideas for an EU framework for cross-border crisis management in the banking sector.

Background

Development of new crisis management regulation for SIBs

In the recent financial crisis, the existing legal arrangements and prudential supervisory instruments proved to be inadequate for resolving SIBs without jeopardising the stability of the financial system as a whole. During the financial crisis, governments therefore implemented bank rescue measures to avert the negative consequences which a bank insolvency would have for the stability of the financial system. However, government intervention of this kind entails the problem of moral hazard. In this context, this means the danger that government support measures, or the prospect of such measures, could create the wrong incentives by averting, or at least mitigating, the negative consequences of misguided action on the part of private entrepreneurs or creditors, for instance, and so contribute to lower risk awareness. Ultimately, such state intervention can therefore encourage individual credit institutions and their management to take greater risks, as they are confident of receiving government aid if necessary, especially if they have reached a critical size (too-big-to-fail problem). Moreover, the financial crisis revealed potential for improvement in terms of the options for restructuring a SIB. A major challenge, not least to effectively prevent future crises, therefore also lies in developing an internationally harmonised recovery and resolution regime for systemically important financial institutions (SIFIs).

Besides its specific operational design, the question of how to fund such a recovery and resolution regime is of key significance. To

avoid moral hazard, the financial sector itself, rather than the government, should primarily provide the necessary funds.

International recommendations and European regulatory proposal

In March 2010, the Basel Committee on Banking Supervision published a report with recommendations on cross-border resolution and reducing the complexity and interconnectedness of cross-border banking groups.¹ These recommendations include, among other things, the development of national resolution regimes and measures to improve coordination between the various supervisory bodies in cross-border cases. At their June 2010 summit meeting in Toronto, the G20 leaders supported these recommendations and committed themselves to implementing the key recommendations.

The Financial Stability Board (FSB) has also taken up the issue and, in October 2010, published recommendations on how to deal with SIFIs.² The FSB, too, believes that the option of an orderly resolution of SIFIs – without using taxpayers' money – must be a viable and credible option if the too-big-to-fail problem is to be tackled effectively. The FSB likewise recommends introducing resolution instruments and regimes that take into

Recommendations of the Basel Committee on Banking Supervision ...

... and the Financial Stability Board

¹ Basel Committee on Banking Supervision, Report and Recommendations of the Cross-border Bank Resolution Group, March 2010: <http://www.bis.org/pub/bcbs169.pdf>.

² FSB, Reducing the moral hazard posed by systemically important financial institutions – FSB Recommendations and Time Lines, October 2010: http://www.financial-stabilityboard.org/publications/r_101111a.pdf.

account cross-border bank resolution and cooperation between national resolution authorities. The FSB recommendations even go so far as to suggest that the competent authorities should be provided with the powers – exercisable under clearly defined criteria – to require credit institutions to make changes to their legal and operational structures and business practices in order to facilitate the implementation of recovery and resolution measures. According to the FSB, cross-border cooperation should take place in banking-group specific crisis management groups uniting the supervisory authorities, central banks as well as finance ministries and resolution authorities from the countries relevant to the banking group.

The FSB is currently carrying out more in-depth work on this issue. It is, for instance, developing criteria for assessing whether the resolution of a SIFI is viable and credible, and considering key elements of institution-specific recovery and resolution plans (RRPs), which are considered necessary to prepare for crisis management.

The European Commission's plans for regulation

Within the European Union, the European Commission has conducted a consultation on the technical details of a possible EU framework for bank recovery and resolution³ based on its communication of 20 October 2010 on a new EU framework for crisis management in the financial sector.⁴ The responses received⁵ will play an important role in shaping a legislative proposal, which is to be passed by the end of 2011. In the consultation paper on the technical details and contents of an EU framework, the Commission provides not

only for more extensive supervision, a catalogue of early intervention powers for supervisors (including the appointment of a special manager to take over from or assist the existing management of a credit institution) as well as arrangements for the intra-group transfer of assets, based on voluntary agreements, but also for recovery and resolution planning in non-crisis times. Under the Commission's proposal, institutions should draw up recovery plans at entity and group level. According to the Commission's explanations, resolution plans should be prepared by the competent authorities, as these plans should also include information on the application of government instruments. In addition, where impediments to resolution are discovered during planning, authorities should be allowed to order measures in non-crisis times. The proposed measures range from specific disclosure requirements and the duty to provide service level agreements⁶ to interventions in an institution's corporate structure. Moreover, the consultation paper contains proposals for a harmonised Europe-wide

³ DG Internal Market and Services Working Document, Technical Details of a possible EU Framework for Bank Recovery and Resolution: http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.

⁴ Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank, An EU Framework for Crisis Management in the Financial Sector, October 2010: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0579:FIN:EN:PDF>.

⁵ Overview of the results of the public consultation on technical details of a possible EU framework for bank resolution and recovery, May 2011: http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_overview_en.pdf.

⁶ Under the European Commission proposal, the authorities should be able to require credit institutions to draw up agreements within the group or with third parties to cover the provision of critical economic functions or services.

resolution regime that would also take into account resolution at group level. As its next step, the Commission plans to examine the need to harmonise the rules on bank insolvencies in a report to be presented at the end of 2012 and, if necessary, to draw up a legislative proposal on this issue, too. Finally, in a last step, the creation of an integrated resolution regime and potentially a European resolution authority is to be considered.

German Bank Restructuring Act

On 1 January 2011, the Bank Restructuring Act entered into force in full in Germany. According to the Federal Government's bill,⁷ the legislative aim is to be able to deal with a distressed SIB without jeopardising the stability of the financial system. The new instruments are, moreover, to allow coordinated action with other competent authorities at the European level if a cross-border banking group becomes distressed. When drafting the Bank Restructuring Act, therefore, care was taken to ensure that the new instruments are compatible with the European Commission's existing ideas for an EU framework for cross-border crisis management in the banking sector.

Omnibus act

The Bank Restructuring Act is an omnibus act containing articles putting in place new legislation and amendments to existing legislation required as a result, articles 1 to 3 of which we will describe in greater detail. Article 1 of the Bank Restructuring Act puts into force the Credit Institution Reorganisation Act (*Gesetz zur Reorganisation von Kreditinstituten*),

which outlines a procedure to recover and reorganise credit institutions. Article 2 of the Bank Restructuring Act strengthens the prudential supervisory toolkit available under the German Banking Act (*Kreditwesengesetz*) by adding new measures for crisis management and extends this toolkit by including the instrument of the transfer order as an official restructuring or resolution measure. In addition, the Restructuring Fund Act (*Restrukturierungsfondsgesetz*; article 3 of the Bank Restructuring Act) stipulates the setting up of a Restructuring Fund as a special fund of the Federal Government to finance future restructuring and resolution measures at banks.

Credit Institution Reorganisation Act

The Credit Institution Reorganisation Act outlines a two-stage procedure for the recovery and reorganisation of credit institutions. This procedure, which has to be initiated by the credit institution, provides a framework for internal crisis management. It offers senior management a set of instruments with which to develop its own solutions and avoid the imposition of supervisory measures.

Recovery and reorganisation procedure

The recovery and reorganisation procedure does not affect the (prudential supervisory) powers of the Federal Financial Supervisory Authority (BaFin), including its right to apply for the initiation of insolvency proceedings under the Banking Act. This could be the case where, for instance, action in accordance with the Credit Institution Reorganisation Act does not seem promising or if reasons for

⁷ Bundestag printed paper 17/3024, p 1.

insolvency arise while the procedure is under way.

The first stage, the recovery procedure, gives senior management additional options to manage a crisis well before insolvency occurs. The reorganisation procedure, which is planned as the second stage, is, in principle, based on the existing insolvency plan procedure. Unlike in the recovery procedure, the reorganisation procedure may involve an intervention in third-party rights (creditor and shareholder rights).

Recovery procedure

Institution may initiate recovery procedure by notifying BaFin

The recovery procedure is initiated by the institution notifying BaFin that it requires recovery (section 2 (1) of the Credit Institution Reorganisation Act). The requisite recovery plan must be attached to the notification; the credit institution has the right to propose a recovery adviser. The recovery plan may basically include all measures suitable for the credit institution's recovery without intervening in third-party rights. It can, however, favour certain recovery loans by giving preferential treatment to the creditors of loans or other credit claims that the credit institution takes out in implementing the recovery plan in the potential event of insolvency within three years of the recovery procedure being ordered (section 2 (2) of the Credit Institution Reorganisation Act). A ceiling must, however, be set for these privileged claims, which may not exceed 10% of the institution's own funds.

As in insolvency proceedings, BaFin has the right to apply for a recovery procedure to be conducted (to be distinguished from initiation by the institution) and, if it is expedient to do so, files an appropriate application with the competent Higher Regional Court (*Oberlandesgericht*) in Frankfurt am Main (section 2 (3) of the Credit Institution Reorganisation Act). BaFin must comment on the recovery plan given its specialist knowledge as the competent supervisory authority. Its feedback should, in particular, include an assessment of the prospects for successful recovery and of the suitability of the proposed recovery adviser.

BaFin's right of application

The Higher Regional Court orders the recovery procedure to be conducted and appoints the proposed recovery adviser provided the person who has been put forward is not obviously unsuitable (section 3 (1) of the Credit Institution Reorganisation Act). As the key figure in the recovery procedure, the recovery adviser implements the recovery plan and is obliged to report regularly to the Higher Regional Court and BaFin on recovery progress (section 6 of the Credit Institution Reorganisation Act). The recovery adviser has extensive powers by law (section 4 of the Credit Institution Reorganisation Act), eg wide-ranging rights to obtain information and the right to issue instructions to senior management. A court order can be used to grant the recovery adviser additional powers or allow additional measures to be taken vis-à-vis the credit institution, provided this is necessary for recovery and if there is a danger that the institution will default on its commitments to creditors (section 5 of the Credit

Court order

Institution Reorganisation Act). The recovery adviser must report both the success and the failure of recovery to the court after having first notified BaFin. The court must then decide whether to end the recovery procedure. By ordering certain measures pursuant to the Banking Act, BaFin can also end the recovery procedure at any time (section 2 (4) of the Credit Institution Reorganisation Act). On the whole, the initiation of a recovery procedure can make it easier for senior management to manage a crisis as it provides the instrument of privileged recovery loans. However, the appointment of a recovery adviser curtails management's powers. Moreover, it is uncertain how the markets will react and what the impact on refinancing costs will be when it becomes known that senior management considers a recovery procedure to be necessary.

Reorganisation procedure

In cases in which a reorganisation procedure is to be conducted after a recovery procedure has failed, the recovery adviser notifies BaFin with the consent of the credit institution. The reorganisation plan must be submitted along with the notification. In cases where a recovery procedure offers no prospect of success from the outset, this second procedural stage can also be initiated immediately through submission of notification and a reorganisation plan to BaFin.

While all credit institutions domiciled in Germany may resort to the recovery procedure to manage a crisis, the scope of application of the reorganisation procedure is limited.

BaFin can apply to the competent Higher Regional Court in Frankfurt am Main to carry out a reorganisation procedure only if there is a going-concern risk to the credit institution pursuant to section 48b (1) of the Banking Act that results in a systemic risk pursuant to section 48b (2) of the Banking Act (section 7 (2) of the Credit Institution Reorganisation Act).

Provided the application to conduct the reorganisation procedure is not rejected because of an inadequate reorganisation plan, the Higher Regional Court decides – after consulting BaFin, the Deutsche Bundesbank and the credit institution – whether there is a going-concern and a systemic risk and whether to order the procedure (section 7 (3) and (4) of the Credit Institution Reorganisation Act).

The reorganisation plan and the reorganisation adviser are – like the recovery adviser and plan in the first procedural stage – key to the reorganisation procedure. The reorganisation plan consists of a descriptive and a constitutive part. It may envisage either the recovery or the liquidation of the credit institution. The descriptive part of the reorganisation plan informs all of the parties involved of the basic elements and effects of the reorganisation plan in preparation for a decision either for or against the plan. The constitutive part determines how the legal position of those involved is to be changed (section 8 (1) sentence 3 of the Credit Institution Reorganisation Act). As mentioned above, the reorganisation plan, unlike the

Court decision on application and prerequisites

Contents of the reorganisation plan

Two initiation options

Prerequisites for a reorganisation procedure

Going-concern and systemic risk within the meaning of section 48b of the Banking Act

Going-concern risk (section 48b (1) sentence 1 of the Banking Act)

“Going-concern risk is the danger of the credit institution collapsing as a result of insolvency if no corrective measures are taken.”

According to the explanatory memorandum to the Federal Government’s bill (Bundestag printed paper 17/3024), this does not have to involve a specific imminent default or imminent overindebtedness. The Banking Act cites cases in which a going-concern risk is presumed to exist owing to a qualified breach of prudential own funds or liquidity requirements (section 48b (1) sentence 2):

“Going-concern risk shall be presumed to exist if

1 the available tier 1 capital represents less than 90 per cent of the tier 1 capital required pursuant to section 10 (1);

2 the modified available capital represents less than 90 per cent of the own funds required pursuant to section 10 (1);

3 the liquid assets available to the institution in a maturity band defined by the statutory order pursuant to section 11 (1) sentence 2 represent less than 90 per cent of the payment obligations that are callable in the same maturity band, or

4 facts are known which warrant the assumption that a shortfall pursuant to numbers 1, 2 and 3 will occur if no corrective measures are taken; this is the case, in particular, if a loss may be anticipated based on the institution’s earnings situation, as a result of which the

conditions of numbers 1, 2 or 3 would be met.”

Systemic risk (section 48b (2) sentence 1 of the Banking Act)

“Systemic risk shall be deemed to exist if there is concern that the credit institution’s going-concern risk could have a significantly negative impact on other financial sector enterprises, on the financial markets or on the general confidence of depositors and other market participants in the proper functioning of the financial system.”

The term “systemic risk” produces a correlation between the going-concern risk of a specific credit institution and the risks to financial market stability. The factors to be taken into account when assessing whether there is a systemic risk, which are listed in section 48b (2) sentence 2 of the Banking Act, are given merely by way of example. These include, for instance, the nature and scope of the institution’s liabilities to other institutions and other financial sector enterprises, interconnectedness with other financial market participants, and the conditions on the financial markets, in particular the consequences which market participants expect the institution’s collapse to have on other financial sector enterprises, on the financial market and on the confidence of depositors and market participants in the proper functioning of the financial market. According to the explanatory memorandum to the Federal Government’s bill, the factors given by way of example in the Act cover the most common, currently known contagion channels through which a crisis at one institution can lead to the impairment of financial system stability as a whole.

recovery plan, can involve intervention in creditors' rights and shareholders' status.

Rights of termination, other reasons for termination or conclusion and registration of claims

Section 13 of the Credit Institution Reorganisation Act stipulates that debt relationships with the credit institution cannot, as a general rule, be terminated as of the day on which BaFin receives an application to initiate the reorganisation procedure until the end of the next business day. This applies to notice of termination and any other reasons for termination or conclusion. Section 14 of the Credit Institution Reorganisation Act lays down how creditors whose rights are subject to intervention pursuant to section 12 of the Credit Institution Reorganisation Act can register their claims. Creditors' voting rights can be determined only if the reason for and the amount of the claim are given when it is registered.

Acceptance of the reorganisation plan ...

The reorganisation plan must specify groups for voting pursuant to sections 17 and 18 of the Credit Institution Reorganisation Act where the rights of those involved are subject to intervention (section 8 (2) sentence 1 of the Credit Institution Reorganisation Act). Pursuant to section 8 (2) sentence 4 of the Credit Institution Reorganisation Act, shareholders are deemed to be a separate group only if the reorganisation plan includes provisions for which a decision by the shareholders' meeting is necessary under company law or is stipulated in the Credit Institution Reorganisation Act. Each group of creditors with voting rights must vote separately on the reorganisation plan (section 17 (1) of the Credit Institution Reorganisation Act). Shareholders vote on the reorganisation plan sep-

arately at a shareholders' meeting called by the reorganisation adviser (section 18 of the Credit Institution Reorganisation Act). The acceptance of the reorganisation plan requires the approval of all groups (section 19 (1) sentence 1 of the Credit Institution Reorganisation Act).

In each of the individual groups of creditors, the vote is decided by a majority as measured by the number of voting creditors as well as by a sum majority according to the volume of claims. However, section 19 (2) to (4) of the Credit Institution Reorganisation Act also provides for cases in which approval is deemed to have been granted despite the required majority not having been reached in a group of creditors or if the shareholders withhold approval.

When the reorganisation plan has been accepted by the groups of creditors and by the shareholders, it must also be confirmed by the Higher Regional Court (section 20 (1) of the Credit Institution Reorganisation Act). Once judicial confirmation has been received, the arrangements laid down in the constitutive part of the plan take effect for and against those involved (section 21 (1) of the Credit Institution Reorganisation Act). The Higher Regional Court, by confirming or rejecting the reorganisation plan, decides on the termination of the reorganisation procedure (section 22 (1) of the Credit Institution Reorganisation Act). However, the constitutive part of the reorganisation plan may stipulate that the reorganisation adviser is to monitor the realisation of the plan even after the reorganisation procedure has been ter-

... and judicial confirmation

Possibilities for intervention in third-party rights in the reorganisation procedure

Conversion of claims to capital (section 9 of the Credit Institution Reorganisation Act)

It can be stipulated in the constitutive part of the reorganisation plan that creditor claims are to be converted into capital shares in the credit institution by means of a debt-equity swap. However, the creditors must agree to a conversion of this kind. Moreover, the existing shareholders must be adequately compensated for such action. The amount of this compensation must be determined by one or more expert auditors.

Other provisions under company law (section 10 of the Credit Institution Reorganisation Act)

The constitutive part of the reorganisation plan may also lay down any provisions permissible under company law and may, thus, include not only the debt-equity swap arrangement but also other changes to the credit institution's structures, for example, amendments to its articles of association or articles of incorporation or the transfer of the credit institution's participation or membership rights in other companies, if this would be beneficial to the reorganisation. The law provides for appropriate financial compensation for loss of assets on the part of existing shareholders.

Spin-off (section 11 of the Credit Institution Reorganisation Act)

According to the explanatory memorandum to the Federal Government's bill, spin-off is a further key element in the reorganisation of

credit institutions. A credit institution may stipulate in the constitutive part of its reorganisation plan that all or part of its assets are to be transferred to a legal entity (which already exists or is to be established) in exchange for the institution being granted shares in this legal entity. Thus, the credit institution's assets are spun off to one or more legal entities by way of (partial) universal succession, which offers a means of dividing the business into sound and unsound units or into different business areas. The constitutive part of a reorganisation plan must contain stipulations regarding the key principles of the spin-off. It can also stipulate that individual assets, liabilities or legal relationships are to be retransferred to the transferring credit institution (section 11 (1) sentence 2 of the Credit Institution Reorganisation Act).

Intervention in creditors' rights (section 12 of the Credit Institution Reorganisation Act)

Pursuant to section 12 of the Credit Institution Reorganisation Act, in principle the constitutive part of the reorganisation plan may also envisage, for instance, a reduction in or a deferral of claims. Pursuant to section 12 (2) and (3) of the Credit Institution Reorganisation Act, claims for which a creditor could assert a compensation claim vis-à-vis a guarantee scheme within the meaning of section 23a of the Banking Act if a compensation event were to occur, claims which are covered by a voluntary guarantee scheme, as well as salary claims by employees and claims for an occupational pension by persons entitled thereto are excluded from this arrangement.

minated (section 22 (2) of the Credit Institution Reorganisation Act).

Amendments to the Banking Act

Strengthening and extending the instruments available to supervisors

Besides the voluntary two-stage procedure under the Credit Institution Reorganisation Act, which aims to achieve a consensus between supervisors, the credit institution and its creditors, changes to the Banking Act envisaged under the Bank Restructuring Act will strengthen and expand the sovereign crisis management toolkit. First, the measures in special cases cited in the Bank Restructuring Act that BaFin can take are intended to strengthen crisis prevention and to create incentives for credit institutions to restructure themselves independently well in advance of an insolvency occurring. Second, BaFin's powers have been extended by the possibility of issuing a transfer order which offers instruments with which to restructure or resolve a failing credit institution in an orderly fashion. The transfer order is, therefore, a key answer to the too-big-to-fail problem which was mentioned in the early part of this article.

Extension of supervisory measures in special cases

Measures to improve own funds adequacy and liquidity

Pursuant to section 45 (1) of the Banking Act, BaFin may order an institution to take measures to improve the adequacy of its own funds and liquidity if the development of its assets, finances or profitability warrants the assumption that it will not be able sustainably to fulfil the statutory requirements. The amended version of section 45 (1) of the Banking Act describes the preconditions for

intervention such that BaFin has the option of intervening at an early stage in order to prevent financial distress. Examples of the preconditions for intervention based on the solvency ratio pursuant to the Solvency Regulation (*Solvabilitätsverordnung*) and the liquidity ratio pursuant to the Liquidity Regulation (*Liquiditätsverordnung*) are intended to provide greater legal certainty. The powers to intervene where statutory minimum capital or liquidity requirements are breached are now laid down in section 45 (2) of the Banking Act. BaFin's ability to order that a restructuring plan has to be presented is a new addition. In this plan, the institution must set out how and within what period of time its own funds adequacy or liquidity is to be sustainably restored. The order may stipulate that BaFin and the Deutsche Bundesbank must regularly receive progress reports. The restructuring plan must be transparent, plausible and substantiated (section 45 (2) sentence 2 of the Banking Act). It must specify concrete and verifiable objectives, interim targets and deadlines for the implementation of the measures described. BaFin may inspect the restructuring plan and the associated documentation at any time. Moreover, pursuant to section 45 (2) sentence 5 of the Banking Act, BaFin may demand that the restructuring plan be amended and lay down requirements in this regard if it considers the specified objectives, interim targets and implementation deadlines to be inadequate or if the institution does not adhere to them.

Under the new section 45c of the Banking Act, BaFin may – as an independent, predominantly preventative prudential instrument –

Possibility of appointing a special representative

appoint a special representative, entrust him/her with performing tasks at an institution and assign him/her the requisite powers. The special representative need not always assume the tasks and powers of a governing body or a member of a governing body of the institution, but may also take on specific, limited tasks. The law stipulates that he/she must be independent, trustworthy and suited to properly carrying out the tasks entrusted to him/her with a view to ensuring the sustainability of the institution's business policy and safeguarding financial market stability. Where he/she is to assume the tasks of a senior manager or governing body, he/she must possess the requisite professional expertise. Section 45c (2) of the Banking Act contains a sizeable yet non-exhaustive list of the tasks that may be assigned to the special representative, such as elaborating a restructuring plan. According to section 45c (7) sentence 1 of the Banking Act, the special representative shall be liable for wilful intent and negligence. Section 45c (7) sentences 2 and 3 of the Banking Act state that liability for damages shall be limited in its amount in the case of negligent conduct.

Introduction of measures vis-à-vis credit institutions in the event of risks to the stability of the financial system – transfer order

*Transfer order
as a new
official measure*

The key amendment to the Banking Act is the introduction of the transfer order as an official measure vis-à-vis credit institutions in the event of risks to the stability of the financial system. Pursuant to section 48a *et seq* of the Banking Act, BaFin can use a transfer order to transfer all or some of a credit institution's

assets including its liabilities to an existing legal entity (transferee legal entity) through spin-off. The transfer order is a means of allowing the measures required to stabilise the credit institution to be taken without the shareholders having to agree to these measures. Thus, for instance, systemically important parts of a credit institution may be transferred to a transferee legal entity. Such a transfer of systemically relevant business units has the advantage that subsequent stabilisation measures can concentrate on the transferee legal entity. As regards the credit institution and the non-systemically important business units that it retains, insolvency proceedings are, in principle, possible after the spin-off, as at least systemic importance and a resultant danger to financial stability are no longer an issue.

A transfer order can be issued only if the credit institution's viability as a going concern is jeopardised, thereby placing the stability of the financial system at risk. For a definition of the terms going-concern and systemic risk, see the description of the reorganisation procedure above (see box on page 65). Another mandatory precondition is that the systemic risk arising from the going-concern risk cannot be eliminated with equal certainty in any other way than through the transfer order. It is, therefore, clear that the transfer order must be regarded only as a measure of last resort. Ultimately, a balance must be found between the interests and rights of those affected by the transfer order and the public interest in maintaining systemic stability. If the transfer order requires or could require financial assistance from the Restructuring

*Preconditions
for transfer
order*

Partial retransfer and partial transfer

It is possible to retransfer individual spun-off assets to the transferring credit institution by means of a retransfer order within four months of a spin-off taking effect. According to the explanatory memorandum to the Federal Government's bill (Bundestag printed paper 17/3024, page 67), a retransfer of this kind may be considered, for instance, if it becomes apparent that the desired objective of overcoming going-concern and systemic risk requires only certain business units and not all of them to be transferred. The spun-off assets to be retransferred are selected in accordance with section 48j (3) of the Banking Act. Other than in specific exceptional cases, for example in connection with financial collateral, the spun-off assets are generally selected on the basis of their significance for averting the systemic risk emanating from the credit institution in an effective and cost-efficient manner. Where they are equally significant for averting this systemic risk in an effective and cost-efficient manner, the selection of liabilities is based on the ranking relevant in insolvency proceedings over the credit institution's assets.

Pursuant to section 48k (1) of the Banking Act, the transfer order may stipulate that only part of the assets, liabilities and legal relationships are to be transferred to the transferee legal entity (partial transfer). Section 48k (2) of the Banking Act contains provisions regarding the selection of business units to be spun off by means of partial transfer. BaFin is authorised to issue further follow-up orders within four months of a spin-off based on a transfer order taking effect.

Deutsche Bundesbank

Fund – eg to stabilise the transferee legal entity or to establish a bridge institution – the transfer order is to be issued in agreement with the Steering Committee pursuant to the Financial Market Stabilisation Fund Act (*Finanzmarktstabilisierungsfondsgesetz*). The benchmark for establishing whether BaFin, the Steering Committee and the Financial Market Stabilisation Agency (*Bundesanstalt für Finanzmarktstabilisierung*) are acting lawfully in issuing and executing a transfer order is the question of whether, after judicious appraisal of the circumstances evident at the time of their action, they could assume that the preconditions for their action have been met. BaFin assesses whether going-concern and systemic risk exists after consulting the Deutsche Bundesbank. The joint assessment of both institutions is to be documented in writing.

Before issuing the transfer order, BaFin may in principle give the credit institution the opportunity to present, within a set time limit, a viable recovery plan indicating in what way going-concern risk will be averted. The transfer order may be issued only if the transferee legal entity agrees to the transfer (section 48c (3) sentence 1 of the Banking Act), which requires notarisation. Where the transferee legal entity does not have the authorisation required, the transfer order shall be deemed to grant authorisation to the transferee legal entity with the same scope as the authorisation granted to the credit institution (section 48g (6) of the Banking Act). Section 48c (5) of the Banking Act contains criteria for preclusion from acting as a transferee legal entity, which are based on the precondi-

tions for the granting of authorisation to conduct banking business.

Consideration to the credit institution and compensation liability on the part of the transferee legal entity vis-à-vis the credit institution

The transfer order shall provide for a consideration to the credit institution if the overall value of the assets to be transferred is positive (section 48d (1) sentence 1 of the Banking Act). This compensation generally consists of capital shares in the transferee legal entity. In exceptional cases, the consideration shall be determined in cash if granting capital shares is unreasonable for the transferee legal entity or threatens to defeat the purpose of the transfer order. The consideration must be commensurate with the value of the transferred assets at the time at which the transfer order is issued. Government assistance and support payments from the Restructuring Fund may not be taken into consideration. An expert auditor appointed by the court at the request of the Financial Market Stabilisation Agency shall verify the adequacy of the consideration. Where a conclusive and reliable valuation of the assets to be transferred is not possible before the transfer order is issued, the transfer order can be based on a provisional valuation; in this case, a final valuation shall be carried out at a later date. The same applies to a partial retransfer or a partial transfer. Where the aggregate value of the assets to be transferred is negative, however, the credit institution must compensate the transferee legal entity in cash (section 48d (6) sentence 1 of the Banking Act).

Publication and announcement and the effects thereof

The transfer order must be published promptly in the electronic Federal Gazette (*Bundesanzeiger*). The credit institution (including the competent works council) and the transferee

Measures at the credit institution and at the transferee legal entity

Key measures at the credit institution (section 48l of the Banking Act)

Pursuant to section 48l (1) of the Banking Act, BaFin may revoke the credit institution's authorisation if, once the transfer order takes effect, the credit institution is unable to maintain its operations in conformity with the provisions of the Banking Act. Moreover, pursuant to section 48l (2) of the Banking Act, as long as the viability of the business units transferred to the transferee legal entity as a going concern is jeopardised and it has not been determined that the restructuring objective has been achieved, BaFin can instruct the credit institution to exercise the voting rights to which it is entitled at the shareholders' meeting of the transferee legal entity in a particular manner, apart from in the cases cited in the Act. In addition, the credit institution may not, without written permission from BaFin, dispose of its capital shares in the transferee legal entity as long as the going-concern risk to the business units transferred has not been lastingly averted (section 48l (3) of the Banking Act).

Key measures at the transferee legal entity (section 48m of the Banking Act)

The transferee legal entity has extensive duties to provide BaFin with information on all circumstances of relevance for assessing the viability of restructuring for the business units transferred. Pursuant to section 48m (1) sentence 2 of the Banking Act, the viability of restructuring is the realisability of creating an asset, financial or earnings situation that ensures the long-term competitiveness of the transferred enterprise (restructuring objective). Section 48m (6) of the Banking Act stipulates that, if the transferee legal entity has been granted support payments by the Restructuring Fund or another form of support payment in order to overcome the going-concern risk or to achieve the restructuring objective, BaFin may, until the restructuring objective has been achieved, prohibit payouts to the shareholders of the transferee legal entity, to the holders of other – precisely defined – own funds components and to creditors to whom certain subordinated liabilities are owed. If the restructuring objective cannot be achieved or can be achieved only on disproportionate economic terms and if the enterprise can be wound up without jeopardising the stability of the financial system, BaFin, in consultation with the Financial Market Stabilisation Agency, may demand that the transferee legal entity draw up a liquidation plan, may declare the liquidation plan drawn up to be binding and may take the measures necessary to execute it (section 48m (7) to (9) of the Banking Act). The liquidation plan must show that, and in what way, the enterprise being maintained as a going concern by the transferee legal entity is to be wound up in an orderly manner.

Deutsche Bundesbank

legal entity must also be informed of the transfer order. Pursuant to section 48g (1) of the Banking Act, the spin-off takes effect when notification of the transfer order is given. The entries necessary to conduct the spin-off, therefore, have only a declaratory effect. Pursuant to section 48g (2) of the Banking Act, once the spin-off takes effect, the spun-off assets earmarked by the transfer order pass to the transferee legal entity, and the credit institution has a right to the consideration or must pay the compensation liability.

Exclusion of calling or termination of debt relationships by virtue of the transfer order alone

The provision in section 48g (7) of the Banking Act, whereby debt relationships may not be called or terminated solely by virtue of the transfer to the transferee legal entity, is particularly important. This provision addresses the event-of-default problem. This occurs when the use of supervisory measures or procedures gives rise (or could give rise) to calling rights vis-à-vis the credit institution or could trigger automatic termination of contract. It is intended to prevent the spin-off being jeopardised by automatic termination or calling rights solely because of the transfer order and the associated capital outflows. Other calling or termination rights are unaffected, however.

Obligations of the credit institution in matters subject to foreign law

Pursuant to section 48i (1) of the Banking Act, if a spun-off asset is subject to foreign law under which the legal effects of the transfer order do not apply, the credit institution is obliged to work promptly towards a transfer in accordance with the relevant provisions under the foreign legislation.

Restructuring Fund Act

The Restructuring Fund Act, which came into force on 31 December 2010, is based on article 3 of the Bank Restructuring Act and provides for a Restructuring Fund for credit institutions to be set up at the Financial Market Stabilisation Agency. All credit institutions within the meaning of section 1 (1) of the Banking Act that are subject to the provisions of the Regulation on the Accounting of Credit Institutions and Financial Services Institutions (*Kreditinstituts-Rechnungslegungsverordnung*) are required to contribute. Promotional banks are exempt given their specific business model. The Restructuring Fund, which will be set up as a special fund of the Federal Government, is to be used to finance future restructuring and resolution measures for SIBs. The amount which a credit institution must contribute is intended to reflect its individual systemic risk and is based, in particular, on its size and interconnectedness in the financial markets. The Restructuring Fund can take the following measures, amongst others: it may establish a bridge bank and acquire participations, it may grant guarantees, and it may carry out recapitalisation measures.

Establishing a Restructuring Fund for restructuring and resolution measures

Under the legislation, the financial resources needed for the Restructuring Fund's measures will be raised by means of an annual contribution and, where necessary, special contributions to be made by the credit institutions required to contribute. The Restructuring Fund's target level amounts to €70 billion. Some €1 billion are expected to be raised on an annual basis. However, the amount raised is volatile because of the way in which contri-

Restructuring Fund measures financed through credit institutions' contributions

Calculating the bank levy pursuant to the Restructuring Fund Regulation

Based on section 12 of the Restructuring Fund Act (*Restrukturierungsfondsgesetz*), the Restructuring Fund Regulation (*Restrukturierungsfonds-Verordnung*), which has yet to be enacted by the German government, stipulates the following legal requirements for collecting the bank levy.

Annual levy

An institution's contribution-relevant liabilities are derived from the total liabilities in its most recently approved financial accounts within the meaning of section 340a of the German Commercial Code (*Handelsgesetzbuch*)

minus the following liability items listed on form 1 of the Regulation on the Accounting of Credit Institutions and Financial Services Institutions (*Kreditinstituts-Rechnungslegungsverordnung*):

- liability item 2, "liabilities to customers" excluding liabilities to legal persons in which the credit institution holds a participation within the meaning of section 271 (1) of the Commercial Code;
- liability item 10, "profit participation capital" excluding profit participation capital that is redeemable within less than two years;
- liability item 11, "fund for general banking risks";
- liability item 12, "equity";

plus

- the nominal volume of derivatives pursuant to section 36 of the Regulation on the Accounting of Credit Institutions and Financial Services Institutions.

Progressivity of the levy

The component of the assessment base that is derived from the liability side of an institu-

tion's balance sheet is multiplied by varying levy rates, which are staggered progressively depending on predefined volume categories.

A uniform levy rate is applied to the nominal volume of derivatives when calculating the annual contribution.

Special contributions

If the Financial Market Stabilisation Agency finds that the funds it requires are not covered by regular levies, it can collect special contributions. On request, it can release individual credit institutions from the obligation to pay such contributions if this would endanger the institution itself.

Reasonable limit, minimum contribution, retroactive collection, contribution ceiling

An institution's annual contribution should not exceed a certain percentage of its annual result according to the profit and loss account after adjustment for profits ceded on the basis of a profit-pooling agreement, a profit transfer agreement or a partial profit transfer agreement (reasonable limit). However, credit institutions must pay at least one annual contribution in relation to the calculated annual contribution. This minimum contribution is always levied even if it exceeds the reasonable limit. Capped contributions must be paid retroactively if the reasonable limit is not exhausted by the regular annual contribution (retroactive collection) in one of the subsequent years. Including retroactive contributions, an institution's total levy payments must not exceed the reasonable limit for the current contribution year. The total contributions levied in a contribution year (annual contribution, any retroactive contributions, any special contributions) must not exceed a certain percentage of the average of the previous three annual results (contribution ceiling).

butions are calculated and depends on the respective bank's earnings situation; the actual inflow of annual funds is therefore difficult to forecast over time.

Bank levy based on systemic features of contributing bank, ...

... statutory order details key elements of levy collection ...

... and collection and transfer of the data required to calculate the levy

With regard to an institution's systemic risk based on its size, the levy is calculated using the balance sheet total and the volume of derivatives. The bank levy has been designed with the intention of being a measure that is simple and robust, but nonetheless risk-adjusted. While the group of banks that will be subject to the levy and the basic aspects relating to collection of the levy have already been laid down in the Restructuring Fund Act, a statutory order (Restructuring Fund Regulation (*Restrukturierungsfonds-Verordnung*)), which has yet to be enacted by the German government and requires approval from the upper house of parliament (Bundesrat), details additional legal stipulations in respect of contribution rates, the definition of a reasonable limit and the collection procedure. The Bundesrat has yet to pass the draft regulation (Bundestag printed paper 17/4977). The main features of levy collection are outlined in the box on page 73. The credit institutions are obliged to send the Financial Market Stabilisation Agency, which is tasked with carrying out the restructuring measures and administering the Restructuring Fund, the data needed to determine and collect the annual and special contributions. The data required to calculate the annual contributions must be confirmed by an external auditor and submitted to the Financial Market Stabilisation Agency by 15 July of each year. Annual contributions will be payable by 30 September of every calendar year, with the first payment

due by 30 September 2011. In order to minimise banks' administrative burden, the data used to calculate the bank levy is to be collected via the Bundesbank's existing prudential reporting infrastructure (ExtraNet).

Assessment and outlook

In introducing the Bank Restructuring Act, Germany has responded to international recommendations to develop national resolution regimes. The Act contains extensive provisions that may facilitate the recovery and reorganisation of banks. Moreover, BaFin's powers of early intervention have been improved through the introduction of additional supervisory measures. However, the high degree of complexity of the supervisory measure that is the transfer order means that the operational details of the transfer of assets, including liabilities, of the credit institution in question still have to be worked out.

In the context of crisis management, cross-border implications must also be considered. Recent experience has made it abundantly clear that crises do not stop at national boundaries. Those credit institutions whose going-concern risk could jeopardise the financial system are predominantly active on a global scale. In such cases, purely national action to resolve a crisis will hardly suffice. What are needed are sustainable solutions, cooperation between the competent national authorities and harmonised resolution regimes at the international or at least the European level in order to take account of the cross-border dimension of global credit insti-

Bank Restructuring Act is German response to international recommendations

Consideration of cross-border aspects

tutions' activities and structures, which are subject to different legal systems, including insolvency legislation. In addition, the German Act has limited scope with regard to foreign legal relationships, as evidenced, for instance, by the event-of-default issue which is addressed in the Bank Restructuring Act. A purely German approach to solving this problem is likely to be insufficient in the case of internationally active credit institutions, as national rules apply only to agents subject to the relevant legislation, who may, however, also have concluded contracts subject to the laws of other legal systems and with contractual partners not subject to EU legislation. Therefore, to resolve the event-of-default issue in connection with resolution measures, international rules and cooperation are necessary. These should, in particular, also involve the relevant international agencies, such as the International Swaps and Derivatives Association.

Potential need for change as a result of European regulation or international recommendations

It remains to be seen what results and recommendations will be developed at the international level and whether the regulation announced by the European Commission means that legal amendments have to be made to current legislation. According to the most recent ideas expressed by the European Commission, banks will, for instance, have to draw up recovery plans at entity and group level, while the competent authorities will already have to produce resolution plans in

non-crisis times. The details of the Commission's proposals still require in-depth discussion; nonetheless, on the question of whether to go ahead in the first place, an international consensus is emerging for producing such recovery and resolution plans as a key pillar of crisis management. The contents of these plans do not, however, correspond to the recovery, reorganisation and restructuring plans stipulated under German legislation.

As regards the bank levy, it should be considered that other EU countries have already introduced, or are about to introduce, similar levies. However, these levies may have a different scope of application and different assessment bases. In order to avoid a double burden, especially for cross-border credit institutions, it is advisable to coordinate the levy concepts between member states or to harmonise them at the EU level. Work on this issue is currently under way. The German bank levy might, therefore, have to be adjusted as a result of future harmonisation steps. Harmonising the basic framework for a bank levy reduces the danger of potentially creating an uneven playing field for EU countries. However, the time is not yet ripe for a cross-border banking fund given the fiscal sovereignty of member states and the necessary link between material and fiscal responsibility.

Bank levies in other EU countries suggest the need for harmonisation of the basic framework