EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 15 November 2011

on the management of financial crises and the setting up of an independent financial stability fund

(CON/2011/93)

Introduction and legal basis

On 20 October 2011, the European Central Bank (ECB) received a request from the Cypriot Ministry of Finance for an opinion on two draft laws. The first relates to the management of financial crises (hereinafter the 'draft law on financial crisis management') and the second establishes an independent financial stability fund to support the stability of the financial system (hereinafter the 'draft financial stability fund law'). On 9 November 2011, the Cypriot Ministry of Finance submitted revised versions of the two draft laws.

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and the third and sixth indents 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[1], as the draft laws relate to the Central Bank of Cyprus and 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 of the draft laws

1.1 The draft law on financial crisis management aims at enabling the Cypriot Ministerial Council, following a proposal of the Central Bank of Cyprus and taking into account the opinion of the relevant supervisory authority, to take, at times of financial crisis, measures addressing liquidity and/or solvency problems in the financial system and/or to enhance the capital base and/or the balance sheet of financial institutions in Cyprus, in a manner consistent with Union State aid rules and the Laws of 2001 to 2009 on State aid control[2]. These include (i) government loans to financial institutions; (ii) government guarantees for loans to be taken by financial institutions and/or bonds issued by financial institutions for an appropriate price; (iii) the provision of capital to financial

1 OJ L 189, 3.7.1998, p. 42.

2 Law 30(I)/2001, *Episimi Efimerida tis Dimokratias* No 3481, 16.3.2001. The Laws on State aid control transposed the State aid *acquis*, entrusting the Office of the Commissioner for State aid control with monitoring its correct implementation in Cyprus.

institutions in return for a corresponding participation in their ownership structure; (iv) government loans or guarantees for an appropriate price and/or a grant for the Deposit Protection Schemes to cover any deficit that may arise in the pay-outs to depositors, in the event of their activation; (v) government loans or guarantees for an appropriate price and/or a grant for the Financial Stability Fund to assist it in fulfilling its mission.

1.2 The draft financial stability fund law aims at establishing an independent, self-financing fund ('the Fund') to enhance the current crisis management and resolution framework in Cyprus and contribute to financial stability. The objectives of the Fund are to (i) support and fund the resolution of ailing credit institutions, avoiding the use of public funds, and (ii) maintain public confidence in the financial system while minimising moral hazard in case of the Fund's intervention.

2. General observations on the draft law on financial crisis management

2.1 Member States have already consulted the ECB on numerous national measures adopted in response to the global financial crisis. Given the broad scope of the support measures envisaged in the draft law, the consulting authority is invited to take into account the ECB's opinions on similar draft legislative provisions in other Member States[3].

2.2 The ECB stresses that it is of the utmost importance that support operations conducted by the national authorities do not interfere with the conduct of the single monetary policy and/or with the Eurosystem's refinancing operations[4]. Given the interdependencies of the Member States' policy responses to the financial crisis, previous ECB opinions have also drawn attention to the importance of a concerted approach throughout the Union to restore confidence in the financial markets[5].

3. General observations on the draft financial stability fund law

3.1 The setting up of bank resolution funds, financed by levies, has already been addressed by the European Council's Conclusions[6] and by the European Commission, which proposes that all Member States set up ex ante resolution funds as part of the planned Union crisis management and resolution framework[7].

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3 All ECB Opinions are available on the ECB's website at www.ecb.europa.eu.

4 See, for instance, paragraph 3.4 of ECB Opinion CON/2008/52.

5 See paragraph 3.7 of ECB Opinion CON/2008/81.

6 See Conclusions of the European Council of 17 June 2010.

7 See European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank, 'Bank Resolution Funds', COM(2010) 254 final, 26.5.2010 and European Commission Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank 'An EU Framework for Crisis Management In the Financial Sector', COM(2010) 579 final, 20.10.2010.

3.2 In line with Opinion CON/2011/29, the ECB reiterates that the primary purpose of resolution funds is to mitigate the effects of a bank failure for the different stakeholders, including customers, the real economy and taxpayers. In particular, this implies that resolution funds should not be used for any form of bailout or to avoid a bank's insolvency. As the existence of resolution funds may raise moral hazard concerns, stringent conditions for their use need to be defined, including no automatic correspondence between the pay-in and pay-out to the fund, with decisions about the use of the funds taken by independent and accountable public authorities. The ECB also reiterates that, when adopting resolution tools for financial institutions, Member States should act in a coordinated manner to avoid significant differences across the Union.

4. Specific observations on the draft law on financial crisis management

4.1 *Underlying principles and triggers for the activation of the national support measures*

4.1.1 Section 5 of the draft law on financial crisis management defines the general principles underlying the measures in Section 4 to be taken by the Cypriot Ministerial Council. Following Opinion CON/2009/12, the consulting authority has (i) expressly provided that any government support measures will be of limited duration and the draft law itself is of temporary duration, (ii) expressly excluded inter-bank deposits, subordinated loans and collateralised liabilities from the scope of application of the government guarantees provided for in the draft law, (iii) covered the pricing of government guarantees consistently with recommendations by the ECB's Governing Council[8], (iv) stipulated that government guarantees for loans to be taken by financial institutions and/or bonds issued by them are to be consistent with the monetary policy of the Eurosystem, and (v) stated that the proposed arrangements comply with Union State aid rules.

4.1.2 Under Section 4(1)(a)(ii) of the draft law, the Cypriot Ministerial Council may issue government guarantees for loans taken out by banks, while, under Section 5(b), government support measures may also be taken vis-à-vis financial institutions facing or likely to face 'insolvency problems'. The ECB reminds the consulting authority that the aims of government guarantees of bank debt should be to: (i) address the funding problems of liquidity-constrained but 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 by avoiding market distortions; and (iii) ensure consistency with the management of liquidity by the Central Bank of Cyprus.

4.1.3 Second, the ECB reminds the consulting authority that it is important to ensure that financial institutions benefiting from government support measures 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 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

8 See the Recommendations of the Governing Council of the European Central Bank on the pricing of recapitalisations, 20 November 2008 (hereinafter the 'ECB's recommendations').

their activities on the basis of government guarantees. The ECB recommends amending the draft law on financial crisis management to include such safeguards.

4.1.4 Third, as regards government recapitalisation measures, the ECB draws the consulting authority's attention to the ECB's recommendations. The aim of recapitalisation measures should be to strengthen the capital position of fundamentally sound financial institutions. The ECB's recommendations stress that the pricing conditions for recapitalisation measures should be risk-based and market-oriented, 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 should be appropriately chosen so that, while being consistent with capital adequacy requirements and encouraging an early end to the State's capital support of banks, these do not result in an excessive increase in the cost of capital. The ECB draws the consulting authority's attention 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 ECB's 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 market conditions, to preserve the temporary nature of the State's involvement and to discourage financial institutions from relying on such involvement for an extensive period of time.

4.1.5 Fourth, regarding the triggers for the activation of the government support measures, the ECB understands that these are to be deduced from a combination of the definition of the term 'financial crisis' in Section 2 of the draft law, and Section 4(2) and Section 5 on the general principles for the support measures. The ECB recommends amending the draft law to specify that access by financial institutions to that framework is activated in emergency cases only.

4.2 *Beneficiary financial institutions*

Pursuant to Section 2 of the draft law on financial crisis management, its provisions are to apply to the 'financial institutions' referred to in it, provided that these have been established and licensed in Cyprus. The ECB understands that, with the exception of branches of banks and other financial institutions registered outside Cyprus, the draft law applies to all financial institutions in Cyprus, including the Cyprus-based subsidiaries of foreign financial institutions. The ECB welcomes the non-discriminatory application of the draft law, which is conducive to the equal treatment of domestic and foreign financial institutions, and in line with the Commission's guidance on the eligibility criteria for beneficiary institutions[9].

4.3 *Central bank involvement in the support measures*

4.3.1 The ECB notes that, pursuant to Section 4 of the draft law, the Cypriot Ministerial Council will decide following a recommendation by the Central Bank of Cyprus whether to support a domestic

9 See paragraph 18 of 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 (OJ C 270, 25.10.2008, p. 8).

financial institution or to exercise any of the other powers conferred on it. The ECB expects that the involvement of the Central Bank of Cyprus would not extend beyond such a recommendation and to otherwise comply fully with the monetary financing prohibition laid down in Article 123(1) of the Treaty. 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 Central Bank of Cyprus.

4.3.2 The ECB also expects that the Cypriot Ministerial Council will use its powers in connection with State support measures in a manner fully compatible with the institutional and financial independence of the Central Bank of Cyprus, thereby safeguarding the proper performance of its tasks under the Treaty and the Statute of the European System of Central Banks and of the European Central Bank. The reference in Section 16(a) of the draft law to the Laws of 2002 to 2007 on the Central Bank of Cyprus is welcome.

4.4 *Additional measures in Sections 7 to 10 of the draft law on financial crisis management*

Sections 7 to 10 of the draft law on financial crisis management provide for a number of powers vested in the Cypriot Minister for Finance to be exercised when the measures laid down in Section 4(1)(a) are taken, and by way of derogation from the Law on Companies and the Law on cooperative credit institutions. These powers include (i) restrictions in the exercise of the voting rights attaching to shares or the voting rights possessed by the shareholders of the beneficiary financial institution; (ii) appointment of the majority of the members of the Board of Directors of the beneficiary financial institution; and (iii) increase of the share capital of the beneficiary financial institution. The ECB notes that, unlike the measures set out in Section 4 of the draft law, the above measures may be 'recovery and resolution measures', to be taken by the resolution authority in the context of a comprehensive bank recovery and resolution regime. The ECB understands that the inclusion of these measures in the draft law is temporary, until such time as an operational recovery and resolution framework has been established in Cyprus, and that the consulting authority will reconsider in the future their interplay with the recovery and resolution framework that is to apply, in the future, to financial institutions operating in Cyprus, and on which the ECB expects to be consulted.

4.5 Section 15 of the draft law on financial crisis management provides for a number of deviations in its application to cooperative credit institutions. The ECB notes that, without prejudice to the separate supervisory regime to which cooperative credit institutions are subject in Cyprus, these qualify as fully-fledged credit institutions for the purposes of the banking legislation. Moreover, the risks to which they are exposed, or those to which they may expose the domestic financial system, are not qualitatively different from those of non-cooperative credit institutions. It follows that cooperative credit institutions should be treated, also for the purposes of the draft law, in a manner that guarantees a level playing field for them and non-cooperative credit institutions (banks) operating in Cyprus. The ECB recommends amending the draft law accordingly.

5. Specific observations on the draft financial stability fund law

5.1 Section 4(2) of the draft financial stability fund law, on the Fund's purposes, should be amended to include, among its objectives, the maximisation of the value of the good assets of an ailing or failed credit institution and the facilitation of the quickest possible return to their productive use, as part of its mitigation of the effects of a bank failure on different stakeholders.

5.2 Section 16(1) of the draft financial stability fund law, on the use of the Fund's resources, does not specify the different resolution measures that the Fund will cover. The ECB understands that this is because a dedicated recovery and resolution framework for financial institutions operating in Cyprus has yet to be established. Besides, the conditions subject to which the funds collected are to be used are not clearly specified except by an implicit reference in Sections 16(1) and (2) to the Management Committee's discretion to decide whether to make disbursements on a case-by-case basis.

5.3 Several of the provisions of the draft law confer on the Fund's Management Committee public law decision-making powers that are neither necessarily consistent with its management tasks, under Section 23 of the draft financial stability fund law, nor with its responsibilities. For instance, the Management Committee may exempt credit institutions from making contributions to the Fund (Section 5 of the draft law), impose sanctions on anyone breaching the provisions of the draft law independently from the competent supervisory authority (Section 18(3) of the draft law), and, as mentioned above, take discretionary decisions as to whether or not to make disbursements to a credit institution (Section 16 of the draft law). The ECB notes that such decisions should be taken by the appropriate resolution authority, rather than by the Management Committee, and invites the consulting authority to reconsider the scope of the powers conferred on it, some of which are more appropriate for a resolution authority.

5.4 Section 22 of the draft financial stability fund law addresses the issue of the Fund's governance structure. The ECB is satisfied that the draft law provides sufficient guarantees for the Management Committee to operate as an independent body and for the statutory enshrinement of its functional independence from the Government. However, the ECB continues to stress the need for the authorities in Cyprus to ensure that the proposed bank resolution fund's management is entrusted to those national authorities that would be *de jure* or *de facto* responsible for resolving ailing financial entities.

5.5 Finally, the ECB continues to stress the need for the draft financial stability fund law to provide for (i) replenishing the Fund, where part or all of its funds are used to support an ailing bank's liabilities, and (ii) the Fund's winding-up.

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

Done at Frankfurt am Main, 15 November 2011.

[signed]

The President of the ECB

Mario DRAGHI