EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 9 December 2013

on measures to strengthen bank stability

(CON/2013/86)

Introduction and legal basis

On 25 November 2013, the European Central Bank (ECB) received a request from the Slovenian Ministry of Finance for an opinion on a draft regulation on the implementation of measures to strengthen bank stability (hereinafter the 'draft regulation').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and the third and sixth indents of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[1], as the draft regulation relates to Banka Slovenije and to rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose of the draft regulation

1.1 The draft regulation implements the Law on Slovenia's measures to strengthen bank stability[2] (hereinafter the 'Law on bank stability'). It replaces the Regulation on the implementation of measures to strengthen bank stability[3] which was subject to earlier ECB opinions[4], and which principally governs the detailed rules and procedures for the implementation of measures to strengthen the stability of banks. These measures, as envisaged by the Law on bank stability, include: (a) the transfer of bank assets to the State-owned Bank Asset Management Company (BAMC) or to dedicated companies[5]; (b) the issuance of State guarantees for the liabilities of the BAMC and of the dedicated companies; and (c) the recapitalisation of banks by the State or the BAMC (hereinafter the 'measures'). While maintaining the general structure and the majority of

1 OJ L 189, 3.7.1998, p. 42.

2 *Zakon o ukrepih Republike Slovenije za krepitev stabilnosti bank* (*Uradni list Republike Slovenije* No 105/2012).

3 *Uredba o izvajanju ukrepov za krepitev stabilnosti bank* (*Uradni list Republike Slovenije* Nos 22/2013 and 51/2013).

4 Opinions CON/2013/21 and CON/2013/67. All ECB Opinions are published on the ECB's website at www.ecb.europa.eu.

5 Dedicated companies are companies that take over the risks of banks. They may be established by the banks or by the banks together with the BAMC, as joint-stock companies, pursuant to Articles 2 and 21 of the Law on bank stability.

the provisions of the above-mentioned Regulation, the draft regulation contains several new and amended provisions, as further described below.

1.2 According to the explanatory memorandum of the draft regulation, the measures laid down in the Law on bank stability may be extended to banks that are not expected to continue to operate in the long term and that will be subject to supervised wind-down. The draft regulation reflects the potential application of the measures to such banks and lays down, *inter alia*, the definition and content of the wind-down plan to be prepared by the bank in question and assessed in the process of approving the application of measures by the Government[6].

1.3 The draft regulation lays down an additional condition relating to the application of any measures approved with respect to a bank under the Law on bank stability, which is that a contract be concluded between the bank in question and the State in which the bank agrees, *inter alia*, to: (a) comply with any commitments given by the State to the European Union in accordance with Union State aid rules; (b) provide the Ministry of Finance with any information required to assess its compliance with such commitments; and (c) reimburse the State in respect of any financial penalties imposed on it by Union bodies due to non-compliance with such commitments[7].

1.4 The draft regulation no longer limits the financial amount of State guarantees that may be issued in respect of the BAMC's liabilities to the value of the assets transferred by banks to the BAMC[8].

1.5 A new Section 6 has been added governing the rules on the BAMC's borrowing and debt management, use of available cash assets and payment of dividends[9].

1.6 The draft regulation no longer stipulates any detailed methodology for assessing the real long-term economic value of claims and potential claims to be transferred to the BAMC[10]. The explanatory memorandum states that the current methodology 'does not meet the requirements of the European Commission'. In the context of the valuation of assets for the purpose of the measures, the draft regulation requires the Ministry of Finance to agree with the Commission as to which entity would carry out the valuation of assets[11]. If such a valuation is performed by the Commission, the bank subject to the measures would not be required to perform the valuation itself[12].

1.7 To further streamline the processes involved in the implementation of the measures, the draft regulation now allows the results of a bank's asset quality review performed 'in accordance with instructions' by the Commission or the ECB to be used in the context of recapitalisation measures, in order to determine the value of the relevant bank's shares, their issue value and the rate of return of the bank's other capital instruments used to increase its capital[13].

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6 See, in particular, Articles 4(2), 7(4), 8(3) and 9(2) of the draft regulation.

7 See Article 12 of the draft regulation.

8 The relevant content of Articles 25 and 26 of the Regulation is not included in the draft regulation.

9 See Articles 36 to 47 of the draft regulation.

10 Annex 2 of the Regulation.

11 See Article 18 of the draft regulation.

12 See Articles 19(1), 20(4), 21(3), 22(5) and 23(4) of the draft regulation.

13 See Article 13(5) and Article 14(2) and (3) of the draft regulation.

1.8 As regards the measure under the Law on bank stability relating to the recapitalisation of banks, the draft regulation now explicitly includes the possibility for such recapitalisation to be done by non-cash contributions, subject to the general conditions for such contributions laid down in the Law on banking[14].

2. Monitoring the BAMC and dedicated companies

The ECB has encouraged the establishment of an independent body that is not involved in the activities of asset management companies established in other euro area countries to which bank assets have been transferred (a) to monitor the operations of the companies concerned; and (b) to have access to relevant information[15]. No such mechanism is envisaged for the BAMC and any dedicated companies that may be established. The ECB believes that such arrangements may prove useful to enhance the acceptance of the BAMC and its work. The consulting authority should consider establishing such a body under the draft regulation or any other appropriate legal act.

3. Financing the BAMC's operations

Article 36(1) of the draft regulation provides that the BAMC may borrow funds when necessary to compensate banks for the assets they have transferred to the BAMC, or to ensure the availability of the resources required by the BAMC to carry on its business. Unlike the current Regulation, the draft regulation also allows for part of such borrowing that exceeds the value of assets transferred by the banks to the BAMC to be backed by State guarantee.

It is important that the BAMC is provided with sufficient resources to efficiently conduct its operations, including the maintenance or increase of the value or marketability of the assumed assets before their ultimate sale. To ensure the BAMC's financial soundness, its capital should be bolstered, preferably through cash contributions.

4. Use of excess cash holdings by the BAMC and dividend payments

4.1 The ECB notes that Section 6 of the draft regulation aims, *inter alia*, to follow the ECB's previous recommendation to provide for the necessary legal arrangements to ensure, in a transparent manner, the timely redemption of State-guaranteed BAMC bonds, other financial instruments and credit claims of transferring banks. As stated in paragraph 6 of Opinion CON/2013/21, this may be accomplished by additional provisions that limit dividend payments by the BAMC and by ensuring that cash held by the BAMC is, as a priority, used to make timely or early repayment of the State-guaranteed bonds, such other financial instruments as may potentially have been issued by the BAMC or credit claims of the transferring banks. The ECB reiterates its view that such cash protocol arrangements should also apply to any entity to which the BAMC's liabilities towards

14 See Article 13(1) of the draft regulation.

15 See paragraph 10 of Opinion CON/2013/21.

banks, arising from bonds or other potential financial instruments or credit claims, would be transferred following expiry of the BAMC's term in 2017, as envisaged by the Law on bank stability. The same requirements should apply in respect of any dedicated companies.

4.2 Article 38 of the draft regulation defines the content of a financial plan to be prepared by the BAMC, including a plan on the use of 'available cash assets', and the draft regulation also stipulates the manner in which such available cash assets should be calculated. The plan for using available cash assets shall stipulate the portion of available cash assets to be transferred to a special 'fund for payment of issued debt securities'. The assets held in this fund, to be managed by the BAMC, may then be used to meet obligations due in relation to securities issued by the BAMC. They may also be used to redeem issued securities when this is economically justified. However, subordinated creditor claims may only be paid when they fall due[16]. The ECB broadly welcomes the introduction of these provisions as they define the basic framework for the redemption of State-guaranteed BAMC bonds and other financial instruments.

4.3 If the BAMC's liabilities are secured by State guarantee, the financial plan shall be submitted to the Ministry of Finance, which may propose amendments to it. If the BAMC does not take such proposed amendments into account, it shall provide reasons for such a decision. Otherwise, the BAMC's management board acts autonomously in adopting the financial plan[17], including the calculation and use of available cash assets, and in deciding on the redemption of issued securities. Given the importance of the management board's decision-making powers in applying the relevant provisions, effective supervision of the BAMC and its board is necessary to ensure that these provisions are applied in line with their underlying purpose. Additionally, the relevant provisions should be more precise by defining the notion of 'excess cash' to facilitate early repayment of the BAMC's liabilities, specifying clearer criteria for assessing when using such excess cash for early repayment of the BAMC's liabilities is 'economically justified', and determining who is responsible for carrying out such assessment[18].

4.4 Amendment of the financial plan is envisaged if substantial differences arise between actual and planned receivables and expenditure in any given financial year. The ECB considers it important that the plan for receivables and expenditure (as part of the financial plan) includes an appropriate temporal breakdown so that any departures from the plan can be spotted and addressed quickly.

4.5 The ECB welcomes the fact that, in line with its previous suggestion, the provisions of the draft regulation introduce limitations on the payment of dividends by the BAMC[19]. The relevant provisions introduce a significant limitation, in particular by not allowing any payment of dividends as long as the BAMC continues to have any liabilities which are backed by State guarantee.

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16 See Articles 37 to 40 and Articles 44 and 45 of the draft regulation.

17 See Articles 41 and 42 of the draft regulation.

18 See Articles 40 and 44 of the draft regulation, and in particular the imprecise criterion that 'it is not expected that the BAMC will realise higher returns on investments than the return it has to pay to holders of issued securities'.

19 See paragraph 6 of Opinion CON/2013/21.

5. Other observations

5.1 In respect of the fact that the draft regulation explicitly permits the recapitalisation of banks under the Law on bank stability using non-cash contributions, subject to the general conditions on such contributions laid down in the Law on banking, the ECB, as stated in previous opinions, generally prefers that, for reasons of financial stability, shares are issued against cash contributions[20].

5.2 Articles 19 and 20 of the draft regulation envisage cases when the real long-term economic value of assets to be transferred to the BAMC is to be assessed by the transferring bank, with the involvement of an independent appraiser, and audited by an independent auditor. It should be clear that any value assessed in this way is merely a suggestion for real economic value as eventually determined by the Commission in cases expected to involve State aid to the transferring bank.

5.3 The draft regulation includes several new or amended provisions reflecting the possible application of measures to banks subject to supervised wind-down. The ECB takes the view that the consulting authority should verify that all relevant provisions of the draft regulation are reviewed from that perspective.

5.4 The draft regulation contains several references to a bank's asset quality review being performed 'in accordance with instructions' by the ECB[21]. In the interests of clarity, the ECB suggests amending this wording to reflect the non-binding nature of any involvement by the ECB in the relevant asset quality review.

5.5 The ECB also invites the relevant authorities to consider implementing the other recommendations made in Opinions CON/2013/21 and CON/2013/67, including (a) stipulating any further specific conditions that dedicated companies have to meet to be able to take over bank assets, as well as minimum conditions on key matters, such as corporate governance standards and conflict of interest rules with respect to such dedicated companies; and (b) taking into account the results of the stress tests (in addition to those of the asset quality review) in the preparation by the Inter-ministerial Committee of a proposal on the execution of measures to be submitted to the Government (as envisaged in Article 8 of the current Regulation)[22].

20 See paragraph 3.5 of Opinion CON/2012/101.

21 See Article 2(2)(4), Article 13(5) and Article 14(2) and (3) of the draft regulation.

22 See paragraph 9 of Opinion CON/2013/21 and paragraph 4 of Opinion CON/2013/67.

5.6 The ECB also considers that the draft regulation would benefit from a careful review before adoption in order to improve its clarity and consistency[23].

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 9 December 2013.

[signed]

The President of the ECB

Mario DRAGHI

23 See e.g. the incomplete first sentence of Article 19(4) and references to Article 8 in Article 12(1) of the draft regulation.