

Mr Jonathan Faull
Director General
Directorate General Internal Market and Services
European Commission

11 August 2014

Dear Mr.Faull,

In connection with your letter of 1 August 2014, asking questions about the state of Corporate Commercial Bank AD (KTB AD) and the depositors' access to their deposits with the bank, we inform you as follows:

I¹. Actions taken by the Bulgarian National Bank (BNB) regarding KTB AD and Victoria Commercial Bank EAD².

1. On 20 June 2014, as the payments to customers had been suspended because of a massive run-on, on the grounds of art.115, par.2, items 2 and 3 of the Law on Credit Institutions (LCI), with Decision No.73/20 June 2014 of the BNB Governing Council, KTB AD³ was placed under special supervision due to a risk of insolvency, for a period of three

¹ The information in Section I has been prepared by the BNB and summarises the measures that have been taken and publicly announced so far with regard to KTB Group.

² Victoria Commercial Bank EAD's previous company name was Crédit Agricole Bulgaria EAD. All shares of Victoria Commercial Bank EAD are held by KTB AD, and the deal was made in 2014 before KTB AD was placed under special supervision. The change of the company name was entered in the Commercial Register on 8 August 2014.

³ KTB AD is the fourth largest bank in Bulgaria and holds an 8.81 percent share of the banking system's assets, according to May 2014 data.

months; the fulfilment of all its obligations was suspended, its activities were limited, its Management and Supervisory Board members were removed from office, and the shareholders having more than 10 percent of its shares were temporarily divested of their voting rights.

2. On 22 June 2014, as the payments to customers had been suspended because of a massive run-on, on the grounds of art.115, par.2, items 2 and 3 of the LCI, with Decision No.76/22 June 2014 of the BNB Governing Council, Victoria Commercial Bank EAD ⁴, whose capital is 100 percent held by KTB AD, was placed under special supervision due to a risk of insolvency, for a period of three months; the fulfilment of all its obligations was suspended, its activities were limited, its Management and Supervisory Board members were removed from office, and the shareholders having more than 10 percent of its shares were temporarily divested of their voting rights.

After placing the two banks under special supervision, the BNB instructed the conservators to ensure that an independent external auditor would make a full analysis and evaluation of the bank group's assets and liabilities within ten days. The BNB and the Government were planning, by 20 July 2014, to take actions to increase the capital and provide liquidity support from the Government, from the state-owned Bulgarian Development Bank, and from the Bulgarian Deposit Insurance Fund, in compliance with the EU state aid rules, so as to ensure the full payment of the obligations to the two banks' customers.

3. On 25 June 2014 an audit of the KTB bank group's assets was ordered. The audit at KTB AD was carried jointly by Deloitte Audit OOD, Ernst and Young OOD, and Afa OOD, and at Victoria Commercial Bank EAD – by Afa OOD. On 11 July 2014 the BNB publicly announced the results of these audits.

The audit of assets was partial and primarily looked at the loan and investment books, and was conducted within ten days. The audit aimed to assess the state and quality of 95.4 percent of the loan portfolio and 99.1 percent of the investment portfolio of KTB, and to make a limited analysis of the bank's liabilities. The audit at Victoria Commercial Bank EAD was similar in scope. The period of the audit assessment was determined by the need of a relatively quick reaction given the importance of the bank group and the fact that the

⁴ Victoria Commercial Bank EAD holds only 0.45 percent of the banking system's assets, according to May 2014 data.

supervisory reports, as provided by the bank group to the BNB, did not indicate any significant problems in the Group's loan portfolio.

The audit at KTB AD found out that important information was missing on the financial position and/or the utilisation of loans for a specific category of borrowers (with loans totalling BGN 3.5 billion out of the entire BGN 5.4 billion loan portfolio). There were strong indications of credit risk with regard to the recovery of credit exposures in this category, which could cause considerable impairments, but as the information was insufficient the auditors could not comment on the amount of required additional impairments.

Therefore, the auditors were requested to make a full evaluation of all KTB assets, as described in point 7.

4. Considering the conclusions in the auditors' reports, the BNB together with the MoF and the main political forces represented in Parliament developed a series of measures incorporated in a draft special law on KTB group restructuring compliant with the state aid rules of the EU. This approach had been beforehand consulted with the Directorate-General for Competition of the European Commission at a meeting in Brussels on 8 July 2014. The draft law included:⁵

- Acquisition of Victoria Commercial Bank EAD by the State;
- Transfer of the good-quality assets and of liabilities (except those of the natural and legal persons connected with the major shareholders) from KTB AD into Victoria Commercial Bank EAD;
- Liquidity support for the newly created state-owned bank - Victoria Commercial Bank EAD - from the Bulgarian Deposit Insurance Fund and the state budget;
- As for the deposits above the insured amount of BGN 196 000, various options were discussed, such as a rescheduling of payments, a tax examination by the competent authorities, etc.;
- The receivables of the bank's shareholders, of subordinated term debt holders and of the depositors connected with the major shareholders would remain on KTB AD's balance sheet, and they would cover all losses;
- KTB AD's license was to be revoked and steps were to be taken to declare the bank bankrupt.

⁵ The draft law was discussed by the Ministry of Finance and experts of the three major political forces represented in Parliament.

5. On 14 July 2014 the consultations convened by the President of the Republic of Bulgaria, and attended by representatives of the main political forces represented in Parliament, the Government and the BNB, did not reach agreement on the draft law on KTB AD⁶ restructuring prepared by the Central Bank and the Government.

6. On 25 July 2014, in compliance with art.121 of LCI, the conservators of KTB AD submitted their Report on the bank's current state. The conservators' report, excluding any data and information that is bank or professional secret, is put up on the BNB website: http://www.bnb.bg/PressOffice/POPressReleases/POPRDate/PR_20140731_EN

7. In July 2014 an audit was assigned to make a thorough evaluation of all KTB AD assets (loans, investment book, buildings, etc.), which must end by 20 October 2014. The assessment is being made by the independent auditors who conducted the partial audit - Deloitte Audit OOD, Ernst and Young OOD, and Afa OOD.

On the basis of that assessment, the bank's assets will be impaired and its own funds will be decreased by that impairment. Depending on the audit results, the major shareholders of KTB AD will be invited to provide, by a certain deadline, the capital and liquidity support required to resume the bank's operations.

If the own funds requirements under Regulation (EU) No.575/2013 are not met, KTB AD's license will be withdrawn under art.36, par.1, item 6 of LCI. If the bank's own funds would reach a negative value, its license should be withdrawn in all cases on the grounds of art.36, par.2, item 2 of LCI.

II. Enabling depositors to have access to their deposits under the Bulgarian law

Directive 94/19/EO, amended by Directive 2009/14/EC, of the European Parliament and the Council on deposit guarantee schemes, with regard to the covered level and the repayment period (Directive 94/19/EO), has been transposed in the Bulgarian law through the Law on Bank Deposit Guarantee (LBDG) and the LCI. The amendments made by Directive 2009/14/EO were forthwith transposed in 2009 by amendments to the above two laws. The amendment to LBDG of 2010 introduced the new deposit coverage level of EUR 100 000, in accordance with the amendment to art.7 of Directive 94/19/EO, adopted with Directive 2009/14/EO.

⁶ The draft law put forward a solution to the problem identical to the one implemented by the Portuguese authorities in restructuring Banco Espírito Santo.

The term ‘unavailable deposit’ is defined in art.1, par.3 of Directive 94/19/EC, as follows:

‘Unavailable deposit’ means a deposit that is due and payable but that has not been paid by a credit institution under the legal or contractual conditions applicable thereto, where either:

i) the relevant competent authorities have determined that in their view the credit institution concerned appears to be unable for the time being, for reasons which are directly related to the financial circumstances, to repay the deposit and the institution has no current prospect of being able to do so.

The competent authorities determine this within the shortest time and in any case no later than five business days after they first became convinced (established) that a credit institution had failed to repay deposits which are due and payable; or

ii) a judicial authority has made a ruling for reasons which are directly related to the credit institution’s financial circumstances and which has the effect of suspending the rights of depositors to make claims against it, if this occurs before the above is established.

When transposing art. 1, par. 3, item i) of Directive 94/19/EC, the national legislation takes the approach that the condition where a credit institution “*appears to be unable for the time being, for reasons which are directly related to the financial circumstances, to repay the deposit and the institution has no current prospect of being able to do so*” is equivalent to determining that institution insolvent. The five days’ term for determining a bank’s financial situation and its ability to repay the guaranteed deposits, stipulated in Directive 94/19/EC, has been introduced as a requirement for the BNB to revoke its license within 5 days of determining that bank’s insolvency.

According to art. 36, pars 2 and 3 of the Law on Credit Institutions (LCI):

Art. 36 (2) The Bulgarian National Bank shall withdraw the license granted to a bank due to insolvency, where:

1. (amended; Darjaven Vestnik, issue 44 of 2009, effective as of 12 June 2009, amended; Darjaven Vestnik, issue 94 of 2010, effective as of 31December 2010) a bank fails to pay its obligation due for more than 7 business days if it is directly related to the bank’s financial status and, at BNB discretion, no repayment on obligation due may be expected in a reasonable period of time; or

2. the amount of a bank’s own funds is negative.

(3) (new; Darjaven Vestnik, issue 44 of 2009, effective as of 1 September 2009) The decision under par. 2 shall be taken by the BNB within five business days from establishing the insolvency..

According to art. 115 of LCI, for the purpose of recovering a bank at risk of insolvency, the BNB may place such a bank under special supervision. While under special supervision, the bank may be subject to different measures provided for in art. 116 of LCI, including suspension of payment of obligations. The purpose is to determine the financial status of the bank and, if justified and possible, such bank to be recovered. **In case the Bank Deposit Guarantee Fund repays the guaranteed amount of the deposits placed with a bank under special supervision while its financial situation is being reviewed, and with no decision reached for its insolvency yet, the bank may lose the larger part of its depositors, which would make its recovery pointless or impossible.**

Art. 23, pars 1, 2, 5 and 6 of the LBDG introduce the requirements for a term of repayment of unavailable deposits according to art. 10 of Directive 94/19/EC:

Art. 23. (1) The Fund shall pay the liabilities of a particular bank to its depositors up to the amount guaranteed, in the cases where the Bulgarian National Bank has withdrawn the banking license granted to the commercial bank.

(2) The Fund shall pay the guaranteed amount of the deposits via a commercial bank determined by its Management Board.

(5) (amended; Darjaven Vestnik, issue 44 of 2009, effective as of 1 of September 2009) Payments from the Fund shall begin no later than 20 business days from the date of the resolution of the Bulgarian National Bank under par. 1.

(6) (new; Darjaven Vestnik, issue 44 of 2009, effective as of 1 of December 2009) In exceptional circumstances, the Fund may extend the term under par. 5 by not more than 10 business days.

In addition, it should be taken into account that Bulgaria has not adopted legislation on bank restructuring, nor is there a fund established for that purpose. An inter-institutional group has been set up for the purpose of transposing in time in the Bulgarian legislation Directive 2014/59/EU of the European Parliament of the Council of 15 of May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU and

Regulations (EU) No 1093/2010 and (EU) No 648/2012 of the European Parliament and of the Council.

III. The current situation

According to art. 36 of LCI in relation with art. 23 of LBDG **repayment of guaranteed deposits is possible within the time frames provided for in Directive 94/19/EC when a bank's license is revoked.**

Where the European Commission may decide that the cited national provisions do not comply in full with Directive 94/19/EC, measures should be taken to amend them within a short time frame. **The option of a possible interim partial access to deposits, which you mention, is not covered by the currently effective legislation either, and cannot be realized without the relevant legal amendments.**

In this relation, consideration should be given that currently the time frame for implementing the new Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes is already under way, with the organization of work necessary for its timely adoption already in place.

Apart from this, consideration should be given to the fact that the guaranteed amount of deposits placed with KTB AD is BGN 3 684.6 million and of those placed with its subsidiary Victoria Commercial Bank EAD it is BGN 55.1 million. As at 31 July 2014, the contributions accumulated at the Bank Deposit Guarantee Fund (BDGF) under art. 16 of LBDG are BGN 2 103.6 million. The shortage as regards the total funds needed for repayment of guaranteed deposits to KTB AD's and Victoria Commercial Bank EAD's customers is BGN 1 636.1 million.

Art. 18 of LBDG provides for different ways of covering the shortage of funds at the BDGF, one of which is by obligating the banks to transfer in advance their annual contributions. According to art. 16, par. 1 of LBDG, the annual contributions in the Fund for any one bank is equal to 0.5 percent of the total amount of the deposit base for the previous year, determined on an average daily basis. In applying such an approach, the additional funds to be collected in the Fund from one contribution transferred in advance by the banks, will be approximately BGN 291 million, which is extremely insufficient to cover the shortage.

Besides, it should be taken into account that collecting annual contributions in advance from banks would have a negative impact on the banking system as such a contribution should be accounted for as financial expenses. That would lead to substantial reduction in the

profit of the banking system in the country, which as at June 2014 totalled BGN 409 million. It should also be taken into account that several banks report negative operating results. A minimum operating profit for the banking system as a result of a possible advance contribution in the BDGF would also lead to a direct reputational risk insofar as the banking system in the country has only recently overcome the crisis caused by the bank run in June 2014.

In this relation and given the sizeable shortage in the BDGF, the latter may be covered only by a loan from the state budget after a relevant decision by the National Assembly (art. 18, art. 4, item 2 of LBDG). Such are the intentions of the Bulgarian authorities.

In line with the agreements reached in July 2014 between the political powers and on the grounds of art. 99, par. 5 of the Constitution of the Republic of Bulgaria, by decrees of the President of 5 August 2014, as of 6 August 2014 the 42nd National Assembly was dissolved, a caretaker government appointed and early parliamentary elections for a new National Assembly scheduled to take place on 5 October 2014.

In this connection, at present the National Assembly is not functioning and any adoption of amendments to the national legislation, if required, or the provision of necessary funds from the state budget for replenishing the BGN 1 636.1 million shortage needed for repayment of the guaranteed amount of deposits of the two banks, would be equally impossible. Such decisions are expected to be taken by the next 43rd National Assembly following the elections on 5 October 2014.

The Bulgarian National Bank and the Ministry of Finance are ready to provide the necessary support within their powers to the competent European authorities for assessment of the compliance of the currently effective legislation with Directive 94/19/EC and for drafting legislative amendments if such are needed.

YOURS SINCERELY,

ROUMEN POROZHANOV
MINISTER OF FINANCE

IVAN ISKROV
GOVERNOR
BULGARIAN NATIONAL BANK