EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 9 February 2009

at the request of the Cypriot Ministry of Finance on a draft law amending the Laws of 2002 and 2004 on the management of revenues and expenditure and on the accounting system of the Republic and other related matters

(CON/2009/12)

Introduction and legal basis

On 16 January 2009, the European Central Bank (ECB) received a request from the Cypriot Ministry of Finance for an opinion on a draft law amending the Laws of 2002 and 2004 on the management of revenues and expenditure and on the accounting system of the Republic and other related matters[1] (hereinafter the 'draft law').

The ECB's competence to deliver an opinion is based on Article 105(4) of the Treaty establishing the European Community and on 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[2], 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 and main features of the draft law

1.1 The draft law is motivated by the ongoing turbulence in the global financial markets and by the Cypriot authorities' wish to place themselves in a position where they can take any necessary measures to support financial institutions without delay, helping preserve confidence in the financial system. According to the explanatory memorandum accompanying the draft law, its purpose is to establish a framework to enable the Cypriot Ministerial Council, following a proposal of the Minister for Finance and taking into account the opinion of the Governor of the Central Bank of Cyprus (CBC), to take, 'in a period of financial crisis', now or in the future, measures intended to address liquidity or insolvency problems affecting financial institutions based in Cyprus and to enhance their capital base or balance sheets 'under conditions that [the

1 Law 112(I)/2002, Official Gazette of the Republic No 3621, 12.7.2002, as amended (hereinafter the 'basic law').

2 OJ L 189, 3.7.1998, p. 42.

Ministerial Council] itself shall determine', without the need for any ratification of these measures by the House of Representatives.

1.2 Under Section 2 of the draft law, which inserts a new Section 30A into the basic law, the Ministerial Council could take any of the following support measures in relation to troubled financial institutions: (i) a Government loan to a financial institution; (ii) a Government guarantee to a financial institution; (iii) the recapitalisation of a financial institution in return for a corresponding participation in its ownership structure; (iv) the purchase of a financial institution's assets; (v) a Government loan or guarantee for an appropriate price and/or a grant paid to deposit-guarantee or investor protection schemes. As the draft law provides no more than the broad outline of what is to be a general Government support framework for the domestic financial system, the ECB understands that the actual terms and conditions subject to which support measures are to be taken by the Ministerial Council will only be determined on an *ad hoc* basis and that the new Section 30A will be activated without the adoption of any formal implementing measures involving Parliamentary assent[3]. The draft law, which does not provide for an expiry date for the powers conferred on the Ministerial Council stipulates that, 'prior to the implementation of a scheme to support the financial sector, the provisions of the Laws on State aid control shall be complied with'[4].

2. General observations

2.1 The ECB has issued a number of opinions at the request of the competent Member States' authorities on national measures adopted in response to the global financial crisis[5]. Given the broad scope of the support measures envisaged in the draft law and the fact that it may not have an opportunity to comment on any formal implementing measures in the future, the ECB invites the consulting authority to take into account the relevant observations made in its recent opinions on similar draft legislative provisions in other Member States, some of which are expressly repeated below.

2.2 The ECB also draws attention to the guidance provided by the Ecofin Council to the Member States in the conclusions of its Meeting of 7 October 2008[6] as well as the Declaration issued by

3 The draft law nevertheless provides for the submission by the competent Minister of *ad hoc* and periodic reports to the House of Representatives, informing the House of any measures adopted in support of the domestic financial sector (see Section 2 of the draft law).

4 Law 30(I)/2001, Official Gazette of the Republic No 3481, 16.3.2001, as amended. The Laws on State aid control transposed into the Cypriot legal order the *acquis* in the area of State aid law, entrusting the Office of the Commissioner for State aid control with the task of monitoring its correct implementation in Cyprus.

5 All ECB opinions are available on the ECB's website at www.ecb.europa.eu.

6 See 'Immediate Responses to Financial Turmoil', Ecofin Council Conclusions of 7 October 2008, available on the former French Presidency's website at www.ue2008.fr. The Ecofin Council recommended that: (i) interventions should be timely and the support should in principle be temporary; (ii) the interests of taxpayers should be protected; (iii) existing shareholders should bear the due consequences of the intervention; (iv) the Government should be in a position to bring about a change of management; (v) management should not retain undue benefits; (vi) governments

the Heads of State of the euro area on 12 October 2008 (hereinafter the 'Declaration')[7]. In particular, the ECB stresses that any initiatives put in place by the competent national authorities to restore confidence in the financial markets should be coordinated and should aim to implement the common principles in question, in a spirit of close cooperation with other Member States and the Community institutions. The principles contained in the Declaration as well as the conclusions raised by the Ecofin Council were endorsed by the European Council of 15 to 16 October 2008[8].

2.3 The ECB also stresses that it is of the utmost importance that support operations conducted by the national authorities do not interfere with the conduct of euro area monetary policy and/or with the Eurosystem's refinancing operations[9]. Given the interdependencies of the Member States' policy responses to the financial crisis, the ECB's opinions have also drawn attention to the importance of a concerted approach throughout the EU, aimed at restoring confidence in financial markets.

2.4 With these general observations in mind, and against the background of the guidance previously given by the ECB and the Community institutions in this regard, the ECB has the following observations to make on the draft law.

3. Specific observations

3.1 Scope, detailed rules and conditions for the activation of the national support measures

3.1.1 The ECB notes that Section 2 of the draft law does not define any conditions, rules or limitations subject to which Government support measures are to be provided. Instead, these are to be determined on an *ad hoc* basis if and when recourse is to be had to the Ministerial Council's powers.

3.1.2 In the light of the above, the ECB strongly recommends that the consulting authority clarifies the coverage of the proposed Government support measures. It also draws attention to the importance of putting a transparent, predictable framework in place. This can only be done by defining expressly in the draft law both the terms and conditions for domestic financial

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may have, *inter alia*, the power to intervene in remuneration; (vii) legitimate interests of competitors must be protected, in particular through the State aid rules; and (viii) negative spill-over effects should be avoided.

7 The text of the Declaration is available on the former French Presidency's website at www.ue2008.fr. The Member States agreed to: (i) ensure appropriate liquidity conditions for financial institutions: (ii) facilitate the funding of banks; (iii) provide financial institutions with additional capital resources to continue to ensure the proper financing of the economy; (iv) allow for an efficient recapitalisation of distressed banks, (v) ensure sufficient flexibility in the implementation of accounting rules; and (vi) enhance cooperation procedures among European countries.

8 See Brussels European Council of 15 to 16 October, paragraph 3 of the Presidency Conclusions.

9 See, for instance, paragraph 3.2 of ECB Opinion CON/2008/52 of 17 October 2008 at the request of the Spanish State Secretary for Economic Affairs on a Royal Decree-Law creating a Fund for the acquisition of financial assets and on a Royal Decree-Law adopting urgent financial and economic measures in relation to the concerted European action plan of the euro area countries and paragraph 3.7 of ECB Opinion CON/2008/81 of 1 December 2008 at the request of the Hungarian Ministry of Finance on a draft law on strengthening the financial intermediary system.

institutions to have recourse to such framework in cases of emergency only, and the parameters of and limitations to the exercise by the Ministerial Council of its powers when deciding whether or not and subject to which conditions to activate the new Section 30A[10]. As regards the definition of 'financial crisis', the ECB understands that financial difficulties faced by individual institutions qualify as a financial crisis under the draft law only when potential systemic disorders can be foreseen and would welcome a clarification in this respect.

3.2 Selection of beneficiary institutions

3.2.1 The ECB draws the consulting authority's attention to the Declaration which states, *inter alia*, that Member States' actions should 'be designed in order to avoid any distortion in the level playing field' and that 'all the financial institutions incorporated and operating in [euro area] countries and subsidiaries of foreign institutions with substantial operations [should] be eligible' to benefit from the actions in question. The ECB has previously stated that 'arrangements that may be seen as providing preferential treatment to specified institutions should be avoided'[11].

3.2.2 Pursuant to Article 2 of the draft law, its provisions are to apply to the 'financial institutions' listed in it, provided that these are licensed by the competent national authorities in Cyprus. The ECB understands that, with the exception of branches of banks and other financial institutions registered outside Cyprus, which are ineligible to benefit, the draft law applies to all Cypriot financial institutions, including the Cyprus-based subsidiaries of foreign financial institutions. The ECB welcomes the non-discriminatory application of the draft law, which is conducive to maintaining a level playing field in the treatment of domestic and foreign financial institutions in Cyprus. Moreover, the ECB notes that the draft law is, in that respect, also in line with the Commission's guidance on the eligibility criteria for beneficiary institutions[12].

3.3 The proposed support measures and the single monetary policy of the euro area

3.3.1 In line with the Declaration, Member States have to act in a coordinated manner to avoid the risk of significant national differences, apt to create distortions in the European financial markets. The euro area Heads of State also acknowledged the need to work in cooperation with the ECB to ensure consistency with the management of liquidity by the Eurosystem and compatibility with the Eurosystem's operational framework. In this respect, the ECB notes that uncoordinated decisions by Member States should be avoided as they may lead to a

10 In this regard see, for instance, paragraph 3.3 of ECB Opinion CON/2008/61 of 28 October 2008 at the request of the Belgian Minister for Finance on a draft royal decree implementing the Law of 15 October 2008 on measures promoting financial stability and in particular establishing a State guarantee for the provision of credit in the context of financial stability, in relation to the protection of deposits and life insurance and amending the Law of 2 August 2002 on the supervision of the financial sector and on financial services, and paragraph 3.3 of ECB Opinion CON/2009/2 of 7 January 2009 at the request of the Latvian Ministry of Finance on a draft regulation establishing procedures for issue and supervision of bank loan guarantees.

11 See paragraph 3.4 of ECB Opinion CON/2008/48 of 15 October 2008 at the request of the Irish Minister for Finance on a draft Credit Institutions (Financial Support) Scheme 2008.

12 See Communication from the Commission, - The Application of State Aid Rules to Measures Taken in Relation to Financial Institutions in the context of the current global financial crisis, paragraph 18.

fragmentation of the euro area money market. Against this background, the ECB has the following specific remarks to make on the possible use, in the future, of the powers granted by the draft law.

3.3.2 First, it follows from the new Section 30A that State guarantees may be issued to cover all types of liabilities of domestic financial institutions and national guarantee schemes. The ECB therefore understands that the draft law does not exclude from its material scope of application, expressly or by implication, interbank deposits, subordinated or collateralised liabilities (such as covered bonds). The ECB repeats its view that State guarantees should not cover interbank deposits, in particular, as this could: (i) entail a substantial distortion in the various national segments of the euro area money market by potentially increasing short-term debt issuance activity across Member States, thus impairing the implementation of the single monetary policy which is an exclusive competence of the Eurosystem under Article 105(2) of the Treaty; and (ii) affect the transmission of monetary policy decisions. The ECB recommends that the draft law be amended to expressly exclude the abovementioned liabilities.

3.3.3 Second, the ECB understands that the Cypriot Government may issue State guarantees for loans taken out by banks. The ECB reminds the consulting authority that the aims of arrangements for granting government guarantees of bank debt should be to: (i) address the funding problems of liquidity-constrained solvent banks by improving the functioning of the market for bank debt of longer term maturity; (ii) preserve the level-playing field amongst financial institutions and avoid market distortions and (iii) ensure consistency with the management of liquidity by the CBC. In line with the Declaration, the ECB notes, moreover, that the euro area Governments should make available a Government guarantee of new medium term (up to five years) bank senior debt issuance, which should be limited in time. The ECB recommends that the draft law be amended to reflect the above.

3.3.4 Third, regarding the *pricing* of State guarantees, the ECB notes that, in the interests of ensuring a level-playing-field, it is crucial to ensure harmonisation of the price determination of such guarantees, both within the euro area and the EU. In particular, it is important to ensure that the price of State guarantees is risk-based and market-oriented and that it is determined on the basis of the costs of a corresponding guarantee in the market. In this regard, it is recalled that the Governing Council of the ECB has considered the appropriate framework for the granting of government guarantees on bank debt issuance and agreed on some recommendations to which the attention of the consulting authority is drawn[13].

3.3.5 Fourth, the ECB reminds the consulting authority that it is important to ensure that the beneficiary financial institutions do not profit from the undue use of their guaranteed status to engage in a heightened level of activities, distorting the market and facilitating abnormal

13 See the Recommendations of the Governing Council of the European Central Bank on the pricing of State guarantees, issued on 20 November 2008, available on the ECB's website at www.ecb.europa.eu

balance sheet growth. In this regard, the ECB reiterates the importance of establishing appropriate safeguards such as limits on the marketing of financial products or on the expansion of their activities on the basis of State guarantees. The ECB recommends that the draft law be amended to include such safeguards.

3.3.6 Fifth, concerning the possible acquisition, under the draft law, of the assets of financial institutions by the Cypriot Government, the ECB has the following observations of relevance from a monetary policy perspective. Although such measures should have a positive impact in restoring confidence in the Cypriot banking system, it is important that the price applied for the acquisition of financial institutions' assets by the Cypriot Government should be determined in a coordinated manner within the euro area and the EU so as not to interfere with the transmission of single monetary policy decisions. This remark also applies to the loans that the Cypriot Government may provide to financial institutions under the draft law.

3.3.7 Sixth, as noted above, the draft law is not expressed to be a temporary measure, nor is there any indication in its text that any actual support measures adopted by the competent national authorities in Cyprus will be of limited duration. The ECB recalls that so open-ended a scheme as the one envisaged under the draft law is not in line with the Declaration and should be avoided. In particular, the Declaration clearly draws attention to the need for any domestic support schemes to be temporary in nature, even if they can be extended or renewed[14]. The ECB recommends that a provision on the temporary nature of the support measures is inserted in the draft law.

3.4 Conditions for State capital investments within the euro area

3.4.1 In line with the Declaration, the ECB reiterates that uncoordinated decisions amongst Member States should be avoided, as they may have a negative impact on the integrity of the euro area and lead to significant differences in the treatment of financial institutions across Member States. This remark also applies to measures related to State capital investments.

3.4.2 The ECB takes the opportunity to restate the points made in its previous opinions. In particular, the ECB draws the consulting authority's attention to the specific recommendations made by the Governing Council of the ECB in the matter of recapitalisations[15]. In this respect, the ECB notes that the aim of any recapitalisation measures should be to strengthen the capital position of fundamentally sound financial institutions in order to improve the functioning and stability of the banking system and to ensure the proper financing of the economy. In particular, a consistent approach should be used in defining the conditions for recapitalisations and the

14 '… In all cases, these actions will be designed in order to avoid any distortion in the level playing field and possible abuse at the expense of non beneficiaries of these arrangements. As a consequence the scheme will be limited in amount, *temporary* (emphasis is ours) and will be applied under close scrutiny of financial authorities …' (Declaration, *supra* fn. 7). Also see Communication from the Commission, *supra* fn. 12, paragraph 24.

15 Recommendations of the Governing Council of the European Central Bank on the pricing of recapitalisations of 20 November 2008 (hereinafter the 'Recommendations'), available on the ECB's website at www.ecb.europa.eu.

pricing of the instruments intended to provide Tier 1 capital to financial institutions. The ECB underlines the importance of appropriate pricing for recapitalisations in terms of the goals of enhancing the stability of the financial system, facilitating a return to normal market conditions and ensuring the proper financing of the economy. In its Recommendations, the ECB stresses that the pricing conditions for capital support should be risk-based and market-oriented, determined by taking into consideration the specific risk of both the specific instrument chosen for injecting capital and the institution concerned. Specific features of the instruments for capital injections (such as preference shares) should be appropriately chosen so that, while encouraging an early end to the State's capital support of banks, they do not result in an excessive increase in the cost of capital.

3.4.3 In line with the Declaration, the ECB also emphasises that harmonisation regarding the expiry of national financial support schemes across the EU and in particular within the euro area is of crucial importance, including for State capital investments in financial institutions. In this context, it is important that the draft law should expressly provide for the temporary nature of the Cypriot Government's intervention. More generally, concerning the issue of the application of State aid rules to measures taken by the Member States in connection with financial institutions in the context of the ongoing financial crisis, the ECB draws the consulting authority's attention to the importance of ensuring that the proposed arrangements comply with the relevant Community law provisions and with the criteria recently laid down by the Commission in its guidance on compliance by financial sector support schemes with EU State aid rules[16] and to the need to ensure that the State's shareholder role as a result of a possible future recapitalisation under the draft law is limited in time. In this respect, and in accordance with the Recommendations, the Cypriot authorities should consider setting out terms for the redemption or conversion of the instruments either on the basis of a fixed period of time or depending on the development of market conditions, so as to preserve the temporary nature of the State's involvement and discourage financial institutions from relying on such involvement for an extensive period of time.

3.5 Central bank involvement in the support measures

3.5.1 The ECB notes that, pursuant to Section 2 of the draft law, the Ministry of Finance proposes to consult the Governor of the CBC prior to deciding whether or not to support a domestic financial institution or to exercise any of the other powers conferred. While appreciating the draft law's recognition of the CBC's expertise in this field, the ECB also expects the CBC's involvement in the procedure not to extend beyond the provision of advice and otherwise to comply fully with the prohibition on monetary financing laid down in Article 101(1) of the Treaty, read in conjunction with Council Regulation (EC) No 3603/93 of 13 December 1993

16 See, for instance, paragraph 3.8 of ECB Opinion CON/2008/68 of 13 November 2008 at the request of the Finnish Ministry of Finance on a draft government proposal for laws amending the Law on the Government Guarantee Fund and the Law on credit institutions.

specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b(1) of the Treaty[17]. In particular, the ECB expects that the support measures envisaged in the draft law will be exclusively financed from the State budget and that, to the extent that their funding may require State borrowing, this will not include pre-financing or refinancing of the State budget by the CBC[18].

3.5.2 The ECB also expects that the Council of Ministers will use its powers in connection with State support measures in a manner fully compatible with the CBC's institutional and financial independence thereby safeguarding the proper performance of the CBC's tasks under the Treaty and the Statute of the European System of Central Banks and of the European Central Bank. The reference, in the new Section 30A to Section 6 of the Laws of 2002 to 2007 on the Central Bank of Cyprus is, in this respect, welcome.

3.6 Funding of deposit-guarantee schemes

The ECB notes that deposit-guarantee schemes have been included in the scope of application of the draft law. The ECB welcomes the intention to make available an emergency funding mechanism to ensure the effectiveness of deposit-guarantee schemes, an important element contributing to financial stability. However, it has reservations whether the emergency funding of a deposit-guarantee scheme should be provided for via a discretionary mechanism such as the one to be established under the draft law. The ECB understands, however, that the rules subject to which the Cypriot deposit-guarantee scheme operates are currently in the process of being amended and the ECB will comment further on the relevant aspects in due course, particularly concerning the funding of the Cypriot deposit-guarantee scheme.

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

Done at Frankfurt am Main, 9 February 2009.

[signed]

The President of the ECB

Jean-Claude TRICHET

17 OJ L 332, 31.12.1993, p.1.

18 In this regard see, for instance, paragraph 3.3 of ECB Opinion CON/2008/88 of 19 December 2008 at the request of the Slovenian Ministry of Finance on a draft decree laying down criteria and conditions for granting guarantees under Article 86.a of the Law on public finance, paragraph 3.2.3 of ECB Opinion CON/2008/92 of 22 December 2008 at the request of the Slovenian Ministry of Finance on a draft decree laying down criteria and conditions for granting loans under Article 81.a of the Law on public finance and paragraph 3.2.3 of ECB Opinion CON/2009/3 of 8 January 2009 at the request of the Slovenian Ministry of Finance on a draft decree laying down criteria and conditions for the implementation of State capital investments and for the conversion of State claims into capital shares under Article 81.a of the Law on public finance.