Pursuant to Article 44 paragraph (2) item 3) of the Central Bank of Montenegro Law (OGM 40/10, 06/13, 70/17) and Article 54 paragraph (5) and Article 101 paragraph (4) of the Law on Resolution of Credit Institutions (OGM 72/19), the Council of the Central Bank of Montenegro, at its meeting held on 28 December 2020, passed the following

DECISION
ON MORE DETAILED REQUIREMENTS FOR SETTING THE RATE OF CONVERSION OF RELEVANT CAPITAL INSTRUMENTS AND LIABILITIES TO EQUITY OF A CREDIT INSTITUTION UNDER RESOLUTION

I. BASIC PROVISION

Subject matter

Article 1

This Decision shall prescribe more detailed requirements and the manner for setting the rate of conversion of relevant capital instruments and liabilities to equity upon the application of the bail-in tool in a credit institution, including the rules further governing exceptional circumstances in which the Central Bank of Montenegro (hereinafter: the Central Bank) may exclude or partially exclude certain liabilities from the application of the bail-in tool.

II. SETTING CONVERSION RATES

Application of the same conversion rate

Article 2

The Central Bank shall apply the same conversion rate for different classes of capital instruments and liabilities, where this ensures the implementation of:

1) the resolution objectives set out in Article 12 of the Law on Resolution of Credit Institutions (OGM 72/19) - (hereinafter: the Law);
2) the principles governing resolution set out in Article 13 of the Law;
3) the sequence of write down and conversion set out in Article 99 of the Law;
4) the safeguards set out in Article 137 paragraph (2) of the Law, in accordance to which no creditor shall be made worse-off by incurring greater losses than they would have incurred if bankruptcy proceedings had been carried out against the credit institution under resolution at the time when the decision to open resolution proceedings against the credit institution was adopted.

Application of different conversion rates

Article 3

(1) Where the conditions referred to in Article 2 of this Decision cannot be met, the Central Bank shall apply different conversion rates to different classes of relevant capital instruments and liabilities.

(2) Different conversion rates shall be applied to classes of capital instruments and liabilities which differ from each other in ranking or classification into priority of claims in bankruptcy proceedings, whereby the following principles must be observed:

1) the conversion rate shall represent appropriate compensation to the affected creditor for any loss incurred through write-down and conversion; and
2) the conversion rate applicable to liabilities that are considered senior in accordance with the hierarchy of settlements in bankruptcy proceedings shall be higher than the conversion rate applicable to subordinated liabilities.

Compensation to Creditors

Article 4

In the case referred to in Article 3 of this Decision, the Central Bank shall compensate the affected creditor for the claims against the credit institution under resolution in the process of application of the bail-in tool on its own, or the application of the bail-in tool in combination with other resolution tools (transfer of claims or debt instruments to a bridge credit institution, transfer of claims by applying the sale of business tool, or transfer of claims by applying the asset separation tool).

Application of conversion rate level

Article 5

In the case of application of different conversion rates set in accordance with the Law and Article 3 of this Decision, the defined conversion rate level shall be applied to liabilities in a specific priority of claims determined in accordance with the law governing bankruptcy and liquidation of banks as if the bankruptcy proceedings have been opened against the credit institution.

III. GUIDING PRINCIPLES FOR CARRYING OUT CONVERSION

Guiding principles

Article 6

(1) The guiding principles for carrying out conversion of relevant capital instruments and liabilities to equity of a credit institution shall be the following:

1) no creditor or shareholder shall be made worse off than they would be under a bankruptcy proceeding (hereinafter: the guiding principle 1);
2) creditor hierarchy (hereinafter: the guiding principle 2);

(2) The objective of the guiding principles referred to in paragraph (1) of this Article is to define the manner in which the Central Bank shall ensure appropriate compensations to creditors in the case of application of different conversion rates to different classes of capital instruments and liabilities.

(3) The condition for the application of guiding principles shall be to provide data on which priority of claims would include a specific claim of the creditor in accordance with the law governing bank bankruptcy and liquidation as well as the assessment of outcome for each priority of claims or for each shareholder and creditor of the credit

institution under resolution as if the bankruptcy proceedings had been opened against the credit institution.

Application of guiding principle 1

Article 7

(1) When applying the bail-in tool, the Central Bank shall set conversion rates so that for each shareholder or creditor the expected value of their combined equity and debt claims after the application of resolution powers, is equal to or greater than the expected value that they would have realised if the bankruptcy proceedings had been opened against the credit institution.

(2) For a creditor whose claim has been fully converted to equity, the estimated value of the received equity instrument should be equal to or higher than the expected recovery of their original claim in the case of bankruptcy proceedings.

(3) For a creditor whose claim has been only partially converted to equity, the expected value of the received equity instrument should be at least as large as the expected recovery of their original claim in the case of bankruptcy proceedings, less the expected value of their remaining claim after the conversion.

(4) When a liability or other instrument is converted to equity, the equity may have more, less, or the same estimated value as the original claim or instrument.

(5) Where the total estimated value of equity received by the affected creditors following write-down and conversion is equal to or greater than the amount of estimated value of the original claim, guiding principle 1 can be satisfied without the application of different conversion rates.

(6) Where the total estimated value of the equity received by the affected creditors following write-down and conversion is lower than the amount of estimated value of the original claim, different conversion rates shall apply.

(7) In the case of application of different conversion rates referred to in Article 3 of this Decision, the Central Bank shall set the rates the application of which shall prevent the possibility of creditors classified as having higher priority claims in the case of bankruptcy proceedings against the credit institution (hereinafter: the senior creditors) being made worse off than they would be if bankruptcy proceedings had been carried out against the credit institution, and, to that end, the Central Bank shall set higher conversion rates for senior creditors which transfer more of the total estimated value of assets and liabilities, or capital.

Application of guiding principle 2

Article 8

(1) When setting conversion rates, the Central Bank shall, in particular, ensure that:

1) the shareholders of the credit institution under resolution shall take the first loss;
2) the creditors of the credit resolution under resolution shall take the loss after shareholders, in accordance with the order of priority of their claims that would

apply if the bankruptcy proceedings had been opened against the credit institution;
3) the creditors that would fall within the same level of priority if bankruptcy proceedings had been opened against the credit institution shall be treated in an equitable manner, except where otherwise prescribed by the Law.

(2) The Central Bank shall set the conversion rates in a manner that would ensure the observance of creditor hierarchy referred to in Article 6 paragraph (1) item 2) of this Decision.

(3) Where it is assessed that, after the application of resolution powers, the a class of creditors takes a loss, or that the value of claims and/or equity claims is less than the value of the claims of that class before resolution, the Central Bank shall not convert other junior classes of liabilities and instruments, or it shall set a minimum conversion rate for them.

Distribution of assets

Article 9

(1) The value of assets after resolution shall be distributed to the senior creditors first, and to the junior creditors second, in accordance with their set claims.

(2) Exceptionally, the Central Bank may set conversion rates that allow the original shareholders (and shareholders whose claims resulted from the conversion of relevant capital instruments at the point of insolvency) to retain some claims or equity.

(3) The original shareholders may retain some value of equity only when there is no need to write down any creditors, i.e. where the bail-in requires only conversion of junior instruments, or conversion of liabilities into shares.

Distribution of equity among multiple classes of creditors

Article 10

(1) Equity may be shared in some proportion by two or more classes of creditors where the claims of one creditor class had been fully converted to equity but more conversion were still required, and where the partial or full conversion of claims of the more senior creditors did not result in a loss for those creditors.

(2) The loss referred to in paragraph (1) of this Article exists where senior creditors receive a total claim and equity claim value lower than the value of their original claim.

Creditor protection

Article 11

(1) The Central Bank shall apply different conversion rates where the junior creditors and shareholders are not made worse off than they would be in the case of bankruptcy proceedings against the credit institution.

(2) Conversion rates for senior creditors should not be disproportionately high, nor should they result in the value of their claims being significantly higher than the value

that would be achieved in the case of bankruptcy proceedings against the credit institution.

IV. EXCLUSION OR PARTIAL EXCLUSION OF LIABILITIES FROM THE APPLICATION OF WRITE-DOWN OR CONVERSION POWERS

General requirements

Article 12

(1) The Central Bank shall not exclude a certain liability or a class of liabilities from write-down or conversion when applying the bail-in tool, other than liabilities referred to in Article 94 paragraph (3) of the Law and the liabilities that the Central Bank may exclude pursuant to the powers referred to in Article 95 of the Law.

(2) The Central Bank's decision on excluding a certain liability or a class of liabilities from the application of the bail-in tool in accordance with Article 95 paragraph (1) of the Law should be based on the analysis of the credit institution under resolution on an case-by-case basis and it shall not be automatic.

(3) When considering the exclusion in accordance with Article 95 paragraph (1) of the Law, and before the final exclusion of a certain liability or a class of liabilities from the application of the bail-in tool, the Central Bank shall firstly consider the possibility of partial exclusion of the liability in question, by limiting the scope of its write-down where possible.

(4) When deciding on whether to exclude a certain liability in accordance with Article 95 paragraph (1) of the Law, the Central Bank shall assess whether the conditions set out in that Article have been met at the moment of application of bail-in tool to the credit institution.

(5) The decision to exclude a certain liability or a class f liabilities from the application of the bail-in tool in accordance with Article 95 paragraph (1) of the Law, should be based on at least one of the resolution objectives referred to in Article 12 paragraph (2) of the Law.

(6) The decision on exclusion or partial exclusion of a certain liability or a class of liabilities from the application of the bail-in tool in accordance with Article 95 paragraph (1) of the Law that implies the use of the Resolution Fund, must be justified, taking into account the due urgency required by the specific circumstances of the case.

(7) Where the Central Bank assesses that a certain liability or a class of liabilities would contribute to the loss absorption and recapitalization in a credible and feasible manner, as well as that these liabilities do not meet the requirements for exclusion set out in Article 95 paragraph (1) of the Law, and that implies the transfer of losses to the Resolution Fund, the Central Bank shall explain:

1) the exceptional circumstances which differ from the circumstances at the moment of resolution planning due to which these liabilities should be excluded from the bail-in tool at the moment of taking the resolution action;

2) why is there the need for exclusion, and in particular, why the exceptional circumstances that have led to it could not have been foreseen during resolution planning;
3) if the need for exclusion had been foreseen in the resolution plan, how did the Central Bank address that need in order to avoid it becoming an impediment to resolvability.

(8) When deciding on the exclusion or partial exclusion of a certain liability or a class of liabilities in accordance with Article 95 paragraph (1) item 1) of the Law, where such exclusion would imply the transfer of losses to the Resolution Fund, the Central Bank shall also explain the following:
1) whether and how the requirements set out in Articles 13 and 14 of this Decision have been met, and
2) why the need for exclusion could not have been addressed through adequate valuation in accordance with Article 44 of the Law.

(9) When deciding on the exclusion or a partial exclusion of a certain liability or a class of liabilities with a view to maintaining the continuity of critical functions and core business lines in accordance with Article 95 paragraph (1) item 2) of the Law, where the exclusion would imply the transfer of losses on the Resolution Fund, the Central Bank shall explain the following:
1) whether and how the requirements under Article 15 of this Decision have been met;
2) why are the liabilities to be excluded more relevant for the continuity of clearly determined critical functions and core business lines than the liabilities that will not be excluded.

(10) Where the Central Bank excludes or partially excludes a certain liability or a class of liabilities in order to avoid giving rise to contagion of adverse effects in accordance with Article 95 paragraph (1) item 3) of the Law, and where such exclusion would imply the transfer of losses to the Resolution Fund, the Central Bank shall explain the following:
1) whether and how the requirements under Article 16 of this Decision have been met;
2) reasons for which the excluded liabilities are more likely to produce contagion of widespread adverse effects within the meaning of Article 95 paragraph (1) item 3) of the Law, than the liabilities which are not excluded.

(11) Where the Central Bank decides to exclude or partially exclude a certain liability or a class of liabilities in accordance with Article 95 paragraph (1) item 4) of the Law, and where such exclusion would imply the transfer of losses to the Resolution Fund, the Central Bank shall explain whether and how the requirements referred to in Article 17 of this Decision have been met.

Exclusion pursuant to Article 95 paragraph (1) item 1) of the Law

Article 13

(1) The Central Bank may exclude a certain liability or a class of liabilities from the application of the bail-in tool only where, due to certain impediments notwithstanding

the efforts of the Central Bank to remove them, it is not possible to bail-in that liability within a reasonable time.

(2) Before deciding on the exclusion referred to in paragraph (1) of this Article, the Central Bank shall in particular:

1) within the resolution plan, deliver a description of procedures which will ensure the availability of information necessary for the purpose of valuation pursuant to Article 44 of the Law and the Decision on Methodologies and Criteria for Determining the Amount of Liabilities Arising from Derivatives, and
2) address all impediments to resolvability of the credit institution, including the circumstances resulting in a potential exclusion which could be foreseen in the resolution planning process when these potential exclusions constitute impediments to resolvability.

Reasonable time

Article 14

(1) When excluding a certain liability or a class of liabilities from the application of the bail-in tool in accordance with Article 95 paragraph (1) item 1) of the Law, the Central Bank shall determine the reasonable time on the basis of determining:

1) when the write-down amount has to be ultimately determined, and
2) when all tasks required for the application of the bail-in have to be completed to meet the resolution objectives, taking into account the situation at the time of the resolution action.

(2) When determining items 1) and 2) of paragraph (1) of this Article, the Central Bank shall assess the following:

1) the need to publish a bail-in decision and to determine the bail-in amount and its final allocation to the various classes of creditors;
2) the consequences of delaying the bail-in decision for market confidence, potential market reactions such as liquidity outflows and the effectiveness of resolution action, taking into account:
   - whether the distress and risk of failure of the credit institution are known to market participants, and
   - the visibility of the consequences of the distress or potential failure of the credit institution to the market participants;
3) the opening time of the market if it can affect critical functions or contagion of adverse effects;
4) the reference dates when capital requirements have to be complied with; and
5) when payments of the credit institution are due, and the maturity of the liabilities concerned.

Exclusion pursuant to Article 95 paragraph (1) item 2) of the Law

Article 15

(1) The Central Bank may exclude a certain liability or a class of liabilities because it is necessary and proportionate to achieving the continuity of certain critical functions, where it assesses that that liability or class of liabilities is connected to a specific critical function due to the continuity of which the bail-in instrument should not be applied to

that liability or class of liabilities, provided that one of the following requirements is met:

1) the application of the bail-in tool on a certain liability or a class of liabilities would undermine the function due to the availability of funding or a dependence on counterparties (such as hedging counterparties, infrastructure or service providers to the credit institution), which may be prevented from continuing or unwilling to continue transactions with the credit institution following a bail-in; or
2) the critical function in question is a service provided by the credit institution to third parties which depends on the uninterrupted performance of the liability.

(2) The Central Bank may exclude the liabilities which are required for risk management (hedging) purposes in the context of critical functions only where:

1) the risk management (hedging) is recognised for prudential purposes and is vitally necessary for maintaining operations related to critical functions; and
2) it would be impossible for the credit institution to replace that measure on reasonable terms within the time required for maintaining the critical function.

(3) The Central Bank may exclude liabilities to maintain a funding relationship only where:

1) it assesses that the funding is vitally necessary for maintaining a critical function;
2) taking into account Article 14 of this Decision, it would be impossible for the credit institution to replace the funding within the time required for maintaining the critical function.

(4) The Central Bank shall not exclude a liability or a class of liabilities solely based on:

1) the maturity of the liability;
2) the expectation of an increase in funding costs which does not jeopardise the continuity of the critical function; and/or
3) expected potential future gains.

(5) The Central Bank may exclude a certain liability or a class of liabilities because it is necessary and proportionate to maintain a core business line, where the exclusion of that liability is key to maintaining the continuity of key operations, services, and transactions of the credit institution under resolution, and to achieving resolution objectives set out in Article 12 paragraph (2) items 1) and 2) of the Law.

Exclusion pursuant to Article 95 paragraph (1) item 3) of the Law

Article 16

(1) When considering the exclusion in accordance with Article 95 paragraph (1) item 3) of the Law, the Central Bank shall, to the greatest extent possible, assess the interconnectedness of the credit institution under resolution with its counterparties.

(2) The assessment referred to i paragraph (1) of this Article shall include the following:

1) considering the exposures to relevant counterparties with regard to the risk that bail-in of these exposures might cause knock-on failures, and

2) systemic importance of counterparties which are at risk of failing, in particular with regard to other financial market participants and financial market infrastructure providers.

(3) When considering the exclusion in accordance with Article 95 paragraph (1) item 3) of the Law, the Central Bank shall, to the greatest extent possible, assess the need for and proportionality of exclusion on the basis of multiple target-relevant indicators, which may be relevant to the individual case and which include the following:

1) the number, size and interconnectedness of credit institutions with similar characteristics as the credit institution under resolution, because it might lead to a widespread loss of confidence in the banking sector or a wider financial system;
2) the number of natural persons directly and indirectly affected by the bail-in, visibility and press coverage of the resolution action, because it poses a significant risk of jeopardising the overall confidence in the banking sector or a wider financial system;
3) the number, size, interconnectedness of counterparties affected by the bail-in, including market participants from the non-banking sector, and the importance of critical functions performed by these counterparties;
4) whether counterparties will be able to access alternative service providers for functions which have been assessed as substitutable, given the specific situation;
5) whether a significant number of counterparties, would withdraw funding or cease making transactions with other credit institutions following the bail-in, or if markets would cease functioning properly as a consequence of the bail-in of these market participants, in particular in the event of generalised loss of market confidence or panic;
6) widespread withdrawal of short term funding or deposits in significant amounts;
7) the number, size or significance of credit institutions which are at risk of meeting the conditions for early intervention, or of meeting conditions due to which the credit institution may not or will not be able to continue its operations, in accordance with Article 34 paragraph (1) of the Law;
8) the risk of a significant discontinuance of critical functions or a significant increase in prices for the provision of these functions (as evident from changes in market conditions for these functions or their availability), or the expectation of counterparties and other market participants in this respect;
9) widespread and significant decreases in share prices of credit institutions or in prices of assets held by credit institutions, in particular where they can have an impact on the capital situation of credit institutions;
10) general and widespread reduction in short or medium term funding available to credit institutions;
11) significant impairment to the functioning of the interbank funding market, as particularly apparent from a significant increase of margin requirements and decrease of collateral available to credit institutions;
12) widespread and significant increases in prices for credit default insurance or deterioration in credit ratings of credit institutions or other market participants which are relevant for the financial situation of credit institutions.

Exclusion pursuant to Article 95 paragraph (1) item 4) of the Law

Article 17

(1) The Central Bank may exclude a certain liability or a class of liabilities from the application of the bail-in tool where the exclusion would avoid the losses borne by other creditors, so that the holders of non-excluded liabilities would be better off than if the bail-in tool had been applied to those liabilities or classes of liabilities.

(2) To assess whether the condition set out in paragraph (1) of this Article has been met, the Central Bank shall compare and evaluate the outcome for all creditors resulting from the potential application of or the exclusion from the bail-in tool, in accordance with valuations referred to in Articles 44 and 100 of the Law.

V. FINAL PROVISION

Entry into force

Article 18

This Decision shall enter into force on the day following that of its publication in the Official Gazette of Montenegro, and it shall apply from the date of application of the Law on Resolution of Credit Institutions (OGM 72/19).

THE COUNCIL OF THE CENTRAL BANK OF MONTENEGRO

CHAIRMAN
G O V E R N OR,

Decision number: 0101-7725-2/2020
Podgorica, 28 December 2020

Radoje Žugić, m.p.