



Eurogroup
The President

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To the members of the Eurogroup and representatives from Denmark and Bulgaria

Subject: Ad-hoc meeting of 12 July to discuss the prospects of Bulgaria participating in the ERM II mechanism

Dear colleagues,

I would like to share with you the main content and course of our discussions on the prospects of Bulgaria's participation in the Exchange Rate Mechanism (ERM II). This meeting was attended by Finance Ministers of the euro area Member States, the European Central Bank (ECB), the representatives of the Minister of Finance and of the Central Bank Governor of Denmark. The Commission, the Bulgarian Finance Minister and Central Bank Governor, were also present.

The Bulgarian Minister presented the commitments of the Bulgarian authorities in view of their intention to apply for ERM II accession and joining Banking Union. We welcomed the commitments taken by the Bulgarian authorities in the areas of banking supervision, notably to enter into close cooperation with the Single Supervisory Mechanism, other financial sector issues and institutional quality and governance, which are highly relevant for a smooth entry and participation in ERM II. You will find annexed to this letter the common understanding of the commitments taken by Bulgaria. We confirmed that our assumption is that Bulgaria will simultaneously join ERM II and the Banking Union and will take further commitments at that point in time, which is standard practice for ERM II applications. In the statement which we adopted at our meeting, we also stressed that we expect to follow a similar approach in the future for other Member States wishing to join ERM II, in line with the principle of equal treatment.

Yours sincerely,

Mário CENTENO

Annex 1: Statement on Bulgaria's path towards ERM II participation

Today the Finance Ministers of the euro area Member States, the European Central Bank (ECB), the representatives of the Minister of Finance and of the Central Bank Governor of Denmark discussed the prospects of Bulgaria's participation in the Exchange Rate Mechanism (ERM II) in the presence of the Commission, the Bulgarian Finance Minister and Central Bank Governor, and issued the following statement.

We welcome the intention of the Bulgarian authorities to put in place the necessary elements for a successful entry into ERM II. Following constructive discussions with the ECB, the Commission, the euro area Member States and Denmark, Bulgaria has taken a number of commitments in policy areas which are of high relevance for a smooth transition to, and participation in, ERM II. With regard to, in particular, banking supervision, Bulgaria is expected to send a request to enter into close cooperation with the ECB in line with the existing procedures, and will undertake the necessary preparations accordingly – including support to the ECB's comprehensive assessment. Additional commitments relate to other financial sector issues and institutional quality and governance. Such reform efforts towards a more robust financial sector, stronger institutions and more efficient economic structures will contribute to the successful participation of Bulgaria in ERM II.

The ECB and the Commission will monitor the effective implementation of these commitments acting within their respective areas of competence as provided for by the Treaties and secondary legislation. Once they have provided a positive assessment, a decision will be taken by the ERM II parties on the formal application of the Bulgarian authorities for ERM II participation. The decision will be linked to the ECB decision on close cooperation, in full respect of the conditions specified in the legal framework. This would imply that Bulgaria simultaneously joins ERM II and Banking Union. The ECB could be expected to conclude its comprehensive assessment within approximately one year after Bulgaria's formal application for close cooperation, and its decision may make the start date of close cooperation conditional on Bulgaria's progress in implementing the possible measures required in relation to the results of the comprehensive assessment.

In line with the relevant secondary legislation, Bulgaria will also participate in the Single Resolution Mechanism (including the Single Resolution Fund) from the date of entry into force of the ECB decision on close cooperation. Therefore, as from that date Bulgaria

should be subject to the obligations stemming from the Intergovernmental Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund, notably the obligation to transfer those contributions to the Single Resolution Fund in accordance with the relevant provisions thereof. To these effects, Bulgaria is expected to take all the necessary steps in order to ratify and deposit its instrument of ratification in due course before the decision on close cooperation enters into force.

In line with past practice, Bulgaria is also expected to take further commitments at the moment of joining ERM II with the aim of achieving a high degree of sustainable economic convergence by the time the euro will be introduced.

We call on the Bulgarian authorities to thoroughly implement the reforms monitored by the Commission under the Cooperation and Verification Mechanism in the areas of judicial reform and the fight against corruption and organised crime in Bulgaria, in light of their importance for the stability and integrity of the financial system.

In the future, we expect to follow a similar approach for Member States wishing to join ERM II, in line with the principle of equal treatment.

Annex 2: Common understanding of the commitments taken by Bulgaria

Banking Union

Measure 1: *Strengthen banking supervision by entering into close cooperation with the ECB and undertaking the necessary preparations in line with the conditions specified in the legal framework for close cooperation with the ECB. The ECB could be expected to conclude its comprehensive assessment within approximately one year after Bulgaria's formal application for close cooperation, and its decision may make the start date of close cooperation conditional on Bulgaria's progress in implementing the possible measures required in relation to the results of the comprehensive assessment. In line with the relevant secondary legislation, Bulgaria will also participate in the Single Resolution Mechanism (including the Single Resolution Fund) from the date of entry into force of the ECB decision on close cooperation.*

This is the first time a Member State's national currency would join ERM II since the start of the EU banking union. Upon the introduction of the euro a Member State now also joins the banking union, which is irreversible and involves direct powers of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) over its banking system. Therefore, participating in ERM II with a view to later adopting the euro also involves – for Bulgaria's as well as for any other Member State's national currency that will in the future join ERM II – preparing for joining the banking union. To this aim, entering a Union's instrument such as close cooperation under the SSM Regulation at the same time when joining ERM II is very helpful. Therefore, Bulgaria should enter close cooperation at the same time as the Bulgarian lev joins ERM II. From the date of entry into force of the ECB decision on close cooperation, Bulgaria should be subject to the obligations stemming from the Intergovernmental Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund, notably the obligation to transfer those contributions to the Single Resolution Fund in accordance with the relevant provisions thereof. To these effects, Bulgaria is expected to take all the necessary steps in order to ratify and deposit its instrument of ratification in due course before the decision on close cooperation enters into force.

All this will contribute to the solidity of the Bulgarian banking system and, therefore, to a successful participation in ERM II.

Macprudential policy

Measure 2: *Develop the macroprudential framework by providing the legislative basis for borrower-based measures, in addition to the existing capital-based measures, as called upon by the ECB Governing Council for all euro area countries¹.*

The current macroprudential framework in Bulgaria relies mainly on capital instruments based on the Capital Requirements Directive IV and the Capital Requirements Regulation (CRDIV/CRR). The so-called “borrower-based measures” are an important complement to these measures. They include limits to the loan-to-value (LTV),

¹ [ECB Governing Council statement on macroprudential policies](#) of 15 December 2016. See also section 3.3 of the [ESRB response to the European Commission's Consultation Document on the “Review of the EU Macro-prudential Policy Framework”](#); Opinion CON/2017/21, paragraph 2.4; Opinion CON/2017/11, of paragraph 2.3; Opinion CON/2018/9, 3.2.

debt-service-to-income (DSTI), debt-to-income (DTI) ratios, maturity limits, and loan amortisation requirements. Such measures aim to limit the build-up of vulnerabilities in real estate markets as they influence the provision of credit and raise resilience by curtailing the tails in the risk exposure. During boom phases, when vulnerabilities are building up, measures acting on the flow of new lending are likely to be more effective for containing excessive credit dynamics, counteracting deteriorating lending standards and preventing the build-up of household indebtedness.

The Bulgarian National Bank (BNB) has currently so called “soft powers” to issue recommendations on such borrower-based measures, but these are not legally binding as the borrower-based instruments are currently not explicitly listed in the Bulgarian law on credit institutions. Although the BNB can issue recommendations, as it has done in the past, these are not legally enforceable.

Given the effectiveness of borrower-based measures, the ECB Governing Council called upon governments in all euro area countries to implement the legislative basis for borrower-based measures. Currently, a large majority of euro area Member States have already adopted the legislative framework for borrower-based measures, and this is expected to be the case also in the few remaining euro area countries.

Against the background of the importance of borrower-based measures in the macroprudential toolkit, Bulgaria needs to implement the borrower-based measures into national legislation. In case the adoption by the Bulgarian Parliament of the already submitted legislation will not be possible before joining ERM II, Bulgaria will need to do so as soon as possible and in any case before euro adoption. The legal basis will include the aforementioned comprehensive set of borrower-based instruments (LTV, DSTI, DTI, maturity limits and loan amortisation requirements).

In this context, the BNB will also further reinforce its macroprudential policy framework by strengthening public disclosure of its macroprudential policy. This includes (i) the objectives and reasoning for the measures taken, (ii) how they are supposed to work, and (iii) an ex-post assessment of effectiveness, also reflecting the recommendations made in the latest Financial Sector Assessment Programme of the International Monetary Fund (IMF FSAP).

Non-banking financial sector

Measure 3: *Enhance the supervision of the non-banking financial sector by i) implementing and reporting on the action plan for supervision of the non-banking financial sector (pension funds and insurance companies) adopted by the regulator in September 2017; ii) preparing and adopting guidelines for the valuation of assets and liabilities in the non-banking financial sector; and iii) designing and implementing a risk based supervisory system under Solvency II.*

A reinforcement of the non-bank supervision is needed side by side with that of banking supervision. The whole financial sector needs to be subject to the highest regulatory and supervisory quality to ensure adequate allocation of capital inflows, which are likely to markedly increase upon entry into ERM II. A strong and well enforced regulatory environment would discourage capital flows from concentrating in protected industries, and from serving vested interests.

(i) Implement and report on the action plan for supervision of the non-banking financial sector (pension funds and insurance companies) adopted by the regulator in September 2017

Efforts will continue towards a sustainable correction of financial sector imbalances. In the non-banking sector, those efforts will include completing follow-up measures resulting from the independent asset quality reviews and stress tests concluded in January 2017 and implementing the supervisor's action plan in order to improve its functioning and continue to improve the health and soundness of the non-banking financial sector.

(ii) Prepare and adopt guidelines for the valuation of assets and liabilities in the non-banking financial sector

Within the non-bank financial sector, improved practices for the valuation of assets and liabilities are needed, especially in the case of illiquid assets and liabilities. Inappropriate valuations have in the past exaggerated the solvency position of insurance firms and pensions funds, as concluded in the 2017 Balance Sheet Review. Guidelines from the FSC would be very beneficial in this respect.

(iii) Design and implement a risk based supervisory system under Solvency II

The Solvency II directive is in application since 2016. Measures to be taken on the basis of the Solvency II Directive and to be fully implemented for the purpose of this process include supervisory action such as challenging some valuations (e.g. on property investments), as well as the amendment of secondary legislation, in particular concerning models for quantitative measurement of different types of risk and the risk premium calculation where the discount cash flow is used.

Insolvency procedures

Measure 4: *Identify, in cooperation with the SRSS, the existing gaps in the insolvency framework and prepare a Roadmap listing the steps that need to be taken to address those, with a focus on i) introducing a system of reliable data collection on insolvency and restructuring proceedings, and (ii) introducing measures to reinforce the judicial infrastructure.*

The economic role of insolvency frameworks is particularly relevant in situations of high outstanding debt. In such conditions, debt overhang reduces the incentives to invest, while high NPL stocks impair the supply and allocation of credit. Efficient insolvency frameworks align incentives in such a way that viable debt is repaid, while unviable debt is resolved. By enabling a faster and less costly resolution of debt distress, efficient frameworks can have a positive effect on bank balance sheets. Increasing the effectiveness of the current insolvency framework in Bulgaria would help to reduce non-financial corporate indebtedness and non-performing loans (NPLs). It would also help to reduce the length of the insolvency proceedings and to increase the recovery rates.

Bulgaria should identify the existing gaps in the insolvency framework, in cooperation with the European Commission's Structural Reform Support Service. Particular focus would be placed on the following areas:

(i) introduce a system of reliable data collection on insolvency and restructuring proceedings

Bulgaria should work on introducing a reliable system of data collection on restructuring and insolvency that would operate in an electronic way and contain, *inter alia*, annual data on the number of different types of insolvency and restructuring proceedings started and terminated in the given year, costs of proceedings, and recovery rates.

(ii) introduce measures to reinforce the judicial infrastructure

To reduce the length of insolvency proceedings and improve the low recovery rates, Bulgaria should look into strengthening the judicial infrastructure, namely by a) organising trainings leading to enhanced proficiency of judges in the insolvency area, and b) introducing more electronic means into the operation of insolvency procedures.

Anti-money laundering

Measure 5: *Strengthen the anti-money laundering framework by addressing any issue potentially identified by the Commission in its assessment of the transposition into national legislation of the fourth anti-money laundering directive (AML4-Directive) and adopting a draft law transposing the fifth anti-money laundering directive (AML5-Directive) at the government level.*

An effective anti-money laundering framework is key to mitigate potential financial abuses but also to reinforce the effectiveness of measures aimed at ensuring financial stability (e.g. macro-prudential measures). As a complement to such measures it therefore has an important role to play in supporting financial sector stability and the overall resilience of the economy.

The fourth anti-money laundering directive (AML4-Directive) strengthens the existing AML rules with the aim of making the fight against money laundering and terrorism financing more effective and of improving transparency. Bulgaria communicated the measures adopted to transpose the directive in April 2018. The Commission is currently analysing these measures to assess their completeness and conformity with the directive. Once this step is completed Bulgaria should address speedily any issue potentially identified by the Commission in its assessment and amend its national law(s) as appropriate.

The fifth anti-money laundering directive (AML5-Directive) substantially amends the fourth anti-money laundering directive to better equip the EU to prevent the financial system from being used for money laundering and for funding terrorist activities. The AML5-Directive: (i) enhances transparency on the real owners of companies, trusts and other legal arrangements; (ii) enhances the powers of EU Financial Intelligence Units, and provides them with access to broad information for the carrying out of their tasks; (iii) limits the anonymity related to virtual currencies and wallet providers, but also for pre-paid cards; (iv) broadens the criteria for the assessment of high-risk third countries and improve the safeguards for financial transactions to and from such countries; (v) sets up central bank account registries or retrieval systems in all Member States; (vi) improves the cooperation and enhances the information flows between anti-money laundering supervisors, between them and prudential supervisors and the European Central Bank.

The fifth anti-money laundering directive (AML5-Directive) was published in the Official Journal of the European Union on 19 June 2018. Member States have 18 months to transpose these new rules into their national order; the exact transposition deadline is on 10 January 2020.

Governance of state-owned enterprises

Measure 6: *Improve, with the assistance of the SRSS, the governance of state-owned enterprises (SOEs) by revising and aligning legislation with the OECD guidelines on Corporate Governance of SOEs.*

The economic performance of state-owned enterprises (SOEs) is relatively poor compared with countries in the region and the private sector. In most sectors of the economy, SOEs are less profitable and less efficient in their use of capital and labour than both private companies and SOEs in peer countries. This lacklustre performance distorts competition and is a source of uncertainty and risk for public finances. The size of liabilities of public enterprises inside and outside the general government is large and a source of risk for the public finances.

The corporate governance framework of SOEs deviates substantially from international good practices, and it is of particular concern given the role and the level of state control over strategic decisions. A more robust SOEs corporate governance aligned with international good practice, could improve the financial performance of the companies, and capital allocation and competition in key sectors of the economy.

With the goal to improve the governance and performance of its SOEs, Bulgaria should, with the assistance of the SRSS and in cooperation with international experts, assess the existing fragmented framework and prepare and adopt a new legislative framework for the SOEs' corporate governance in line with international good practices, as defined by the OECD guidelines.