



OPINION OF THE EUROPEAN CENTRAL BANK
of 2 July 2012
on the recapitalisation of the Cyprus Popular Bank
(CON/2012/50)

Introduction and legal basis

On 30 May 2012, the European Central Bank (ECB) received a request from the Cypriot Ministry of Finance for an opinion on a Ministerial Decree regarding the recapitalisation of the Cyprus Popular Bank Public Co. Ltd. (hereinafter, the ‘Ministerial Decree’).

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 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 provisions¹, as the draft decree relates to a national central bank 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 contents of the Ministerial Decree

- 1.1 The Ministerial Decree lays down a scheme for the recapitalisation of the Cyprus Popular Bank (CPB), with the involvement of the Government of the Republic of Cyprus. The legal basis for the Ministerial Decree is Article 4 of the Management of Financial Crises Laws of 2011 to 2012 (No.2)², read in conjunction with Articles 6, 7 and 14 thereof.
- 1.2 More specifically, Articles 3 and 4 of the Ministerial Decree provide that the Government of the Republic is to underwrite the full amount of a rights issue to be launched by the CPB. The issue is to be open to existing shareholders and new investors alike and will be up to an amount of EUR 1 800 million. The Republic is to acquire any non-subscribed rights in consideration for the provision of zero-coupon government bonds with a one-year maturity which are to be automatically renewed upon maturity. The government bonds are to be listed on the Cyprus Stock Exchange and are stated

¹ OJ L 189, 3.7.1998, p. 42.

² Law N. 200(I)/2011 *Episimi Efimerida tis Dimokratias* No 4314, 30.12.2011, p. 1678, as amended by Law 40(I)/2012, *Episimi Efimerida tis Dimokratias* 4330, 27.4.2012, p. 371. The ECB was previously consulted on the Financial Crises Law and issued Opinion CON/2011/93 in response.

to be traded without restrictions³. The rights are issued at a price of EUR 0.10 per share⁴. To facilitate the Government's exit strategy, freely transferable, non-listed share warrants are to be issued to the Republic⁵, with any shares acquired by the Republic being eligible to be repurchased within five years, either by the CPB's shareholders through exercise of their share warrants, by the CPB itself or by third parties⁶. The Republic reserves its right to exchange at any time, in whole or in part, the government bonds through which it has subscribed to the rights issue with cash⁷.

2. General observations on the Ministerial Decree

The ECB understands that the Ministerial Decree is a follow-up to the European Banking Authority's (EBA) publication of a formal Recommendation and final figures relating to the recapitalisation needs of European banks on 8 December 2011. The EBA's Recommendation and figures were part of the broader European package agreed by the European Council on 26 October 2011 and confirmed during the ECOFIN Council on 30 November 2011. This package aims to address the current situation in the Union by restoring stability and confidence in the markets. The ECB stresses the importance of bank recapitalisation as an essential condition for financial and systemic stability, as well as a condition precedent to the preservation, by Eurosystem counterparties, of their eligible counterparty status, within the meaning of Section 2.1 of Annex I to the Guideline ECB/2011/14 of 20 September 2011 on monetary policy instruments and procedures of the Eurosystem⁸.

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

While the ECB welcomes the initiative of the Cypriot authorities to recapitalise the CPB, it has the following observations to make on the particular recapitalisation scheme proposed in the Ministerial Decree.

3.1 *Recapitalisation needs of the CPB*

The Ministerial Decree estimates that the total recapitalisation needs of the CPB will not exceed EUR 1 800 million. In the event that the CPB's rights issue fails to attract sufficient private sector participation, the Government would need to provide the necessary capital up to the amount of EUR 1 800 million⁹. Should the need for a government capital injection prove to be higher than the

³ Ministerial Decree, Article 4(4).

⁴ Ministerial Decree, Article 5.

⁵ Ministerial Decree, Articles 4(2) and 6.

⁶ Ministerial Decree, Article 9(1).

⁷ Ministerial Decree, Articles 4(4) (iii).

⁸ OJ L 331, 14.12.2011, p. 1.

⁹ Taking into account that the rights issue will be exercised at EUR 0.10 a share against the current share price of EUR 0.08, the private sector participation in the rights issue is expected to be very modest.

amount currently envisaged in the Ministerial Decree, this would not provide an adequate legal basis for government capital injections in excess of EUR 1 800 million.

3.2 *Monetary financing considerations*

3.2.1 The monetary financing prohibition in Article 123 of the Treaty prevents central banks from providing overdraft facilities or any other type of credit facility to the public sector, including any financing of the public sector's obligations *vis-à-vis* third parties¹⁰. The ECB has repeatedly stated that the financing of credit institutions by a national central bank (NCB), granted independently and at its full discretion, other than in connection with central banking tasks (such as monetary policy, payment systems or temporary liquidity support operations) is incompatible with the monetary financing prohibition¹¹. This applies, in particular, to the support of insolvent credit institutions. The rationale behind the ECB's stance is that, by financing an insolvent credit institution, an NCB would be assuming a state task. The same concerns apply to the Eurosystem financing of a credit institution which has been recapitalised to restore its solvency by way of direct placement of state-issued debt instruments where no alternative market-based funding sources exist (hereinafter the 'recapitalisation bonds'), and where such bonds are to be used as collateral. Against this background, the ECB notes that, in such a case of a state recapitalisation of a credit institution by way of direct placement of recapitalisation bonds, the subsequent use of the recapitalisation bonds as collateral in central bank liquidity operations raises monetary financing concerns.

3.2.2 Furthermore, Article 123 of the Treaty prohibits central banks from purchasing debt instruments issued by Member States directly from Member States. Thus, debt instruments issued by central governments may be purchased on the secondary market only and such purchases made on the secondary market may not be used to circumvent the objective of Article 123 of the Treaty¹². In this respect, the ECB notes that, in the absence of any alternative market-based funding sources for recapitalisation bonds, and to the extent that such bonds have been acquired by the credit institution in the context of a direct placement, the acceptance of the bonds used for the recapitalisation as collateral could amount to a circumvention of the prohibition on direct purchases of debt instruments from central governments by the central bank.

3.2.3 In view of the legal constraints under the monetary financing prohibition, a case-by-case assessment of the existence of alternative market-based funding sources will be required for credit institutions receiving central bank financing, where they have been recapitalised to restore their solvency by way of direct placement of recapitalisation bonds which are to be used as collateral.

¹⁰ See Article 1(1)(b)(ii) of 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 (OJ L 332, 31.12.1993, p. 1).

¹¹ See, for example, the ECB's Convergence Report May 2012, pp. 29-30.

¹² See the seventh recital of Council Regulation (EC) No 3603/93.

3.3 *Fiscal considerations*

The use of recapitalisation bonds entails a number of fiscal drawbacks which are linked to their non-funded nature. Recapitalisation bonds have to be booked by the recipient bank at book value, meaning that they cannot be issued at a substantial discount to serve recapitalisation purposes. Moreover, as the total amount of government bonds to be issued for recapitalisation purposes depends on the prevailing market rates, their issuance could have adverse implications on the government balance for years to come. Besides, the increased government debt burden can reduce a government's options for raising funds from the private market increasing the likelihood that the issuing government has to turn to international or foreign parties for financial support. Finally, in those cases where recapitalisation bonds bear interest, the unfunded character of their issuance increases the government's debt service payments.

3.4 *Recapitalisation versus resolution*

In view of the fact that the support measures under the Ministerial Decree¹³ aim to address solvency problems at a financial institution, the ECB considers that the objectives pursued by the support measures may be better achieved through bank resolution tools. A fully-fledged bank resolution regime, comprising tools such as bridge banks, asset separation and transfers of business would offer legally sound means of resolving institutions on the brink of insolvency, safeguarding financial stability, whilst addressing stakeholder rights¹⁴.

3.5 *Financial stability considerations*

With respect to the choice of recapitalisation instruments, the recapitalisation of banks with funded or, *a fortiori*, unfunded government bonds has a number of drawbacks from a financial stability perspective. More specifically, market participants may not regard the injection of unfunded recapitalisation bonds as a credible recapitalisation technique, as it does not result in the provision of fresh cash to the banks, and thus may not help restore market access. Despite the fact that it can serve as a means of meeting the capital adequacy ratio, recapitalisation through the injection of such unfunded recapitalisation bonds can only change the risk absorption capacity of the bank gradually over time, as cash flows associated with these bonds are accumulated. Also, recapitalisations through government bonds forming part of the bank's assets can reinforce the feedback loop between the state and the bank. This is to be avoided.

3.6 *Central bank involvement*

The ECB notes that the Ministerial Decree caters for the involvement of the Central Bank of Cyprus (CBC) at various stages of the recapitalisation process envisaged in the Ministerial Decree.

¹³ Ministerial Decree, Article 4 (1)

¹⁴ In this context see the Commission's 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) 280/3).

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These stages include (a) the approval of the repurchase of own shares by the CPB, (b) the appointment to the CPB of an Independent Advisor who is responsible, *inter alia*, for preparing a restructuring plan, and (c) the appointment of up to five members of the CPB's Board of Directors¹⁵. When considering the CBC's supervisory tasks, and the powers conferred upon it under the Management of Financial Crises Laws of 2011 to 2012, the ECB is satisfied that the CBC's involvement at various stages of the recapitalisation process does not raise concerns relevant to the CBC's independent exercise of its Eurosystem tasks, in line with the Treaty and the Statute of the European System of Central Banks and of the European Central Bank.

This opinion will be published on the ECB's website 6 months after its adoption.

Done at Frankfurt am Main, 2 July 2012.

[signed]

The President of the ECB

Mario DRAGHI

¹⁵ Ministerial Decree, Articles 9(2), 10(1) and 11(1).