New German netting legislation following Federal Court of Justice decision of 9 June 2016

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German netting rules - general

- Special termination and liquidation regime for derivatives and other financial contracts traditionally accepted

- However, latent conflict between equal treatment of creditors and general rules for continuation of contracts (cherry picking) in insolvency and such special termination and liquidation regime

- Post crisis rising prejudice regarding financial sector privileges in insolvency scenarios
German netting rules – Financial Collateral Directive (FCD)

• German netting rules not fully in line with EU law framework

• Article 7(1) FCD provides that Member States shall ensure that a close-out netting provision can take effect in accordance with its terms notwithstanding the commencement or continuation of insolvency proceedings in respect of the collateral provider and/or the collateral taker

• Germany has been reluctant in implementing the FCD – various provisions, including Article 7(1) FCD, have not been (fully) implemented in Germany
Legal position prior to Federal Court of Justice decision of 9 June 2016

- Potential conflict between German statutory netting regime and contractual netting rules in master agreements for financial transactions

- General recognition of contractual netting rules in respect of collateralised transactions based on FCD requirements

- Recognition of contractual netting rules in respect of non-collateralised transactions within the boundaries of the German statutory netting regime
  - "safe harbor transactions"
  - treatment of "mixed" master agreements
Federal Court of Justice decision of 9 June 2016

Key points:

• Contractual netting rules in master agreements for financial transactions deviating from the German statutory netting regime are invalid

• Impact on timing of termination: contractual termination vs. opening of insolvency proceedings

• Impact on timing of valuation: contractual window of 5 BD vs. 2nd BD after opening of insolvency proceedings

• Impact on method of valuation: contractual methodology vs. "market or exchange price"
Amendment of German netting legislation (§ 104 InsO)

- Court decision caused major regulatory compliance issue because CRR recognizes only contract based netting (not statute based)

- Commitment of the German legislature to recognize contractual netting rules in master agreements for financial transactions

- Extension of catalogue of "safe harbor transactions"

- Recognition of certain contractual deviations:
  - timing of termination
  - timing of valuation
Remaining issues

- Catalogue of "safe harbor transactions"
- Article 7(1) FCD still not fully implemented in Germany
- Model-based valuation
- Treatment of "mixed" master agreements