EUROPEAN CENTRAL BANK

EUROSYSTEM

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President

Mr Joaquín Almunia
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European Commission
1049 Brussels
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Subject: Banking Communication – treatment of subordinated debt in precautionary recapitalisation

Dear Mr Almunia

In preparation for its assumption of supervisory responsibilities, and as mandated by the SSM Regulation, the ECB envisages to carry out a comprehensive and rigorous bank balance sheet assessment, that should from the outset solidify the ECB's credibility as a supervisor and enhance transparency and confidence in euro area banks. This will be financial-stability enhancing both for the individual banks as well as for the financial system as a whole.

It is essential that Member States commit credible public backstops to ensure that resources are available in case private sources of capital are insufficient in the face of capital shortfalls. The absence of a public commitment would undermine the credibility of the exercise from the outset. While we hope cases of public recapitalisations will be exceptional, they may nonetheless be needed. This does not mean that taxpayers will ultimately foot the bill. Indeed there have been several examples in the recent past where viable banks have been recapitalised with public money as a means of enhancing confidence and stability, and where the funds involved were paid back in a timely manner with the State making a non-negligible return (e.g. Banco Popolare, Natixis, Société Générale or Goldman Sachs in the US).

In this context, we are concerned by the interaction with the new State aid guidelines foreseen to enter into force mid-August.

We agree that for a bank whose capital falls below the minimum regulatory capital ratio or that would be assessed as "failing or likely to fail" if the recapitalisation does not take place, mandatory burden-sharing of shareholders and subordinated debt holders prior to any use of public funds is warranted. If the Bank Recovery and Resolution Directive (BRRD) had already entered into force, banks in this situation would have been put under resolution and the authorities would have had the bail-in tool to ensure shareholders and creditors would be the first in line to absorb losses.

However, forced conversions of debt into equity may not be warranted in certain situations where a bank after an asset quality review has a level of capital that is above the regulatory minimum, but is below the

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hurdle rate in a stress test, or requires an additional capital buffer for any other justified reason according to the supervisor, and recapitalisation via capital planning is considered momentarily not possible or would take too long. In this situation the bank is not in resolution (i.e. is not assessed as "failing or likely to fail" if it is not recapitalised), has a viable business model, but the supervisor still requires that it holds a higher capital cushion with the aim of enhancing confidence.

Requiring the mandatory conversion of the subordinated debt for "precautionary recapitalisations", as seems to be implied by the revised State aid guidelines, could negatively impact the subordinated debt market, which would in the future be wary of a 'non-resolution' probability of conversion. This scenario is also not compatible with the current early intervention framework under BRRD that requires as a pre-condition for conversion the assessment that without this conversion the bank would no longer be considered viable. Moreover, such a treatment of subordinated debt would impact pricing, increase contractual uncertainty regarding the situations under which subordinated debt could be converted and could be considered disproportionate for the subordinated creditors that faced a 'breach' of their initial contract, namely when compared to the shareholders which were only diluted. By structurally impairing the subordinated debt market, it could lead to a flight of investors out of the European banking market, which would further hamper banks' funding going forward. All in all, an improperly strict interpretation of the State aid rules may well destroy the very confidence in euro area banks which we all intend to restore.

Under most circumstances, a bank above the regulatory minimum requirements should be able to find the additional capital in the market. However, this may not happen in all circumstances with the necessary speed. It should also be considered that, given the systemic nature of the SSM comprehensive bank assessment, which will involve most of the euro area banking sector at the same time, coupled with the currently unfavourable macroeconomic conditions as well as the fact that for many banks a recapitalisation exercise was already taking place just over a year ago, there is a significant risk of 'crowding out' and the probability that private funds may be insufficient to cater for all cases where banks need extra precautionary capital is likely to increase. It is of the utmost importance that the recapitalisation process be conducted smoothly, to avoid disorderly deleveraging.

For all these reasons we are convinced that in certain situations State aid should be possible for precautionary recapitalisations without subordinated debtors being mandatorily converted. To ensure that strong incentives are in place for banks to do their utmost to access private sources of capital before resorting to State aid, existing shareholders should be severely diluted. Incentives should also be in place to ensure public recapitalisations are temporary as banks would pay back the State as timely as possible. This can be achieved via effective capital planning.

We noted that the new State aid guidelines of the Commission envisage exceptions related to the need to preserve financial stability, to respect fundamental rights and to avoid disproportionate results. I am also aware that the ECB Director General Financial Stability has already contacted the DG Competition to explore how these exceptions can be activated to cater for the cases I have indicated above. I look forward to the outcome of that dialogue at the technical level, but I would like to stress that it is crucial that this complex issue is formally clarified before we begin the balance-sheet assessment foreseen in the SSM Regulation.

Kind regards,