Jörg Asmussen: Exchange of views with the Economic and Monetary Affairs Committee of the European Parliament on financial assistance to Cyprus

Introductory statement by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the European Parliament, Brussels, 8 May 2013.

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Dear Madam Chair,

Honourable Members of Parliament,

Thank you for inviting me to this exchange of views on financial assistance to Cyprus.

The substance of the decisions, and process of how they were taken, have been debated controversially – also in this House. I am therefore pleased to be given the opportunity to provide the ECB's views and to participate in a public debate on this matter.

Initial conditions in Cyprus

Before discussing the key elements of the EU/IMF adjustment programme, it is very important to understand how Cyprus got itself into such difficult situation in the first place.

Why were imbalances of such magnitude allowed to develop?

What made the nature of the challenges faced by Cyprus so exceptional?

I find these essential questions that I hope we can address during our exchange of views today.

Let me focus here on the banking sector.

In the 2000s, the Cypriot economy evolved towards a rather unbalanced business model with an inordinate weight for the financial industry. The country aimed to become leading provider of international banking services. Cypriot banks attracted large inflows of foreign deposits. They expanded their balance sheets dramatically over recent years, both domestically and externally. The overall banking system represented more than 700% of GDP. In terms of employment, every third job was related to the financial and professional service sector.

An active use of the relevant policy tools could – and indeed should – have curbed these unsustainable developments. But prudential supervision was too weak and did not prevent the build-up of large financial sector imbalances. Asset growth outpaced deposit inflows. Banks became increasingly exposed to funding vulnerabilities. They tried to attract deposits by offering very high deposit rates – on average, nearly 2 percentage points higher than in the rest of the euro area [1]. Domestic credit expansion and imprudent lending practices fuelled a domestic property boom. As the bubble burst, non-performing loans increased dramatically. Moreover, Cypriot banks underwent sizeable losses following the Greek debt restructuring. This further deteriorated the soundness of their balance sheets.

The lop-sided nature of the economic model was not confined to the banking sector alone. At the same time, significant external and internal imbalances had built up – notably persistent current account deficits, significant losses in competitiveness, rising fiscal deficits and public debt. All this left Cyprus in a weak position to tackle the problems of its banking sector. And these problems appeared to be daunting – especially compared to the small size of the

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1 The rate for term deposits from households and non-financial corporations as of March 2013 was 4.4% in Cyprus and 2,5% in the euro area.

economy. The two largest banks, which account for half of the domestic banking sector, had prospective capital needs of close to EUR 8 billion – or 44% of GDP. This is what the independent due diligence exercise revealed in February 2013.

If the sovereign had shouldered these massive recapitalisation needs, debt would have risen to 145% of GDP. This would have critically endangered public debt sustainability. At the same time, traditional ways of burden sharing by the private sector bank creditors were limited, given little junior debt outstanding in banks.

All this made the situation in Cyprus highly challenging and exceptional. One needs to bear in mind the starting conditions when assessing the design of the EU/IMF programme, to which I will now turn.

Key elements of the EU/IMF programme

Three key objectives guided the negotiations of the MoU: first, to reduce the risks posed by the financial sector; second, to preserve debt sustainability; and third, to restore the conditions for sustainable and balanced growth. Combining these three objectives has proved to be a challenge, to say the least.

Not only did the programme have to strike the right balance between short-term financial stability concerns and long-term debt sustainability considerations. It also had to be framed within a political context which requires unanimous decisions in the Eurogroup and ESM decision making bodies.

Due to these exceptional economic and political circumstances, programme negotiations dragged on for too long, and the situation of the banking sector became critical. This forced the ECB to act. The provision of Emergency Liquidity Assistance (ELA) by the national central bank is aimed at supporting solvent banks facing liquidity problems. Without a credible recapitalisation perspective, the two largest and weakest Cypriot banks could not have been considered solvent any longer. Further providing ELA to these banks would not have been in line with the rules of the Eurosystem and, ultimately, with the Treaty provisions. Therefore, the ECB decided on 21 March that ELA would be continued if and only if a programme was in place that would ensure the solvency of the banks concerned. After the Eurogroup agreement on 25 March, the ECB did not object to the request for the provision of ELA by the Central Bank of Cyprus. On both occasions, the ECB acted strictly in line with its Statute. It implemented the existing rules. Nothing more, nothing less.

The finally agreed EU/IMF programme reflects the three objectives I mentioned earlier. In particular, it was decided to cover the capital needs of the two largest banks exclusively through the own contributions of uninsured depositors and senior and junior debt holders. The creditors of the two banks would not be made worse-off than they would have been in the case of liquidation, which would have been the alternative to the programme. This is necessary to guarantee the sustainability of public debt. It will also contribute to restoring the conditions for sustainable and balanced growth. In addition, the EU/IMF programme foresees a rapid and substantial downsizing of the domestic banking sector, from about 550% to about 350% of GDP at the beginning of the programme. This is indispensable to reduce future contingent liabilities from the banks to the sovereign. The EU/IMF programme also foresees the full protection of deposits below 100,000 euros which will not suffer any loss from the resolution strategy.

Despite the unprecedented steps taken so far, the banking sector has not yet been stabilised. The burden sharing arrangement negatively affected depositor confidence and required the introduction of temporary and proportionate capital controls and restrictions on deposit withdrawals. Short term risks are high, as the deep recession is expected to take a toll on banks' balance sheets. The reliance of the largest bank on ELA continues to be exceptionally high. Hence, firm steps are needed to complete the financial sector reform so as to rebuild confidence in the viability of the banking system.

Let me now turn to the lessons which we can draw from the experience in Cyprus.

Lessons from the Cypriot experience

The Cypriot case has been a salutary reminder of the importance of establishing banking union as swiftly as possible. Only then we will be able to break the negative interaction between sovereigns and their banking systems.

First, it has shown that the speedy entry into force and implementation of the single supervisory mechanism (SSM) is essential. The centralisation of supervision as well as the effective use of macroprudential tools should help identify and prevent the persistent accumulation of financial imbalances at an early stage. This will help ensure a more resilient and viable financial sector. A financial sector that is capable of contributing to sustainable growth.

Second, it has demonstrated that we urgently need a European framework for the resolution of financial institutions. This should include a clear set of commonly known *ex ante* rules for bail-in, buffers of 'bail-inable' assets and depositor preference.

Regarding the latter, the new framework should place depositors at the top of the creditor hierarchy and ensure that the role of DGS in resolution is limited to insuring eligible depositors. This will contribute to reducing the risks to financial stability by providing legal certainty and predictability to resolution.

Third, it has revealed the pressing need to establish a single resolution mechanism (SRM). The SRM is a fundamental pillar of the banking union and is a necessary complement to the SSM. This requires a strong authority at its centre which should provide timely and impartial decision-making which minimises the costs of resolution. The SRM should have a European resolution fund at its disposal which should have access to a temporary and fiscally neutral public backstop.

I thank you for your attention and stand at your disposal for questions.