EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 19 November 2010

on the restructuring of banks

(CON/2010/83)

Introduction and legal basis

On 4 October 2010, the European Central Bank (ECB) received a request from the German Federal Ministry of Finance for an opinion on a draft law on the restructuring and organised winding up of banks, the creation of a restructuring fund for banks and the extension of the limitation periods for management and supervisory board members' liability towards listed companies and banks (Law on restructuring) (hereinafter the 'draft law').

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 (TFEU) 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 law relates to the Deutsche Bundesbank and contains rules applicable to banks which 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 law

1.1 The general purpose of the draft law is to afford the competent authorities the powers and tools to resolve situations of distressed banks whose failure would pose a risk to the stability of the financial system. The draft law also aims to ensure that the consequential costs of dealing with the failure of such institutions are met by the private sector, i.e. the banking industry, and not by public funds, to the extent possible.

1.2 The draft law introduces new supervisory and resolution tools and procedures for the stabilisation, reorganisation, and, as a last resort, the orderly winding up of banks with a registered office in Germany which are in financial difficulties. For this purpose, the draft law introduces two main sets of measures.

(i) It provides for a two-stage procedure for the stabilisation and reorganisation of banks. Both

1 OJ L 189, 3.7.1998, p. 42.

stages of the procedure are introduced voluntarily at the credit institution’s initiative and serve to enable it to overcome the financial difficulties under its responsibility. When initiating this procedure, the credit institution will provide a plan for the stabilisation or reorganisation. Moreover, the relevant procedure and its underlying plans only become effective if the Federal Financial Supervisory Authority (BaFin) regards them as appropriate and if they are approved by the Higher Regional Court. In both stages of the procedure, an advisor is to be appointed by the Court. The role for this advisor is modelled on that of the special representative under the Law on banking and the provisional insolvency administrator.

The stablilisation stage of the procedure is designed as an early intervention measure to correct financial difficulties. It does not involve any interference with shareholder or creditor rights.

The reorganisation stage does interfere with such third party rights. It may only take place if the existence of the distressed bank is at risk and this constitutes a threat to the system, meaning that the measures taken must be covered by a manifest public interest. The reorganisation stage provides for rules on creditor voting and, if relevant, shareholders as regards the reorganisation plan under which they give or are deemed to give their consent to the plan. If the procedure described above is unlikely to succeed, the BaFin may immediately take the intervention measures set out under Article 2 of the draft law (amendment to the Law on banking).

(ii) The draft law also significantly increases Bafin’s powers and tools to restructure and wind up banks by amending the current law on banks (Article 2 of the draft law, as mentioned above). This amendment contains, as a measure of last resort, BaFin’s power to order the transfer of assets from the failing bank to a new safe haven entity (‘bridge bank’) (new Section 48a of the Law on banking), if the distressed bank is at risk and this constitutes a threat to the system. A bridge bank is a bank which is independent from an organisational and financial perspective. The establishment of such a bank may be necessary if, at the relevant time, no credit institution is available to take over the relevant assets and liabilities. This is intended to ensure that stabilisation measures can subsequently focus on the new bank, whilst the non-systemically relevant parts of the old institution can be wound up under the ordinary insolvency procedure. The draft law also enables the BaFin to appoint a special representative, who may be given the power to act as the institution’s statutory organs. These new measures can be taken by the BaFin without prior agreement of creditors or shareholders.

1.3 In addition to these new procedures and tools, Article 3 of the draft law establishes a restructuring fund for banks (the ‘Fund’) and transfers new duties related to the management of this Fund to the Federal Authority for Financial Market Stabilisation (FMSA). The purpose of the Fund, a Federal special-purpose vehicle, is to finance future bank restructuring and winding-up measures. All

German banks will be obliged to contribute to the Fund. The amount of an individual institution's contribution will be based on the systemic risk it poses, and this is determined according to the size of the bank and its cross-linkage within the financial market. In this regard, an institution's liabilities must be taken into account and other relevant indicators may also be considered. The FMSA will be responsible for implementing restructuring measures and administering the Fund.

1.4 In addition to these key elements, the draft law extends the period of limitation for claims against Members of the Board of Management and the Supervisory Board who breach their managerial duties under the Law on stock corporations from 5 to 10 years. It also amends the Law on the Financial Market Stabilisation Fund and the Law on financial markets stabilisation acceleration so that the new procedures and tools mentioned above would, in the application of some transitional provisions, replace the stabilisation measures of the Fund.

2. General observations

2.1 The ECB welcomes the draft law as it strengthens the tools and procedures available to the national authorities for effective early intervention, reorganisation and restructuring of distressed banks.

The ECB notes that, in accordance with the Council conclusions of May 2010, the European Commission presented a communication which defined the milestones for a major overhaul of the Union's regulatory framework. This overhaul is to be undertaken from 2011 onwards and aims to establish a holistic, coordinated and more harmonised framework for preventative action, early intervention and resolution management. In particular, the Commission announced legislative proposals aiming at further harmonisation of a wide set of early intervention and resolution tools. The ECB broadly supports such plans and notes that a common set of tools should be designed with the aim of allowing authorities to address problems with a distressed bank, without needing to resort to public support. In turn, such tools should also facilitate a private sector solution or, when appropriate, ensure the liqidation of the bank in a way which has minimal effects on financial stability.

In this context, it is noted that the draft law significantly enhances the tools available to the national authorities, in particular by introducing a comprehensive framework for reorganisation which would enable the transfer of assets, or parts of thereof, of a systemically relevant bank to a private bank, or temporarily to a State 'bridge bank' or a debt to equity swap.

2.2 The ECB welcomes the acknowledgement of the German Government, as reflected in the explanatory notes to the draft law, of the need for coordinated action at Union level and the need for any national proposal to be integrated and aligned with the current preparatory work of the European Commission on a cross-border crisis management framework for the financial sector (EU crisis management framework)[2]. Member States may need to adopt measures on crisis management

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2 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 on 'An EU Framework for Crisis Management

in the interests of urgency. However, prior to the adoption of the EU crisis management framework in the form of a Union legal instrument, and even before its implementation, Member States should take into account developments at Union level in the preparation of such a framework and should thus avoid any national legislation conflicting with it, in accordance with the general principle of sincere cooperation and loyalty pursuant to the Treaty on European Union. In this respect, the ECB also refers to guidance provided by the Council (ECOFIN)[3], as well as the Declaration issued by the Heads of State of the euro area[4].

2.3 It should also be ensured that the application of the draft law complies with Article 107(3)(b) TFEU, meaning that domestic support measures to banks in distress and their terms of application must comply with the principle of non-discrimination and competition law and the State aid rules of the Union.

3. Procedure for the stabilisation and reorganisation of banks

3.1 In Section 19(4) of Article 1, the draft law provides for the deemed consent of shareholders to the reorganisation plan, where the majority of the creditors have voted in favour and where the measures under the plan are proportionate and aim to prevent serious negative effects on other financial institutions arising from the failure of the bank concerned. This constitutes an interference with shareholder rights as guaranteed by Directive 77/91/EC[5], notably Article 25(1) on the increase of capital, for example in the case of a debt to equity swap. The explanatory notes to the draft law extensively address this legal issue. The ECB recognises the manifest conflict arising between shareholder rights and public interest issues in such a situation, and this may need to be addressed at national level as a matter of urgency. However, legal uncertainty could be exacerbated by provisions which clearly breach the Directive and merely rely on a possible future change in Union law in this regard. The existing conflict between the strong protection of shareholder rights and the legitimate protection of public interests needs to be addressed at Union level, respecting the principle of the primacy of Union law.

3.2 The stabilisation and reorganisation plans may only enter into force if they have been approved by the Higher Regional Court. Under this procedure, the Court is the final authority, after the BaFin's prior involvement. As the ECB has stated in previous opinions, in many cases the banking supervisory authority will be best placed to assess whether a distressed bank is able to continue in

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in the Financial Sector', COM(2010) 579 final of 20 October 2010; Commission Communication on an EU Framework for Cross-Border Crisis Management in the Banking Sector on 20 October 2009.

3 See the recent Council (ECOFIN) report to the European Council on the state of play on financial levies and taxes, and for guidance to the Member States in the conclusions of the ECOFIN meeting see 'Immediate responses to financial turmoil', Council Conclusions of 7 October 2008, both available on the Council's website at www.consilium.europa.eu.

4 The text of the declaration of 12 October 2008 is available on the former French Presidency's website at www.ue2008.fr.

5 Second Council Directive 77/91/EC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent (OJ L 26, 31.1.1977, p. 1).

business[6] and therefore will also be able to assess the appropriateness of such plans. Whilst this is reflected in the draft law, the requirement for the Court to approve the plans may mean that the restructuring is not always quick.

3.3 The provisions concerning the content of the reorganisation plan (Section 8(2) of Article 1) provide for the building of voting groups among the creditors, whose composition depends not only on the creditors' legal position but also their respective economic interests. The sub-division following the concept of 'economic interest' might create legal uncertainty unless the criteria for making these decisions, which may have direct consequences on creditor rights, are more clearly stipulated.

4. Amendments to the Law on banking – Improved instruments for resolution of systemically relevant banks

4.1 The draft law's introduction of the option of a full or partial transfer of a distressed bank's assets and liabilities to a bridge bank is welcomed. The Eurosystem highlighted the importance of such a resolution tool in ensuring the continuity of essential business operations of systemically important banks when replying to the Commission's initial analysis of a future EU framework for crisis management and resolution[7]. The availability of such resolution tools is also in line with the recommendations on the need for an enhanced convergence of national crisis management regimes adopted at both international and Union levels[8]. In view of the increasing inter-dependencies between financial systems and the need to address the possible systemic impact of the failure of cross-border financial institutions, the domestic crisis management frameworks may need to be further aligned with future regulatory initiatives at Union level. These initiatives address, *inter alia*, existing problems in the coordination of resolution and insolvency proceedings concerning cross-border banks.

4.2 In line with its previous position, the ECB sees the need for the close involvement of central banks in prudential supervision[9]. The ECB notes the involvement of the Deutsche Bundesbank, together with the BaFin, in assessing whether an existential risk to the credit institution and a systemic risk are present (Section 48b(3) of Article 2 of the draft law). The involvement of the Bundesbank is consistent with its role as a member of the European System of Central Banks in contributing to the stability of the financial system (Article 127(5) TFEU).

4.3 Pursuant to the provisions on transfer orders (Section 48a *et seq.* of Article 2), the choice of assets and liabilities to be transferred from the distressed credit institution to another entity will depend

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6 Opinion CON/2005/36, paragraph 10. All ECB opinions are available on the ECB's website at www.ecb.europa.eu.

7 See the Eurosystem's reply of 8 February 2010 to the public consultation by the Commission launched in its Communication on an EU Framework for Cross-Border Crisis Management in the Banking Sector on 20 October 2009.

8 See in particular 'Report and Recommendations of the Cross-border Bank Resolution Group', March 2010, available at www.bis.org and 'Practical Guide on Cross-Border Insolvency Cooperation' adopted by UNCITRAL on 1 July 2009, available at www.uncitral.org; and the Communication of the Commission of 20 October 2010 on 'An EU Framework for Crisis Management in the Financial Sector', COM(2010) 579 final.

9 Opinion CON/2010/7, paragraph 2.1.1; Opinion CON/2007/33, paragraph 2.1.

considerably on the BaFin's discretion. There are no specific rules or other criteria in the draft law which provide the basis on which assets should be selected for transfer[10]. Although it may be necessary to retain some flexibility to allow the BaFin to address different possible situations, some basic rules to be respected by the authorities in exercising this power would be useful as there could be considerable intrusion on the rights of creditors and on the principle of equal treatment (priority rights etc.). Whilst such basic rules would maintain a degree of flexibility, they would also limit the discretion in exercising this power with a view to promoting legal certainty on the market for bank debt.

5. Suspension of close-out netting clauses

5.1 Section 13 of Article 1 fo the draft law provides that contractual relationships with a credit institution cannot be terminated until the business day following the date of an institution's application to BaFin for the initiation of the reorganisation procedure. The ECB supports the rationale behind this temporary prohibition, as it may be essential to efficiently and safely transfer en bloc assets, such as derivative contracts with counterparties, to a bridge bank or another new entity to preserve the distressed bank's business operations until it can be safely reorganised.

Moreover, Section 48g(7) of Article 2 of the draft law contains an outright ban on counterparties terminating contracts with banks which are the subject of a spin-off of assets to another entity based on a BaFin transfer order.

As stated in recommendation 9 of the Report and Recommendations of the Basel Committee on Banking Supervision's Cross-border Bank Resolution Group[11], 'the ability of relevant [national] authorities to impose a brief delay on the exercise of early termination and netting rights would maximise the possibility of transfer to a sound financial institution, a bridge bank or another public entity provided that the period of time during which the authorities can delay immediate operation of contractual early termination rights pending a transfer is clearly defined and limited, after which full termination and close-out rights would be available for all financial contracts not transferred to a solvent transferee;'.

5.2 The ECB notes that any suspension of counterparties' close-out netting rights conflicts with Directives 98/26/EC[12], 2002/47/EC[13] and 2001/24/EC[14]. Article 7(1)(b) of Directive 2002/47/EC

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10 Article 2 Section 48j(3) only provides that the selection of the remaining spin-off assets depends on how significant they are to an effective, cost-efficient defence of the systemic risk emanating from the credit institution. It is unclear if this sentence is at all applicable in the case of partial transfer, as Section 48k(2) only refers to the fourth to sixth sentences. This seems to be a drafting error as Section 48j(3) only has five sentences. Therefore the reference is understood to be to the third to fifth sentences; i.e. the main sentence dealing with selection of remaining spin-off assets for re-transfer.

11 Basel Committee on Banking Supervision, 'Report and Recommendations of the Cross-border Bank Resolution Group', March 2010, available at www.bis.org.

12 Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (OJ L 166 , 11.06.1998 p. 45), as amended by Directive 2009/44/EC of the European Parliament and of the Council of 6 May 2009 (OJ L 146, 10.6.2009, p. 37).

13 Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, (OJ L168, 27.6.2002, p. 43).

requires Member States to ensure that in case of financial collateral a close-out netting provision can take effect in accordance with its terms notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures or any purported assignment, judicial or other attachment or other disposition of or in respect of such rights. Similarly, settlement finality is required by Directive 98/26/EC for netting within Union designated payment and securities settlement systems. Article 25 of Directive 2001/24/EC further provides that netting agreements shall be governed by the law of the contract which governs such agreements. The ECB notes that the master agreements on which close-out netting rights are based are often concluded by German banks under the laws of other jurisdictions, such as English or New York law. It is legally uncertain whether the proposed temporary stay would be consistent with the existing provisions of Union law. Also, it is unclear under Union law whether the proposed stay could be enforced against a German credit institution which has entered into a netting agreement governed by English or New York law or other non-German laws. In view of these legal uncertainties, any statutory powers to impose a temporary stay on such contracts should be coordinated closely at Union level.

6. The restructuring fund and bank levy

6.1 The ECB welcomes the establishment of the Fund as part of a broader range of initiatives aiming at strengthening financial stability. The Fund regime entails the further disengagement of the State in favour of restructuring primarily financed by the banking sector[15]. This financing regime is in line with the G20 and the European Commission communications[16].

6.2 Nonetheless, the ECB considers that the Fund should provide financial support to mitigate the impact of an institution’s distress, i.e. in the context of a resolution, and should not be used for the purposes of a bail-out. The purpose of resolution funds is to mitigate the effects of a failure on different stakeholders by trying to maximise the value of remaining assets and facilitate, if possible, a quick return to their productive use. In some cases, this type of fund may help to continue the performance of core services by creating a bridge bank that will be sold afterwards. The costs incurred in these activities should be borne by the private sector, thus avoiding recourse to public funds to support distressed institutions. From this perspective, the ECB acknowledges the intention of the German authorities to establish a fund with a wider scope.

6.3 It cannot be excluded however that in a crisis situation, funding by the industry may be insufficient and that supplementary use of public funds may be necessary. In that case, the banking sector should be called upon to reimburse the State for the public funds it has provided. The principle of ex post recovery from the banking sector should promote additional market discipline and address moral hazard risk.

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14 Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions (OJ L 125, 5.5.2001, p 15).

15 See Opinion CON/2010/45.

16 Commission Communication on Bank Resolution Funds, COM (2010) 254 final, 26 May 2010.

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

Done at Frankfurt am Main, 19 November 2010.

[signed]

The President of the ECB

Jean-Claude TRICHET