



**OPINION OF THE EUROPEAN CENTRAL BANK**  
**of 1 February 2013**  
**on a resolution framework for credit and other institutions**  
**(CON/2013/10)**

### **Introduction and legal basis**

On 11 January 2013, the European Central Bank (ECB) received a request from the Cypriot Ministry of Finance for an opinion on a series of draft laws establishing a draft resolution framework for credit and other institutions operating in Cyprus (hereinafter the ‘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 on the third and 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<sup>1</sup>, as the draft laws 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 laws**

1.1 The draft laws are intended to establish a comprehensive framework for the recovery, restructuring and resolution of credit and other institutions, with a view to safeguarding the smooth operation of the financial system and serving the public interest. The resolution framework is to consist of proposed amendments to (i) the Banking Laws of 1997 to 2009<sup>2</sup>, (ii) the Co-operative Societies Laws of 1985 to 2012<sup>3</sup>, (iii) the Financial Crises Management Laws of 2011 to 2012<sup>4</sup>, and (iv) the Special Tax on Credit Institutions Laws of 2011 to 2012<sup>5</sup>, as well as of (v) a draft law and accompanying Regulations on the Establishment and Operation of a Deposit Protection and Resolution of Credit and Other Institutions Scheme (hereinafter the ‘Scheme’), and finally (vi) a draft law on the resolution of credit and other institutions (hereinafter the ‘draft law on resolution’).

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<sup>1</sup> OJ L 189, 3.7.1998, p. 42.

<sup>2</sup> Law 66(I)/1997, *Episimi Efimerida tis Dimokratias* No 3168, 18.7.1997.

<sup>3</sup> Law 22/1985, *Episimi Efimerida tis Dimokratias* No 2043, 29.3.1985.

<sup>4</sup> Law 200(I)/2011, *Episimi Efimerida tis Dimokratias* No 4313, 30.12.2011.

<sup>5</sup> Law 84(I)/2011, *Episimi Efimerida tis Dimokratias* No 4282, 29.4.2011.

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- 1.2 In particular, the amendments to the Banking Laws reinforce the powers of the CBC to (i) collect information from banks, including its powers of entry and inspection, (ii) intervene early, in terms of new powers to mandate (a) an increase of the share capital of the bank, without strict compliance with company law rules, (b) the submission of recovery plans and information for the Central Bank of Cyprus to draw up resolution plans in its capacity as resolution authority, and (c) the imposition of limits on dividend payments and the remuneration of the officials, executive officers and directors of a bank. Finally, the amendments to the Banking Laws introduce a new special liquidation procedure, which includes the appointment of a special liquidator, where (a) the bank's licence has been withdrawn, (b) the bank holds deposits covered by the Deposit Protection Fund, and (c) the special liquidation of the bank is in the public interest.
- 1.3 The amendments to the Co-operative Societies Laws are intended to bring its text in line with the draft law on resolution. In particular, the amendments to the Co-operative Societies Laws empower the Co-operative Societies Commissioner to demand (i) an increase of the share capital of a co-operative credit institution (CCI), (ii) the submission of recovery plans and information to the resolution authority for the development of resolution plans, and (iii) limits on the payment of dividends and the remuneration of the officials and directors of CCIs. The proposed amendments also insert into the Co-operative Societies Laws provisions relevant to the special liquidation of CCIs, and the appointment of a special liquidator in cases where (a) the licence of a CCI has been withdrawn, (b) the CCI holds deposits covered by the Deposit Protection Fund, and (c) the special liquidation of the Co-Operative is in the public interest.
- 1.4 The draft law and accompanying Regulations on the Establishment and Operation of a Deposit Protection and Resolution of Credit and Other Institutions Scheme abolish (i) the Deposit Protection Fund established under Section 34 of the Banking Laws, and (ii) the Financial Stability Fund, established under Section 3(1) of the Financial Stability Fund Law<sup>6</sup>, and replace them with a separate legal entity, comprised of two separate funds, namely (a) a deposit protection fund, and (b) a resolution fund (hereinafter collectively referred to as the 'Funds'). The Funds are to be kept separate through two distinct accounts, one for each of the Funds<sup>7</sup>. The Scheme applies to banks and branches of banks established in Cyprus, banks operating on a cross-border basis and the Housing Finance Corporation (hereinafter collectively referred to as the 'covered credit institutions'). The Scheme will: (i) compensate depositors from the Deposit Protection Fund, in the event a covered credit institution is unable to repay depositors, or a receivership or liquidation order has been issued in relation to a covered credit institution, and (ii) fund the resolution measures provided for in the draft law on resolution. All covered credit institutions, unless

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<sup>6</sup> Law 201(I)/2011, *Episimi Efimerida tis Dimokratias* No 4313, 30.12.2011.

<sup>7</sup> The Deposit Protection Fund is to be funded by the resources of the existing fund, the future contributions of covered credit institutions, the transfer and liquidation of assets, the proceeds of sanctions imposed by the Scheme's Committee, and loans which the Scheme may secure, backed by guarantees of the covered credit institutions. The Resolution Fund is to be funded by the resources of the existing fund in the form of levies collected on banks by virtue of the Special Tax on Credit Institutions Laws, future contributions, the transfer and liquidation of assets, the proceeds of sanctions imposed by the Scheme's Committee, and loans.

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exempted by the Committee of the Scheme, are to pay contributions to the Deposit Protection Fund, as per the accompanying Regulations. Branches of banks established in another Member State may be exempted if covered by deposit protection schemes in their home Member States. The affairs of the Scheme are to be managed by an independent committee, chaired by the Governor of the CBC.

- 1.5 The amendments to the Financial Crises Management Laws aim to *inter alia* (a) broaden the scope of that law through a delegation to the Council of Ministers of powers for the adoption of support measures, on a recommendation of the CBC, subject to certain conditions,<sup>8</sup> (b) make the granting of government support to any of the Funds conditional on their management committees having exhausted every possibility to obtain additional resources either from the covered institutions or through borrowing, (c) require an evaluation of the long-term viability of the applicant financial institution prior to a recommendation by the Council of Ministers to adopt support measures, (d) remove references to the existence of a ‘financial crisis’ as a precondition for the adoption of support measures, and (e) introduce provisions on the management, by the Council of Ministers, on a recommendation of the CBC, of hybrid capital and subordinated liabilities of financial institutions that have received or have applied for support.
- 1.6 Finally, the draft law on resolution establishes a framework for intervention in, and the implementation of, resolution measures in relation to credit institutions where (a) the affected institution is not, or is likely to no longer be, viable, or (b) in the absence of such measures, the institution will be unable to observe its capital adequacy and/or liquidity requirements, or (c) resolution measures are necessary to safeguard the public benefit or serve the public interest. The main objectives of the draft resolution law are to (i) ensure continuity of banking and financial services, (ii) avert adverse effects on the financial system, (iii) safeguard the stability and smooth operation of the financial system, and (iv) protect public funds and depositors. Intervention is based, *inter alia*, on the following principles: (a) shareholders and stakeholders are to be the first to bear losses, (b) creditors are to absorb losses after shareholders and creditors of the same rank are to be treated equally, (c) no creditor is to be worse off than if the affected institution had been liquidated as part of an insolvency procedure, (d) the senior management of an affected institution is to be replaced and be liable for any breaches of their duties, (e) any interference with property rights is to comply with the Constitution of the Republic of Cyprus and the European Convention on Human Rights, and not be in conflict with the *acquis communautaire*. The CBC will act as resolution authority, with the power to issue, on consultation with the Minister for Finance, relevant orders for the implementation of the following resolution measures: (i) an increase of the share capital of an affected institution, (ii) the sale of the business of an affected institution, including the transfer of some or all of its assets and liabilities, (iii) the transfer of assets or liabilities to a bridge bank or to an asset management company and (iv) bail-in. The CBC will also

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<sup>8</sup> See paragraph 4 of this Opinion.

have, as resolution authority, the power to appoint special administrators to take over the management of the CI under resolution.

- 1.7 The ECB understands that the proposed adoption of a comprehensive framework for the recovery, restructuring and resolution of credit and other institutions is motivated by a possible financial support programme for Cyprus in response to the impact of the sovereign debt crisis on the Cypriot banking sector and economy.

## 2. General observations

- 2.1 Subject to its remarks in the remainder of this opinion, the ECB welcomes the draft laws as a means of enhancing financial stability in Cyprus. The ECB has previously been consulted on previous legislation on these subjects<sup>9</sup>.
- 2.2 The ECB reminds the consulting authority that according to Article 4 of Decision 98/415/EC, the ECB must be consulted ‘at an appropriate stage’ in the legislative process. This implies that the consultation should take place at a point in the legislative process that affords the ECB sufficient time to examine the draft legislative provisions and adopt its opinion.

## 3. The draft law on resolution

- 3.1 The ECB notes that, in keeping with other national resolution frameworks recently subject to ECB consultation, Section 4 of the draft law on resolution provides for the priority of claims in the event of the liquidation of an institution under resolution. In particular, Section 4(3) will rank the claims of uninsured depositors in liquidation ahead of those of other general unsecured creditors. This appears to be motivated by financial stability and practical considerations specific to Cyprus and its banking sector. However, the ECB points out that the *pari passu* status of uninsured creditors has been adopted in recent resolution laws in other euro area countries, including Spain and Ireland. Views on the impact of granting preferential ranking to depositors are highly divergent, as such preferential ranking may have an impact on the funding costs of banks given the greater efforts likely to be made by other creditors to secure their claims. This impact could be somewhat mitigated if priority claims were only extended to guaranteed deposits. Granting priority status to insured deposits is warranted, as this reduces potential losses to insured depositors of a liquidated institution and, as a result, the risk of bank runs as well as any excessive depletion of the deposit guarantee scheme<sup>10</sup>.
- 3.2 Furthermore, Section 5(6) of the draft law on resolution will require the CBC, in exercising its powers as resolution authority, to take all measures necessary to ensure the effective separation

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<sup>9</sup> See Opinions CON/2011/29 and CON/2011/93. All ECB opinions are published on the ECB’s website at [www.ecb.europa.eu](http://www.ecb.europa.eu).

<sup>10</sup> See Opinion CON/2013/3, paragraph 4 and Opinion CON/2012/99, paragraph 8.2.

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between its supervisory tasks pursuant to the Central Bank of Cyprus Laws of 2002 to 2007<sup>11</sup>, and its resolution tasks, as provided for in the draft law on resolution. The ECB expects the same degree of separation to apply to the CBC's monetary policy tasks, in line with the Treaty and the Statute of the European System of Central Banks and of the European Central Bank.

- 3.3 Further, the ECB refers to the principle of financial independence which requires Member States not to put their NCBs in a position where they have insufficient financial resources to carry out all their tasks<sup>12</sup>. The ECB expects that the new tasks assigned to the CBC under the draft law on resolution will not affect the resources it currently allocates to supervision and to the performance of its monetary policy tasks.
- 3.4 Moreover, Section 6(1) of the draft law on resolution, entitled 'Conditions for the adoption of resolution measures', provides that the resolution authority may only take resolution measures in relation to institutions which, based on the assessment of the CBC, as resolution authority, are no longer viable or are likely to no longer be viable, thereby giving rise to a credible risk that the institution may no longer meet its obligations and/or continue to operate as a going concern. The ECB welcomes the application, under the draft law on resolution, of resolution measures to non-viable entities only, both for conceptual reasons, and for reasons of consistency with the Commission proposal of 6 June 2012 for a Union framework for bank recovery and resolution<sup>13</sup>.
- 3.5 The ECB notes that Section 12 of the draft law does not exclude guaranteed deposits from the scope of bail-in measures. At the same time, the general principles of the draft law<sup>14</sup> point to the conclusion that, in the event of a bail-in, guaranteed deposits would not be affected. For reasons of clarity, the ECB would invite the consulting authority to consider an explicit reference in Section 12 of the draft law to the exclusion of guaranteed deposits from the scope of an eventual bail-in.
- 3.6 Finally, the ECB notes that the draft law on resolution authorises the CBC, as resolution authority, to issue directives or to adopt decrees, so as to give effect to its decisions.<sup>15</sup> The draft law on resolution may require further provisions for the enforcement of the directives or decrees issued by the CBC, as resolution authority, as well as other measures envisaged to enforce the draft resolution law. In this respect, the consulting authority may also wish to insert a provision in the draft law on resolution, requiring third parties, including governmental authorities, to recognise, enforce and observe the terms of such directives or decrees.

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11 Law 138(I)/2002, *Episimi Efimerida tis Dimokratias No 3624*, 19 July 2002.

12 See ECB Convergence Report 2012, p. 25.

13 Proposal for a directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 (COM(2012) 280 final).

14 Section 3(1)(e) on the protection of depositors and Section 4(3) on the priority of guaranteed deposit claims, in conjunction with the 'no creditor worse off than in insolvency' principle set out in Section 3(2)(d).

15 See, for instance, Section 8(1) of the draft law on resolution.

#### **4. Amendments to the Financial Crises Management Law**

According to Section 4 of the draft law amending the Financial Crises Management Law (hereinafter, ‘the draft crises law’), the Cypriot Council of Ministers is to activate the Financial Crises Management Law on an application from a financial institution ‘in order to safeguard its long-term viability’. This will be subject to a recommendation from the CBC, if the latter considers it probable that resolving the applicant may have more serious repercussions on the stability of the financial system and/or may result in higher public spending than the application of support measures under the draft crises law. Section 4 might be understood as being compatible with the provision of financial support to viable and non-viable financial institutions alike<sup>16</sup>. As pointed out earlier in this opinion, non-viable financial institutions fall within the remit of the draft law on resolution. While the ECB agrees that the competent national authorities should have a margin of discretion when deciding to which institutions to grant State support, the interaction of State support schemes with national resolution frameworks requires careful consideration to avoid legal ambiguities and practical implementation uncertainties at times of crisis. The ECB is of the view that the restructuring of a non-viable entity as a going concern (‘open bank scenario’) instead of its resolution as a gone concern (‘closed bank scenario’) should only be considered under exceptional circumstances, where the orderly resolution of a credit institution would have seriously damaging effects on the stability of the financial system, with heightened risks of cross border contagion<sup>17</sup>.

#### **5. Amendments to the Cooperative Societies Laws**

Section 4 of the draft law amending the Cooperative Societies Laws inserts a new Section 49BA on the special liquidation of CCIs. The ECB notes that CCIs currently benefit from a cross-guarantee extended to them from the Cooperative Central Bank<sup>18</sup>. Although not explicitly stated in the draft law, the ECB understands that the liquidation of individual CCIs would only be possible on the assumption that the cross-guarantee could be lifted, albeit only temporarily and on an individual basis.

#### **6. The establishment and operation of a deposit protection and resolution of credit and other institutions scheme**

As explained earlier in this opinion, the proposed Deposit Protection Fund will compensate depositors, while the proposed Resolution Fund will fund resolution measures. The ECB notes with satisfaction that

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<sup>16</sup> Section 4 provides that support measures are conditional on (a) a financial institution applying for support to safeguard its long-term viability, and (b) an assessment by the CBC that the resolution of the financial institution in question, under the law on resolution, may have more serious repercussions on the stability of the financial system or result in higher public spending than the application of support measures under the Financial Crises Management Law.

<sup>17</sup> See Opinion CON/2013/3, paragraph 6 and Opinion CON/2012/99, paragraphs 1 and 6.2.

<sup>18</sup> The liabilities of the Cooperative Central Bank are, in turn, guaranteed by CCIs, as shareholders of the Cooperative Central Bank.

whilst the Deposit Protection Fund may borrow from the Resolution Fund, the Resolution Fund may not borrow from the Deposit Protection Fund if the funds available to it prove insufficient for its tasks<sup>19</sup>. The clear separation between the two Funds in terms of their lending capabilities is also in line with the draft law on resolution, according to which the financing of the implementation of resolution measures falls within the remit of the Resolution Fund, with the Deposit Protection Fund only paying an amount equal to the value of the covered deposits<sup>20</sup>.

## **7. Amendments to the Special Tax on Credit Institutions Law**

The draft law amending the Law on the special tax on credit institutions reflects the replacement of the Financial Stability Fund by a Resolution Fund and will transfer the 25/60 of the total revenues levied through the imposition of the special tax, to finance the Resolution Fund, from 1 January 2017 to a dedicated account held at the CBC. In this regard, the ECB draws the attention of the consulting authority to Opinion CON/2011/29<sup>21</sup>.

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

Done at Frankfurt am Main, 1 February 2013.

[signed]

*The President of the ECB*

Mario DRAGHI

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<sup>19</sup> See Section 10(1) of the draft law on the establishment and operation of a deposit protection and resolution of credit and other institutions.

<sup>20</sup> See Sections 9(6) and 10(7) of the draft law on resolution.

<sup>21</sup> See, in particular, paragraph 2.