EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 4 April 2011

on a special tax on banks and on the setting up of an independent financial stability fund

(CON/2011/29)

Introduction and legal basis

On 11 March 2011, the Cypriot Ministry of Finance forwarded to the European Central Bank (ECB), for information, two draft laws under consideration by the House of Representatives, one relating to the imposition of a special tax on banks (hereinafter the 'draft law on a special tax on banks') and another on a fund to support the financial system (hereinafter the 'draft law on a fund to support the financial system'). On 24 March 2011, the Ministry of Finance replaced the draft law on a special tax on banks and the draft law on a fund to support the financial system with a new draft law on the imposition of a special tax on credit institutions, covering both topics (hereinafter the 'draft law').

The ECB is competent to deliver an opinion on the draft law. Its 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 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 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 law

1.1 The ECB understands that, under Part I of the draft law, a temporary ad hoc tax is to be levied for 2011 and 2012 on all banks and cooperative credit societies operating in Cyprus, equivalent to 0.095% of the deposits of their domestic and foreign depositors, with the exception of inter-bank deposits. The special tax in question is intended to contribute to the Government's short-term budgetary targets; it may not exceed 20% of the total taxable profits of the taxable institutions for 2011 and 2012. Part of the revenue to be collected through this ad hoc tax will finance the 'Independent Financial Stability Fund' (hereinafter the 'bank resolution fund'). The draft law will on the one hand address fiscal imbalances in Cyprus, by generating an estimated EUR 60 million

1 OJ L 189, 3.7.1998, p. 42.

annually in tax revenue; and on the other hand, finance the establishment of the bank resolution fund.

1.2 Part II of the draft law establishes a financial stability fund, by providing a fiscal buffer for banking sector risks. The setting up, management, governance, resolution measures, the amount of contributions to the Fund and its operation are to be governed by regulations to be drafted by the Central Bank of Cyprus and adopted by the Council of Ministers.

2. Remarks on Part I of the draft law

2.1 As the ECB has stated in an earlier opinion[2], taxes on financial institutions should be considered in relation to the dual objective of ensuring a more equitable distribution of the costs arising from their potential failure between taxpayers and the financial sector and of addressing the risks that they pose. Using the proceeds of any ad hoc taxes imposed on banks for general budgetary purposes would be undesirable, to the extent that such taxes would place undue burdens on banks, hampering the provision of credit, with a knock-on effect on growth in the real economy. This might result in extra charges for their customers and may also induce certain banks to cut back on their activities, leading to a reduction in the availability of credit and creating uncertainty for banks, with a detrimental effect on the banking sector's long term growth.

2.2 In the light of the above, the ECB recommends a comprehensive impact assessment of the proposed measure, to ensure that the public benefit from its imposition will outweigh any potential negative implications for banks, their customers and the economy.

2.3 The ECB notes that while an institution's liabilities represent one of the most reliable indicators of the amounts necessary for a bank resolution, the choice of an institution's deposits as the basis for calculating the special tax to be levied from it, in conjunction with the 20% profits-linked cap, could unduly penalise profitable institutions with a deeper retail deposit base compared to their competitors. This would unduly reward risk-taking that is not backed by a solid retail deposit base.

3. Remarks on Part II of the draft law

3.1 According to the European Council's conclusions[3], Member States should introduce systems of levies and taxes on financial institutions to ensure fair burden-sharing and to set incentives to contain systemic risk. Such levies or taxes should be part of a credible resolution framework. More specifically, setting up bank resolution funds, financed by levies, has already been addressed by the European Commission, which proposed that all Member States should set up ex ante resolution funds as part of the planned EU crisis management and resolution framework[4]. The ECB supports

2 See Opinion CON/2010/62, paragraph 3.2.

3 See conclusions of the European Council of 17 June 2010.

4 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

the Commission's proposal and considers that resolution funds could provide a useful means to support bank resolution, based on clear, stringent and properly communicated conditions.

3.2 In particular, the primary purpose of resolution funds should be 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. The existence of resolution funds may, nonetheless, raise moral hazard concerns. Therefore, stringent conditions for their use need to be defined, including no automatic correspondence between the pay-in - that is, the contribution to the fund - and the pay-out, and decisions about the use of the funds should reside with independent and accountable public authorities. Failure to establish dedicated resolution funds may result in increasing the dependence of the financial sector on public funds in times of stress and also further reinforce the risk of moral hazard.

3.3. When adopting resolution tools for financial institutions – as in the present case in setting up a bank resolution fund – Member States should act in a coordinated manner to avoid significant differences having counterproductive effects. The ECB therefore welcomes the consulting authority's intention of ensuring that Union law, the European Commission's recommendations and the best practices of other Member States are to be taken into account when drafting the regulations referred to in draft Article 12(4)(b)[5]. While the ECB cannot appraise the bank resolution fund before the regulations have been drafted and submitted to it for its assessment, it can nevertheless provide some general comments concerning their scope and structure.

3.4. The regulations should explicitly set out the different measures that the bank resolution fund will cover. In particular, the regulations should specify how the funds collected are to be held and managed and under which conditions they are to be used. Furthermore, the regulations should address the objectives of the proposed bank resolution fund, which, as already stated above, should be to mitigate the effects of a failure on different stakeholders by trying to maximize the value of remaining assets and to facilitate, if possible, a quick return to their productive use. To avoid creating incentives for moral hazard, the regulations should expressly stipulate that any monies paid out of the bank resolution fund should not be used for any form of bailout or to avoid a bankruptcy.

3.5 Concerning the issue of the bank resolution fund's governance structure, the ECB stresses 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, for its management committee to operate as an independent executive body and for the fund's functional independence from the Government to be statutorily enshrined.

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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.

5 Article 12(4)(c)(i) of the draft law.

3.6 Finally, the regulations should cater for replenishing the resolution fund where part or all of its funds are used to support an ailing bank's liabilities. They should also cater specifically for the fund's winding up.

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

Done at Frankfurt am Main, 4 April 2011.

[signed]

The President of the ECB

Jean-Claude TRICHET