EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 1 October 2009

on the issuance of special government bonds to credit institutions

(CON/2009/78)

Introduction and legal basis

On 15 September 2009 the European Central Bank (ECB) received a request from the Cypriot Ministry of Finance for an opinion on (i) a draft law on the issuance of special government bonds to credit institutions (hereinafter the 'draft law'); and (ii) a draft decree of the Minister of Finance elaborating on and implementing the draft law (hereinafter the 'draft decree').

The ECB's competence to deliver an opinion is based on Article 105(4) of the Treaty establishing the European Community and on 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 law and draft decree relate to the Central Bank of Cyprus (CBC) 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 and main features of the draft law and draft decree

1.1 *Purpose*

The stated purpose of the draft law and draft decree is to authorise and regulate the proposed issuance by the Minister of Finance of special government bonds to be used as collateral by eligible credit institutions 'for obtaining liquidity from the European Central Bank and/or the interbank market'[2], with the aim of enhancing market liquidity and reinforcing the national economy against the adverse effects of the global financial crisis[3]. In particular, eligible credit institutions to which the special government bonds have been allocated are to come under an obligation to use the proceeds of the liquidity raised for the granting of credit to domestic households and small and

1 OJ L 189, 3.7.1998, p. 42.

2 Article 5(4) of the draft decree provides that 'The credit institutions that are allocated the special government bonds shall use the said bonds only as collateral for obtaining liquidity from the European Central Bank and/or the interbank market.'.

3 Draft law, Article 4.

medium enterprises (SMEs)[4], thereby indirectly contributing to a reduction of the pressure on lending interest rates. In order to safeguard the proper implementation of the terms and conditions governing the issuance and use of the special government bonds, the draft law and draft decree foresee (i) the establishment of a special, six-member Committee, entrusted with monitoring tasks[5]; and (ii) the imposition of sanctions in cases of non-compliance by the beneficiaries of the special government bonds with the terms and conditions of their issuance and use[6].

1.2 *Main features*

The draft law foresees the issuance and contractual allocation (effectively, the 'lending') to eligible credit institutions of zero coupon special government bonds, with a value of up to EUR 3 billion and a maturity of up to three years[7]. The offering of bonds to eligible credit institutions is to last for six months from the entry into force of the draft decree; this period can be extended subject to the approval of the European Commission[8]. The bonds in question, which are to be listed on the Cyprus Stock Exchange, are to be issued and allocated at nominal value, in packages of EUR 1 million[9], against payment of a commission to the Ministry of Finance[10] and provided that their prospective holders have assigned adequate collateral to the Government of Cyprus[11]. At the expiry of the contracts entered into for their allocation, the special government bonds are to be returned by their holders and cancelled[12]. The draft law and draft decree also provide details on (i) the level of and pricing of the commission payable by beneficiary credit institutions to the bonds' issuer[13]; (ii) the collateral eligibility criteria (including the type of eligible collateral and the 'haircuts' applicable to different types of collateral)[14]; (iii) the capital adequacy ratios that beneficiary credit institutions will need to maintain[15]; and (iv) the maximum amount of special government bonds to be allocated to each eligible beneficiary[16].

4 Draft law, Article 8(3); draft decree, Article 5(4).

5 Draft decree, Article 6.

6 Draft law, Article 14.

7 Draft law, Articles 3 and 5; draft decree, Article 5.

8 Draft law, Article 7; draft decree, Article 3(2).

9 Draft law, Article 8(2); draft decree, Article 5(2).

10 Draft law, Article 10; draft decree, Article 5(8).

11 Draft law, Article 11; draft decree, Article 5(9)(a). According to Article 5(10)(e) of the draft decree, the collateral in question is to be kept at the CBC or the Authority for the Supervision and Development of Cooperative Credit Societies, for the credit institutions supervised by them.

12 Draft law, Article 8(1); draft decree, Article 5(3).

13 Draft law, Article 10; draft decree, Article 8.

14 Draft decree, Articles 5(9) and (10).

15 Draft law, Article 6; draft decree, Article 5(5).

16 Draft law, Article 13; draft decree, Article 5(6).

2. General observations

2.1 The ECB draws the consulting authority's attention to previous ECB opinions issued at the request of other Member States and, in particular, to its comments on draft legislation sharing some of the features of the draft law and draft decree[17].

2.2 As already mentioned in previous opinions relating to national-level measures adopted in light of the financial turmoil, it is important that, regard being had to (i) the similarities of the causes and consequences of the crisis in the Member States; and (ii) the potential interdependencies of policy responses, national authorities coordinate their actions with their EU partners (*inter alia* with regard to the end of nationally-devised financial crisis exit schemes). The ECB draws, in this regard, attention to the declaration of the euro area summit in Paris of 12 October 2008, confirming the commitment of the euro area Heads of State to act decisively and in concert so as to restore confidence in financial markets and to help re-establish efficient financing conditions across the economy by means of (i) ensuring liquidity; (ii) facilitating the funding of banks; (iii) providing additional capital resources to financial institutions; and (iv) recapitalising distressed banks[18]. These aims and principles were also endorsed by the European Council on 15 and 16 October 2008. Against this background, the ECB points out that initiatives put in place by national governments to restore confidence in the financial markets should aim at implementing the above aims and principles, in a spirit of close cooperation with other Member States, the EU institutions and the ECB. In particular, it is recalled that harmonisation of the measures implemented at national level is essential to ensure the integration of financial markets within the EU and, in particular, within the euro area. The ECB also emphasises that coordination regarding the duration of national financial support schemes across the EU is of crucial importance to ensure a level playing field[19]. In addition, the ECB recalls the need for national support measures to be temporary in nature.[20] The ECB notes that the measures envisaged in the draft law and draft decree are indeed temporary in nature, ensuring that the involvement of the Cypriot State will be limited in time.

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17 See, in particular, CON/2008/44 of 3 October 2008 at the request of the Irish Minister for Finance on a draft Credit Institutions (Financial Support) Bill 2008; 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; CON/2008/57 of 21 October 2008 at the request of the German Ministry of Finance on a Law on the implementation of a package of measures to stabilise the financial market and an order on its implementation; CON/2008/58 of 23 October 2008 at the request of the Banca d'Italia on behalf of the Italian Ministry for Economic Affairs and Finance on two Decree-Laws containing urgent measures to guarantee the stability of the banking system and the continuity of the provision of credit; CON/2008/59 of 24 October 2008 at the request of the Swedish Ministry of Finance on a draft proposal on stabilising measures for the Swedish financial system; CON/2008/65 of 12 November 2008 at the request of the Banca d'Italia on behalf of the Italian Ministry for Economic Affairs and Finance on a draft ministerial decree containing provisions to implement Decree-Law No 157/2008 on further urgent measures to guarantee the stability of the credit system; CON/2008/79 of 27 November 2008 at the request of the Greek Ministry of Economy and Finance on a draft law on enhancing liquidity of the economy to address the impact of the international financial crisis and on a draft decision on its implementation; and CON/2009/12 of 9 February 2009 on the terms and conditions for the grant of State loans and guarantees in emergency situations. All ECB opinions are published on the ECB's website at www.ecb.europa.eu.

18 See 'Declaration on a concerted European action plan of the euro area countries', available on the former French Presidency's website at www.ue2008.fr.

19 See notably ECB Opinions CON/2009/24, paragraph 3.1 and CON/2009/54, paragraph 2.5.2.

20 See notably ECB Opinions CON/2009/24, paragraph 2.2 and CON/2009/62, paragraph 3.3.

2.3 With these considerations in mind and against the background of the concrete guidance previously provided by the ECB and the EU institutions in this regard, the ECB has the following observations to make on the draft law and draft decree.

3. Specific comments

3.1 *Eligibility for support*

The draft law and draft decree lay down a number of eligibility criteria that credit institutions need to fulfil in order to have access to the special government bonds under consideration in this opinion. The ECB notes with satisfaction that the subsidiaries of foreign credit institutions are expressly included within the scope of eligible credit institutions, as required by the European Commission in its guidance on the compliance of financial sector support schemes with State aid rules[21].

3.2 The ECB also notes that the draft law and draft decree provide that the main criterion for the allocation of the bonds is to be the contribution of each eligible credit institution to the financing of domestic households and SMEs as at 31 December 2008, calculated on the basis of each credit institution's 'aggregate domestic market share in business and housing loans'[22]. In the interests of clarity and legal certainty and with a view to ensuring equal treatment amongst financial institutions and avoiding market distortions, it is advisable that any element of discretion inherent in the allocation of special government bonds be removed from the draft law and draft decree and that any additional considerations of relevance to the determination of their allocation be explicitly mentioned in the draft legal acts.

3.3 *Calculation of commissions and pricing*

The ECB notes that Article 5(8) of the draft decree specifies the commission to be charged upon allocation of the special government bonds. It also notes that the specification of this commission recognises the ECB's contribution to the harmonisation and coordination, across the EU, of the pricing of State guarantees. In particular, the ECB recalls that it is important to ensure that the pricing of such government schemes is risk-based, market-oriented and determined on the basis of the costs of a corresponding scheme in the market. In this respect, the ECB understands that this commission is calculated in such a way that all three conditions are fulfilled.

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21 See the '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' of 13 October 2008, available on the Commission's website at www.ec.europa.eu. Paragraph 18 thereof specifies that 'The eligibility criteria of financial institutions … must be objective, taking due account of their role in the relevant banking system and the overall economy, and non-discriminatory so as to avoid undue distortive effects on neighbouring markets and the internal market as a whole. In application of the principle of non discrimination on the grounds of nationality, all institutions incorporated in the Member State concerned, including subsidiaries, and with significant activities in that Member State should be covered by the scheme'.

22 Draft law, Article 9; draft decree, Article 5(7).

3.4 *Haircuts*

The ECB notes that Article 5(10) of the draft decree specifies the level of haircuts to be applied to collateral provided by the beneficiary credit institutions to the Cypriot government in return for the bonds allocated to them. The types of eligible collateral are listed in Article 5(9)(b)(i) to (iv). Under Article 5(9)(b)(i), collateral eligible in the Eurosystem for credit operations is also to be eligible as collateral for the allocation of the bonds. In the interests of clarity, Article 5(9)(b)(i) could benefit from the specification of the haircuts applicable to collateral eligible in the Eurosystem for credit operations when this is tendered by beneficiary credit institutions in consideration for the allocation of the bonds.

3.5 *Reporting obligations*

Article 5(12) of the draft decree foresees quarterly reporting obligations for beneficiary credit institutions vis-à-vis the Ministry of Finance. The ECB notes that Article 5(12)(c) could benefit from clarification as to the conditions subject to which the 'justification' referred to in that provision is to be provided. In particular, it is unclear whether, in its current formulation, the reference made in that provision is to an increase in total credit facilities to SMEs and households or to the total outstanding amount of such credit facilities and whether it is the former or the latter that should correspond to the amount of special government bonds allocated to each beneficiary credit institution. The ECB understands Article 5(12)(c) to be consistent with the former interpretation.

3.6 *Role of the central bank*

The ECB notes the CBC's role in the proposed issuance of the special government bonds under consideration in this opinion and in the monitoring of their use. In particular, Article 3 of the draft law requires a recommendation of the Governor of the CBC prior to the adoption of any ministerial decrees determining the terms of its implementation. Moreover, the draft decree provides for the participation of two CBC representatives in the special Committee foreseen in Article 6(1) thereof, with the task of monitoring the draft law's implementation and ensuring that the liquidity secured by beneficiary credit institutions benefits domestic borrowers and the national economy at large[23].

3.7 In addition, the ECB notes that the administrative penalties foreseen in Article 14 of the draft law in cases of non-compliance by beneficiary credit institutions with the terms and conditions for the use of the special government bonds as well as the partial or total revocation of such bonds allocated to non-compliant beneficiary credit institutions, can only be imposed following a recommendation of the Governor of the CBC (or of the Commissioner, as the case may be).

3.8 While appreciating the draft law's recognition of the CBC's expertise in its fields of competence, the ECB also expects that the CBC's advisory functions will be performed in full compliance with

23 The Committee, which is to be chaired by a representative of the Ministry of Finance, is to consist of two representatives of the Ministry of Finance (appointed by the Minister), two representatives of the CBC (designated by the Governor of the CBC and appointed by the Minister of Finance) and two representatives of the Authority for the Supervision and Development of Cooperative Societies (designated by the Commissioner and appointed by the Minister).

its institutional and financial independence and 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 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b(1) of the Treaty[24]. In this respect, the ECB welcomes the clarification of Article 6(3) of the draft decree which expressly provides that the establishment and operation of the Committee referred to in Article 6(1) is to be without prejudice to the competences of the CBC (or of the Authority for the Supervision and Development of Cooperative Societies).

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

Done at Frankfurt am Main, 1 October 2009.

[signed]

The President of the ECB

Jean-Claude TRICHET

24 OJ L 332, 31.12.1993, p. 1.