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OPINION OF THE EUROPEAN CENTRAL BANK

of 24 June 2009

on further financial market stabilisation measures

(CON/2009/54)

Introduction and legal basis

On 26 May 2009, the European Central Bank (ECB) received a request from the German Federal Ministry of Finance for an opinion on a draft law on the further development of financial market stabilisation (hereinafter the 'draft law'). On 15 June 2009, the ECB received a further request from the German Federal Ministry of Finance for an opinion on a proposal to amend the wording of the draft law (hereinafter the 'proposed amendment').

The ECB's competence to deliver an opinion is based on Article 105(4) of the Treaty establishing the European Community 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[1], as the draft law relates 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 law and the proposed amendment

1.1 While the German Federal Government has already taken steps to stabilise the financial markets with the Law on financial market stabilisation[2], credit institutions nevertheless hold large volumes of structured securities (e.g. asset backed securities, collateralised debt obligations, etc.) and there are further assets with increased default risks in the balance sheets of credit institutions and financial services institutions. These securities and assets are difficult to evaluate and are not easily sold in a volatile market environment. They entail credit and liquidity risks that may result in the write-off of the value of the securities. Thus, confidence in the holders of these instruments and their financial resources may be impaired.

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1 OJ L 189, 3.7.1998, p. 42.

2 Law on financial market stabilisation of 17 October 2008, (2008) *Bundesgesetzblatt I*, p. 1982.

1.2 *The draft law*

1.2.1 Against this background, the draft law provides for short-term measures to remove structured securities from the balance sheets of financial holding companies, credit institutions and their subsidiaries (hereinafter the 'transferring institutions'). It also creates certainty with regard to write-offs.

1.2.2 Under the draft law, a transferring institution may transfer structured securities (hereinafter the 'transferred securities') at a reduced book value[3] to a special purpose vehicle (SPV) that is established for this purpose. In return, the transferring institution receives bonds for the same value issued by the SPV and guaranteed by the Sonderfonds Finanzmarktstabilisierung (SoFFin, Financial Market Stabilisation Fund), i.e. by the State. Thus, the transferring institution has State guaranteed bonds instead of volatile assets on its balance sheet. The interest and repayment of the bonds are serviced from the cash flows of the transferred securities. In return, the transferring institution pays a guarantee fee adequately reflecting the risk connected to the transferred securities to the Government (the SoFFin). The real economic value of the securities is determined at the time the securities are transferred. If, based on a risk evaluation, the value of the securities is reduced, an additional deduction is made and the resulting value is the 'fundamental value'.

1.2.3 The transferring institution is obliged to pay a compensatory fee from the amount available for distribution to shareholders. The compensatory fee is equal to the difference between the discounted book value and the fundamental value and is paid in equal annual instalments over the life of the structured security, up to a maximum of 20 years. This payment is made to the SPV to compensate for expected losses arising from the purchase of the asset. The interest rate advantage arising from the deferred payment of the difference between the reduced book value and the fundamental value must be remunerated in the form of a market-based fee for the SoFFin's guarantee.

1.2.4 Any funds remaining after the SPV's dissolution are paid to the transferring institution's shareholders. If the compensatory fee fails to cover losses stemming from the transferred securities, the transferring institution is liable and must fully compensate the Government for such losses out of the amount available for distribution to shareholders. As a consequence, the shareholders of the transferring institution are responsible for all losses stemming from the transferred securities.

1.2.5 The transferring institutions eliminate the risks associated with the transferred securities once they are written down to the reduced book value. To attract new investors and to shield them from the risks associated with the transferred securities, the transferring institutions may issue preferential shares, which may also have voting rights. Such preferential rights have priority over other shareholders and the SoFFin's claims.

3 This is the higher of 90 % of the book value as stated in the last audited annual accounts or the real economic value as defined by the Commission; this haircut on the book value is subject to the proviso that the transferring institution retains a core capital ratio of at least 7 %.

1.3 *The proposed amendment*

1.3.1 The proposed amendment provides for the transformation of the current Finanzmarktstabilisierungsanstalt (Financial Market Stabilisation Authority) into the Bundesanstalt für Finanzmarktstabilisierung (FMSA, Federal Authority for Financial Market Stabilisation), a Federal authority with legal capacity under public law, within the sphere of responsibility of the Federal Ministry of Finance. Further, under the proposed amendment the deadline for applying to the FMSA for support measures is extended until 31 December 2010.

1.3.2 In substance, the proposed amendment provides for measures to clean up the balance sheets of credit institutions, financial holding companies, their subsidiaries and SPVs with respect to risk positions and non-strategic business areas. These transferring institutions are able to transfer these risk positions and business areas to an organisationally and financially independent winding-up agency separately established under public law for each institution by and under the supervision of the FMSA. As the winding-up agencies are not subject to the provisions of the Banking Act within the framework of the EU law requirements of the Banking Directive[4], the assets transferred to the winding-up agencies are not subject to the own funds requirements.

1.3.3 The registered office, tasks, organisation, governance and surveillance etc. of these agencies are to be regulated in the statutes of each agency, which are to be published in the Federal Bulletin.

1.3.4 The principle of proprietary responsibility applies, so that a winding-up agency and the direct and indirect owners of the transferring institutions which have a stake in the winding-up agency are liable to pay compensation for any losses. This is a direct and comprehensive liability for the losses of the winding-up agency. At the same time, the liability of the State is to be excluded as far as possible.

1.3.5 According to the explanatory memorandum accompanying the proposed amendment, consideration for the transfer of risk positions and business areas depends on the design of the transfer and on who is ultimately liable for the transferred assets. As stated in the explanatory memorandum, a *Landesbank* (a bank owned by a German Federal State) should only be able to use this scheme once the Federal States that hold shares in that *Landesbank* have committed themselves to a reorganisation of the *Landesbank* sector.

2. General observations

2.1 All the comments and recommendations in relation to the rescue package of the German authorities made by the ECB in Opinion CON/2008/57 and Opinion CON/2009/24 apply equally to the draft law and the proposed amendment.

4 See Section A. of the explanatory memorandum accompanying the proposed amendment.

2.2 In line with its previous opinions, the ECB emphasises the following:

(i) when adopting measures to deal with the financial crisis, Member States should act in a coordinated manner in order to avoid significant differences in national implementation having a counter-productive effect, which may involve distortions in global banking markets. Moreover, it is crucial to ensure consistency with the management of liquidity and with the operational framework of the Eurosystem[5]. Such considerations are particularly important in ensuring a sufficiently level playing field within the euro area;

(ii) the ECB welcomes the fact that the SoFFin, as well as the newly created FMSA, is organisationally separate from the Deutsche Bundesbank, as recommended in Opinion CON/2008/57. In this respect, the ECB reiterates its comments made in paragraph 3.1 of Opinion CON/2008/57 on other aspects of compliance with Article 101 of the Treaty;

(iii) as concerns eligibility for support, the ECB notes that, as mentioned in Opinion CON/2008/57, the measures under the draft law are available to credit institutions and financial holding companies which have their registered office in Germany, or their subsidiaries.

2.3 The Eurosystem has assessed the features and implementation modalities of asset support schemes and has developed a number of guiding principles[6] for the attainment of the following objectives: (i) safeguarding financial stability and restoring the provision of credit to the private sector while limiting moral hazard; (ii) ensuring that a level playing field within the single market is maintained to the maximum extent possible; and (iii) containing the impact of possible asset support measures on public finances. The seven guiding principles identified are sufficiently broad to apply to all schemes falling under the wide category of asset support measures. These concern: (i) the voluntary nature of participation, with institutions with large concentrations of impaired assets being given priority; (ii) a broad definition for eligible assets; (iii) transparency of valuation of the assets; (iv) an adequate degree of risk sharing; (v) a sufficiently long duration of the schemes; (vi) governance of the institution according to business principles; and (vii) making such support schemes conditional on certain commitments by the participants.

2.4 *The draft law*

2.4.1 The draft law provides for an asset support scheme according to which a transferring institution sets up its own SPV and transfers securitised assets to it. In exchange, the SPV issues Government guaranteed bonds to the transferring institution. Moreover, under the draft law, the original shareholders of the transferring institution remain liable for any of the SPV's losses, as long as these are covered by the future amounts available for distribution to shareholders of the transferring institution. Under this model, the securities are removed from the transferring institutions' balance

5 See Opinion CON/2008/57. All ECB opinions are available on the ECB website at www.ecb.europa.eu/ecb/legal/opinions/html/index.en.html.

6 Guiding Principles for Bank Asset Support Schemes issued on 25 February 2009, available on the ECB website at www.ecb.europa.eu.

sheets, while on the other hand the profit distributable to the shareholders will continue to be used until all risks of the securities are covered. For this reason, the draft law may be considered a 'hybrid' asset support scheme.

2.4.2 Since the shareholders of the transferring institutions thereby have to fully bear the cost of the scheme as long as the transferring institutions exist, moral hazard as well as incentives to participate are likely to be limited. In addition, possible complexities in determining the correct value of the transferred securities are partially circumvented, as valuation only has an effect for the addressees of the distributable profits of the transferring institution. If the transferred securities are overvalued, the compensation fee paid over the guarantee period would be too low. The difference would then be paid from future distributable profits, which would not be distributed to the shareholders but to the Government. In the event of undervaluation, the opposite occurs and the shareholders would profit from the SPV's profits. The effect of the scheme on the federal budget and debt may be limited, given that upfront payments by the government are not necessary.

2.4.3 For the reasons given in paragraphs 2.4.1 and 2.4.2 above, the scheme provided for by the draft law is broadly in line with the guiding principles, subject to the specific observations below.

2.5 *The proposed amendment*

2.5.1 The proposed amendment defines in very broad terms: (i) the possible beneficiaries of the scheme, (ii) the types of assets to be covered, and (iii) the conditions and modalities of the scheme introduced by the proposed amendment. These must be laid down in the statutes of each winding-up agency. The proposed amendment thus leaves a wide margin of discretion to the FMSA and the Ministry of Finance to decide whether to establish a winding-up agency and on whether to specify further the modalities and conditions for the transfer of assets to such agency. The ECB recommends that the proposed amendment should follow the guiding principles set out in paragraph 2.3 above and it should be specified that the proposed amendment, and any implementing measures or decisions adopted pursuant to the proposed amendment, should be interpreted in the light of these guiding principles.

2.5.2 The ECB notes that the initial deadline for applying for support measures by the SoFFin is prolonged for one year until 31 December 2010. As stated before[7], the ECB emphasises that harmonisation regarding the expiry of the various financial support measures within a particular country and the national financial support schemes across the EU is of crucial importance in order to ensure a level playing field.

2.5.3 Due to the general nature of the drafting of the proposed amendment, no more specific comments can be made on it at this point.

7 See Opinion CON/2009/6.

3. Specific observations on the draft law

3.1 *Eligibility of assets as collateral in Eurosystem refinancing operations*

3.1.1 The draft law does not specify any restrictions on the guaranteed bonds that will be provided in exchange for the transferred securities.

3.1.2 The ECB assumes that the debt securities issued by the SPV will be straight bonds rather than, for example, structured securities. This is important for the eligibility of these bonds in Eurosystem credit operations. It should be noted that for example subordinated securities with an appropriate guarantee may be only temporarily eligible as collateral for Eurosystem refinancing operations, i.e. until the end of 2010. For legal certainty reasons, clarification of this issue in the draft law would be welcomed.

3.1.3 The ECB understands that, according to the draft law, the SoFFin's guarantee covers all issuer obligations in relation to payments of principal, interest and any other amounts due under the transferred securities. Again, this is important for the eligibility of these bonds in Eurosystem credit operations.

3.1.4 The draft law does not specify whether the SPV may sell or pledge the transferred securities received or whether they must be held to maturity. If they can be repoed out or sold by the SPV (which will not be a counterparty to the Eurosystem), then they may be available for use as collateral in Eurosystem credit operations[8].

3.2 *Financial Stability*

3.2.1 The scheme provided for by the draft law is expected to offer two possible sources of relief for transferring institutions. First, the exchange of transferred securities for government guaranteed bonds may provide transferring institutions with collateral that can be used to access central bank liquidity. Second, from a regulatory perspective, exchanging securities subject to high capital requirements for government guaranteed bonds may free up capital.

3.2.2 The provision of liquidity and the freeing up of capital would allow transferring institutions to continue their lending activity. Despite the cap on the haircut of 10 %, the risk is that some institutions may have limited incentives to participate in the scheme because of low capital buffers. However, this risk is limited by the condition that the transferring institution retains a core capital ratio of at least 7 % and the haircut is only needed if the fundamental value is lower than the book value. In addition, potential new investors could be discouraged from injecting capital into the transferring institution due to a future allocation of distributable profits to cover the SPV's losses; however, this is mitigated by the ability of the transferring institutions to issue preferential shares granting new shareholders priority over the SoFFin's claims. Since the draft law allows for compensation for potential losses in the form of share issues to the SoFFin and this implies

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8 This requires that the transferred securities fulfil the ECB's eligibility criteria and are repoed out or sold to an eligible Eurosystem counterparty.

increased government involvement in the banking sector, the ECB considers that an assessment of the extent of this additional public involvement should be made and exit strategies be formulated.

3.2.3 Finally, the ECB understands that the transferring institutions continue as going concerns, i.e. they will not be wound up. Therefore, a condition for participation is the maintenance of adequate capital levels, a sound business policy and a solid business model. In the event of the transferring institution's insolvency and a loss on the SPV's portfolio, the Government would become responsible for losses on the guaranteed transferred securities. Consequently, the Government has an incentive to avoid the insolvency of a transferring institution by providing further support measures. In this regard, the draft law may necessitate further public support measures.

3.3 *Accounting*

3.3.1 In the context of the implementation of the draft law, the ECB notes that the accounting treatment of the transferred securities is unclear. Under the current proposal, the shareholders of the transferring institutions remain liable to cover any losses on the transferred securities out of their future amounts available for distribution to shareholders. Clarification is required as to whether: (i) the accounts of the SPVs must be consolidated; and (ii) the transferred assets meet the requirements for derecognition under IAS 39. In addition, given that transferring institutions remain liable for losses, they may not obtain relief from an accounting perspective. However, further clarifications in this regard would be helpful, and the ECB understands that such clarifications may already be under preparation.

3.3.2 Under the draft law, the 'compensatory fee' is paid annually by the transferring institutions from their distributable income, over a maximum of 20 years. The obligation to pay this fee is inextricably linked to the decision and ability of the transferring institution to pay dividends to shareholders. In this context, it should be further assessed whether this scheme achieves its intended purpose given that it is unclear whether transferring institutions are required to set up provisions (against net income) for these additional losses in their annual financial statements.

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

Done at Frankfurt am Main, 24 June 2009.

The President of the ECB

Jean-Claude TRICHET