EUROPEAN CENTRAL BANK

EUROSYSTEM

# OPINION OF THE EUROPEAN CENTRAL BANK

## of 24 May 2011

## on the introduction of a compensation scheme for distressed banking institutions

## (CON/2011/45)

**Introduction and legal basis**

On 29 April 2011, the European Central Bank (ECB) received a request from the Danish Ministry of Economic and Business Affairs for an opinion on a draft law amending the Law on a guarantee fund for depositors and investors, the Law on financial stability, and the Law on payment of State income tax (introduction of a compensation scheme for distressed banking institutions)[1] (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 and the sixth indent 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[2], as the draft law relates to the 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 law**

1.1 The draft law provides for a scheme to transfer the assets and liabilities of a distressed credit institution to another financially sound credit institution, by allowing the Danish Guarantee Fund for Depositors and Investors (hereinafter 'the Fund') to provide funds or a guarantee covering all unsubordinated creditors of this distressed credit institution as further specified in the Notes on the draft law.

1.2 The draft law will amend the Law on a Guarantee Fund for Depositors and Investors, the Law on financial stability, and the Law on payment of State income tax, and will establish a compensation scheme for distressed banking institutions. It will thereby amend the Law on amendments to the

1 Law on a guarantee fund for depositors and investors, cf. Consolidated Law No 133 of 22 February 2011; Law on financial stability, cf. Consolidated Law No 875 of 15 September 2009, §7 of Law No 1273 of 16 December 2009, §1 of Law No 721 of 25 June 2010, and §14 of Law No 1556 of 21 December 2010; and Law on payment of State income tax, cf. Consolidated Law No 1365 of 29 November 2009. The scheme introduced by the draft law is partially a reintroduction of a Danish scheme that existed until 2007, but in the light of Union State aid rules at that time was considered inoperative. The Danish term for this possibility of compensating an acquiring bank is known as a 'dowry' scheme, which is also the subtitle of the Danish version of the present draft law. The unofficial English version is available on the website of the Danish FSA at http://www.ftnet.dk/en/Regler-og-praksis.aspx.

2 OJ L 189, 3.7.1998, p. 42.

2010 financial stability regime, Bank Package III, on which the ECB gave its opinion on 28 May 2010[3].

1.3 The scheme set up by Bank Package III on 1 October 2010 established a more permanent and general regime for handling distressed banking institutions to replace the general Danish State guarantee scheme for ordinary individual creditors and depositors which expired on 30 September 2010. It introduced a controlled winding-up mechanism of a distressed credit institution through the Financial Stability Company (hereinafter the 'Company') compared to the traditional and often lengthy winding-up procedures and compulsory sales in a bankruptcy. This winding-up mechanism is activated where a credit institution is unable to meet the capital adequacy requirements and the credit institution then has the option either to transfer its activities to a buyer designated by the Company or to enter normal bankruptcy proceedings with the clear aim of winding it up and of transferring existing customers to other institutions. The Company injects capital into the new subsidiary in accordance with the capital adequacy requirements of the Law on Danish financial business. If more liquidity is required than can be raised in the central bank's regular market operations, the Company can provide a liquidity facility, to ensure that the liquidity adequacy requirements are met. The injected capital will earn a market return, to be borne by the subsidiary.

1.4 As the second and separate element of the winding-up regime, the Fund has set up a Winding-Up Department of the Guarantee Fund, separated by Chinese walls from the Fund's ordinary guarantee obligations. The Winding-Up Department may guarantee loans for the capitalisation and liquidity, and it will bear any losses incurred through the winding-up. The capital of the Winding-Up Department will be provided through guarantees from Danish banking institutions. Where the capital requirements exceed the guarantees, the Winding-Up Department can raise loans guaranteed by the State[4].

1.5 The draft law[5] has the aim of overcoming practical difficulties of Bank Package III by facilitating the identification of market-based solutions for distressed banking institutions no longer fulfilling the capital requirements of the Danish Financial Supervisory Authority (FSA). The draft law includes the possibility for the Guarantee Fund for Depositors and Investors to provide financial assistance and/or guarantees for all unsubordinated creditors to another institution in connection with the complete transfer of the business of the distressed credit institution. The conditions are (1) that it has proved impossible to find any private, market-based solution; (2) that this solution is economically more advantageous to the Guarantee Fund than the existing alternatives of winding-

3 See Opinion CON/2008/54. Since the start of the financial crisis in 2007 Denmark had previously introduced three major laws and amendments on which ECB has been consulted. See Opinion CON/2009/6, and Opinion CON/2010/45. All ECB opinions are published on the ECB's website at www.ecb.europa.eu.

4 According to the existing § 6, subsection 5 of the Law on a guarantee fund for depositors and investors, the Minister for Economic Affairs may, with the approval of Parliament's Finance Committee, provide a guarantee for a loan made to the Fund to meet its commitments. With the creation of the new and separate winding-up department of the Fund, a similar possibility of taking out a loan with the approval of the Finance Committee will also be provided for, if the resources of this department should not suffice to cover the winding-up obligations of the Fund.

5 The draft law leaves it to the Minister to decide on the date of its entry into force, and according to the Notes on the draft law this is to allow for the time needed for the Commission to consider the compatibility of the draft law with Union rules - see the General notes 8. Union law and the Notes on individual provisions, No 4.

up and insolvency proceedings under the Financial Stability Company; (3) that a transfer to another institution is deemed by the FSA to be financially and managerially sustainable in the longer term for carrying on the business of the failed institution by the acquirer; and (4) that it is compatible with Danish and Union rules on competition and State aid. The financing of the new compensation scheme will be fully borne by the banking sector and has no budgetary consequences for the Danish State[6]. As with the existing scheme, the Danish State will continue to bear the residual risk of a State guarantee, if the FSA considers that the Fund needs to take up loans on the capital markets to provide sufficient funds.

1.6 The Chair and banking sector representatives of the Fund need a unanimous decision on providing compensation from the Fund for a market-based transfer of the distressed credit institution, in order to prevent any discrimination and distortion of competition, and it is for the Company to execute such decision, which may make its execution conditional on a transparent bidding procedure open to all interested parties[7].

## 2. General observations

The consultation process both in relation to the ECB and to Danish authorities and market participants was launched simultaneously with the presentation of the draft law to Parliament on 29 April 2011[8]. The consulting authority has set a deadline of 10 May 2011 for the receipt of the ECB's opinion and has informed the ECB that the draft law is urgent because of the intention of having it adopted before the end of the current parliamentary year. Although the consulting authority appears to invoke the exemption provided for in Article 3(2) of Decision 98/415/EC, which allows for a reduction below the minimum time limit for submission of the ECB's opinion of one month in case of extreme urgency, the ECB finds that sufficient argumentation for such urgency has not been adduced. Furthermore, the ECB draws the consulting authority's attention to the second sentence of Article 4 of Decision 98/415/EC that provides that the ECB must be consulted 'at an appropriate stage' in the legislative process. This implies that the consultation should take place at a stage in the legislative process that affords the ECB sufficient time to examine the draft legislative provisions and to adopt its opinion in the required language versions at a point in time which also enables the relevant national authorities to take the ECB's opinion into consideration before the legislative provisions are adopted.

## 3. Specific comments

3.1 The ECB welcomes the fact that the compensation scheme does not entail any further engagement by the State in the winding-up of distressed banking institutions, but that the new scheme will be fully based on financing by the banking sector.

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6 See the General Notes on the draft law.

7 See the General Notes, 3.1.

8 On 27 April 2011 the Ministry sent the draft law on the compensation scheme.to the ECB with information on the presentation and general hearing of the draft law on 29 April 2011.

3.2 The ECB also welcomes that - as stated in the General Notes on the draft law - a credit institution for which the FSA has set a deadline to fulfil the solvency criteria must first seek a market-based solution. According to this approach, a compensation scheme is a subsidiary measure where the credit institution considers that it has lost its capital or either is or must expect to be insolvent; it is only available where the credit institution's own efforts to find a market-based solution have proved unsuccessful.

3.3 The ECB supports the rules for the transfer of the failed credit institution to another credit institution and the provision of funds for its transfer as set out in the Notes[9], which lay down that it must take place on a market-conforming basis. Further, the ECB welcomes the detailed measures prescribed to ensure that a transfer and economic assistance are in accordance with the principle of non-discrimination and on market terms, and that a market-based bidding procedure must be launched where several banking institutions have expressed a potential interest in taking over the distressed institution[10].

3.4 Furthermore, the ECB welcomes that the Fund will operate on a least-cost basis, i.e. that it will only participate in the winding-up of a credit institution by providing funds or guarantees to cover all the credit institution's unsubordinated creditors, where this is assessed to be the cheaper solution for the Fund compared to other options.

3.5 The ECB supports the Chinese walls between the Fund and the Fund's Winding-up Department to safeguard depositor's interests. In principle, a winding-up facilitation should not lead to the bailout of the failed credit institution.

3.6 The ECB notes that the new compensation scheme is in line with the European Commission's plans for a directive on guarantee schemes that will provide more crisis management tools[11].

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

Done at Frankfurt am Main, 24 May 2011.

[signed]

*The Vice-President of the ECB*

Vítor CONSTÂNCIO

9 See Notes on individual provisions, 2.

10 See Notes on individual provisions, 2, subsection (2).

11 See General Notes, 8. Union law, third paragraph.