



EUROPEAN CENTRAL BANK
EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK
of 26 April 2011
on recovery and resolution measures for credit institutions
(CON/2011/39)

Introduction and legal basis

On 28 February 2011, the European Central Bank (ECB) received a request from the Irish Minister for Finance (hereinafter the ‘Minister’) for an opinion on the Central Bank and Credit Institutions (Resolution) Bill 2011 (hereinafter the ‘draft law’).

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 provisions¹, as the draft law relates to the Central Bank of Ireland (hereinafter the ‘Central Bank’) and contains 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 draft law was foreseen as one of the actions implementing the financial assistance programme agreed between the Minister, the European Commission, the ECB and the International Monetary Fund to restore confidence in the banking sector and achieve financial stability in the Irish economy², alongside the Credit Institutions (Stabilisation) Act 2010 on which the ECB issued its opinion on 17 December 2010³ (the ‘2010 Act’). The draft law will apply to banks, building societies and credit unions licensed in Ireland (collectively referred to as ‘authorised credit institutions’)⁴. However, the draft law will not apply to ‘relevant institutions’ to which the 2010 Act applies (which includes Irish licensed banks to which financial support has been given by the

¹ OJ L 189, 3.7.1998, p. 42.

² See the Memorandum of Understanding on specific economic policy conditionality of 3 December 2010, page 4, available on the Commission’s website at www.ec.europa.eu.

³ Opinion CON/2010/92. All ECB opinions are available on the ECB’s website at www.ecb.europa.eu.

⁴ Section 2(1) of the draft law.

Minister) until they cease to be relevant institutions for the purposes of the 2010 Act⁵. The ECB notes that the draft law would, therefore, create a permanent crisis management and resolution regime for ‘authorised credit institutions’ only; the temporary regime created by the 2010 Act will expire on 31 December 2012, unless extended. Given the exclusion⁶ of ‘relevant institutions’ under the 2010 Act from being ‘authorised credit institutions’ under the draft law, an Irish credit institution will be subject to one stabilisation and resolution regime only, at any given time.

- 1.2 The draft law grants the Central Bank a set of resolution powers over the authorised credit institutions. It provides that, amongst other things, the Central Bank: (i) may, if specified ‘intervention conditions’ are satisfied, propose special management orders to appoint a special manager to an authorised credit institution or propose transfer orders relating to all or any part of an authorised credit institution’s assets and/or liabilities; (ii) shall administer a fund to be applied to the resolution of financial instability in, or an imminent serious threat to the financial stability of, authorised credit institutions; (iii) may establish a bridge bank which could on a temporary basis hold the assets and liabilities of an authorised credit institution and carry on a banking business; (iv) may petition for the winding up of an authorised credit institution under a new liquidation regime for such institutions, and may nominate two members to the liquidation committee; (v) may direct an authorised credit institution to prepare and, when necessary or desirable, implement, a ‘recovery plan’, and may itself prepare a ‘resolution plan’ in respect of any such institution. The draft law also foresees that the Minister: (i) has certain regulatory powers in relation to the abovementioned fund, bridge banks and the transfer of assets and liabilities; (ii) is to be consulted before certain decisions in relation to an authorised credit institution are taken; and (iii) has the right to nominate one member to the liquidation committee.

2. General observations

- 2.1 In line with its previous opinions, the ECB emphasises that, when adopting resolution measures for financial institutions, Member States should act in a coordinated manner in order to avoid significant differences in national implementation having a counterproductive effect, which may involve distortions in global banking markets. Against this background, any national measure should ensure a sufficiently level playing field within the euro area, which is of key importance to maintaining the integrity of the euro area banking system.

⁵ Section 69(1) of the 2010 Act provides that it ceases to have effect on 31 December 2012 unless extended; Section 69(2) and (3) clarify, however, that any order or requirement made continues to have effect and that the provisions of the Act remain effective with respect to such orders and requirements. At the current time, ‘relevant institutions’ under the 2010 Act comprise: (i) all of the main Irish credit institutions, namely: Allied Irish Banks, p.l.c., Anglo Irish Bank Corporation Limited, Bank of Ireland, EBS Building Society, Irish Nationwide Building Society and Irish Life and Permanent plc; (ii) any subsidiaries/holding companies of those institutions; and (iii) all credit unions (of which there are more than 400). If the draft law is enacted as currently drafted, credit unions will no longer be ‘relevant institutions’ under the 2010 Act (as Part 3 of Schedule 1 of the draft law will amend the definition of ‘relevant institution’ by deleting the reference therein to credit unions) and the 2010 Act will no longer apply to credit unions except to the extent that any orders or requirements have been made in regard to them under the 2010 Act.

⁶ It would be helpful if it was made clear that this exclusion does not stop the relevant institution from being authorised to carry on banking business.

- 2.2 The ECB welcomes the wider powers under the draft law that will be available to the Central Bank, to manage and resolve financial institutions which are financially distressed and whose demise would threaten the stability of the financial system. They will include, for instance, the appointment of special managers with the intent of preserving or restoring a credit institution's financial position. As in the case of the 2010 Act, the resolution powers foreseen under the draft law, which are exercised by *ex parte* application to a court without a full hearing on the merits⁷, have the potential to raise legal issues with respect to the exercise of the property rights of institutions' shareholders and creditors. Thus, it is important for any regime to properly balance these fundamental rights with the general interest in the financial system's stability. In this regard, the ECB would welcome if the draft law would include some elaboration of the rights of transferors, creditors and other third parties as regards compensation and certain other rights and remedies, if any, in respect of the resolution orders.
- 2.3 Measures that are intended to safeguard financial stability should involve cooperation with the relevant Member State authorities, in line with Union legislation and the arrangements in place, such as the Memorandum of Understanding on cooperation between the financial supervisory authorities, central banks and finance ministries of the European Union on cross-border financial stability⁸.

3. Specific observations

Central Bank independence

- 3.1 The draft law specifies in Section 6 that nothing in its provisions prevents the performance by the Governor or the Central Bank of their functions in relation to any credit institution authorised or regulated in the State, or affects any obligation arising under the Treaties governing the European Union or the European Communities or the ESCB Statute. The ECB notes that Section 6 does not expressly refer to the Treaty principle of central bank independence nor state that it prevails over any incompatible draft law provision. However, the ECB understands that it confirms the obligations arising under the Treaties, including the protection of central bank independence.
- 3.2 In its opinion on the 2010 Act, the ECB recommended that any 'relationship framework' prepared under that measure should recognise the Central Bank's institutional and financial independence and the Governor's personal independence⁹. The ECB notes that Section 89 of the draft law expressly limits the extent of any intervention by the Minister in the performance of the Central Bank's functions in the context of any relationship framework which may be prepared under the draft law. In this respect, an explicit reference should be made to the principle of central bank independence.

⁷ See, e.g., Section 23(1) concerning transfer orders and Section 41(1) concerning special management orders.

⁸ Concluded on 1 June 2008. Available on the ECB's website at www.ecb.europa.eu.

⁹ Paragraph 3.3 of Opinion CON/2010/92; see also similar observations in paragraph 3.1.6 of Opinion CON/2009/93.

- 3.3 The ECB notes that Section 82(1) of the draft law states that the Minister may in certain circumstances make orders mitigating any unfairness or undue hardship caused by the operation of Section 81 of the Act which impacts on the rights of counterparties dealing with authorised credit institutions under relevant agreements. The ECB recommends that Section 82 be amended to require the Minister to consult with the Central Bank prior to making any such order.

Extra-territorial effect

- 3.4 As set out above, the draft law will apply to banks, building societies and credit unions licensed in Ireland ('authorised credit institutions'). However, the ECB notes that the draft law provides that a transfer order and a special management order may be made in relation to a 'subsidiary' or 'holding company' of an authorised credit institution, as well as in relation to the authorised credit institution itself (Sections 20 and 38 of the draft law). The ECB understands that the definitions of 'subsidiary' and 'holding company' under the draft law may include foreign corporations¹⁰. The ECB assumes therefore that the Irish legislator intends the resolution measures contained in the draft law to also apply to foreign incorporated holding companies and subsidiaries of authorised credit institutions. The ECB notes that these measures may only be enforceable against such foreign legal entities to the extent permitted under the foreign law applicable to them.

Bank levy

- 3.5 Section 12 of the draft law provides that authorised credit institutions shall contribute to the Credit Institutions Resolution Fund (the 'Fund') in accordance with regulations. While the ECB notes that such regulations are to be made by the Minister and that these regulations are to provide for the rate of contribution, or method of calculation of such rate (Section 14(1) of the draft law), the method of calculation is not sufficiently clear from the draft law. In particular, it is not clear to what extent foreign assets and liabilities of authorised credit institutions, or indeed foreign assets and liabilities of foreign subsidiaries of authorised credit institutions, would be included in the calculation. The ECB would welcome more explicit clarification in the draft law as to which assets and liabilities of authorised credit institutions come within the scope of the Fund contribution calculations, and that assets and liabilities of foreign subsidiaries of such authorised credit institutions are excluded from the calculation of the contribution.

Establishment of 'bridge banks'

- 3.6 Under Section 16 of the draft law, the Central Bank may form private companies as bridge banks to which the assets and liabilities of an authorised credit institution may be transferred on a temporary basis pursuant to a transfer order. Sections 9(2) and 16(4) provide that any such bridge banks shall be capitalised from the fund with the consent of the Minister. The ECB welcomes the introduction in the draft law of the option of addressing a possible crisis situation through the transfer of a distressed institution's assets and liabilities to a bridge bank. The availability of a bridge bank is

¹⁰ The draft law defines 'subsidiary' and 'holding company' with reference to section 155 of the Irish Companies Act 1963 and to the Irish European Communities (Companies: Group Accounts) Regulations 1992.

recognised as part of an enhanced convergence of national legal schemes for crisis management and resolution which are developing at both international and European level¹¹. The ECB welcomes in particular that Section 16(4) of the draft law prohibits the Central Bank from providing capital to any bridge bank from its own resources. In this respect, the ECB would welcome an explicit mention in the draft law that the Central Bank as a shareholder in a bridge bank will in no event assume or finance any obligation of a bridge bank, and that this role will remain, under any circumstances, consistent with the prohibition of monetary financing under Article 123 of the Treaty, as supplemented by Council Regulation (EC) No 3603/93¹², which prohibits, inter alia, any financing by a central bank of the obligations of the public sector vis-à-vis third parties, and further that Sections 9(2)(c), 16 and 18 shall be without prejudice to the independence of the Central Bank, in particular its financial and institutional independence.

Recovery planning

3.7 Section 73 of the draft law entitles the Central Bank to direct an authorised credit institution to prepare and submit to the Central Bank, for review, a recovery plan to facilitate, without recourse to State aid, the continuation or securing of the business of such an authorised credit institution. The Central Bank may direct the relevant authorised credit institution to make such changes to its recovery plan as the Central Bank considers appropriate. The ECB notes that this provision is broadly in line with the recommendations of the Commission's DG Internal Market and Services latest working document on a possible EU framework for bank recovery and resolution¹³. The ECB would welcome the incorporation of the detailed provisions of the working document into any code of practice issued pursuant to Section 73(3) of the draft law.

Valuation mechanism

3.8 The ECB notes that Sections 22(4) and 31 do not set out any specific approach to valuation of the assets transferred. The reliance on a competitive process (Section 22(4)), and the appointment of an independent valuer only if the valuation is disputed (Section 31(1)), do not seem sufficient to allow for a transparent and legally certain valuation. Although a detailed methodology may not be necessary at the level of the law, it should minimally set out the principles that will be used to determine the value of the assets. This is a precondition for a fair treatment of creditors and other third parties, as their right of compensation may only be duly assessed against this information. It is important that market participants are informed in advance what rights they will have to claim compensation and on what valuation basis.

¹¹ See in particular the DG Internal Market and Services Working Document, Part 4 G3, referred to in footnote 8; the 'Report and Recommendations of the Cross-border Bank Resolution Group', March 2010, available on the Bank for International Settlements' website at www.bis.org; and the 'Practice Guide on Cross-Border Insolvency Cooperation' adopted by UNCITRAL on 1 July 2009, available on UNCITRAL's website at www.uncitral.org.

¹² Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions in Article 104 and 104b(1) of the Treaty (OJ L 332, 31.12.1993, p. 1).

¹³ See http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.

Collateral and netting

3.9 The ECB notes that Section 81 of the draft law would have the effect of ‘switching off’ the rights of counterparties to the authorised credit institutions under ‘relevant agreements’ in certain events. Those events include the adoption of the draft law and any order made under powers thereunder. Section 81(4) sets out a list of consequences that are to be ‘switched off’. Those consequences include ‘any event of default or breach of any right arising’ under a relevant agreement. At the same time Section 85 states that nothing in the draft law shall affect the operation of, inter alia, the Irish regulations implementing the Settlement Finality Directive and the Financial Collateral Arrangements Directive¹⁴ (FCAD), in relation to any agreement to which the authorised credit institution or its subsidiary is a party.

Moreover, the draft law also amends the 2004 and 2010 Regulations implementing the FCAD in Ireland. For instance, Schedule 2, Part 2 of the draft law provides for an amendment to the effect that ‘for the avoidance of doubt, nothing in Regulation 6, 7, 10 and 11 or 12 [of the 2010 Regulations] shall affect the operation ... of Section 81 of the draft law.’¹⁵

3.10 The ECB understands that the intention behind Section 81 is to ensure that a measure adopted under the draft law is not deemed to be an ‘enforcement event’¹⁶ for the purposes of the FCAD as implemented in Ireland, but that it does not aim to interfere with the close-out netting rights per se of the counterparty under a relevant agreement. Also, Section 85 expressly leaves undisturbed Regulation 30 of the 2011 Regulations¹⁷, which states that the netting agreement is governed solely by the law of the contract that governs the agreement.

Moreover, by denying to counterparties the consequences which normally would occur under their agreement in the event of the adoption of a measure under the draft law, it could be argued that these provisions prevent the close-out netting provisions from ‘[taking] effect in accordance with their terms’ as required by the FCAD. The ECB recommends that the interaction of these provisions with the FCAD is clarified, if necessary in an explanatory note to the draft law.

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

Done at Frankfurt am Main, 26 April 2011.

[signed]

The President of the ECB

Jean-Claude TRICHET

¹⁴ Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and security settlement systems (OJ L 166, 11.6.1998, p. 45); and Directive 2002/47/EC of the European Parliament and the Council of 6 June 2002 on financial collateral arrangements (OJ L 168, 27.6.2002, p. 43).

¹⁵ Schedule 2, Part 2 of the draft law amends the European Communities (Financial Collateral Arrangements) Regulations 2010.

¹⁶ As defined in Article 2(1)(1) of the FCAD.

¹⁷ European Communities (Reorganisation and Winding-Up of Credit Institutions) Regulations 2011.