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NOTE

from:	General Secretariat of the Council
to:	Delegations
Subject:	Summary record of the Extraordinary meeting of the European Parliament **Committee on Economic and Monetary Affairs (ECON)**, held in Brussels on 8 May 2013

The meeting was chaired by Ms Bowles (ALDE, UK).

1. Adoption of the agenda

The agenda was adopted.

2. Chair's announcements

Ms Bowles (ALDE, UK) announced that the new deadline for amendments on the report on the Union programme to support specific activities in the field of financial reporting and auditing for the period of 2014-2020 was 10 June 2013.

3. Economic Dialogue and exchange of views with members of the troika on financial assistance to Cyprus

ECON/7/09392

In their opening statements[1], Mr Rehn and Mr Asmussen listed the main events that had led to the economic support programme for Cyprus, the key elements of the adjustment programme, the actions undertaken by the Commission and the ECB to help Cyprus in the path of sustainable growth, to preserve financial stability in Cyprus and the EU, and to protect the integrity of the euro area and the single market, as well as the lessons learnt from the Cypriot experience.
Both concluded that the establishment of the banking union and its main building blocks including the Single Supervisory Mechanism (SSM), the macroprudential tool box, the European framework for the resolution of financial institutions, and the Single Resolution Mechanism (SRM), were essential to break the link between sovereigns and the banking system, to help identify and prevent the persistent accumulation of financial imbalances at an early stage, to ensure a more resilient and viable financial sector capable of contributing to sustainable growth and job creation, and to reduce the risks of financial stability by providing legal certainty and predictability to resolution.
Additionally, Mr Rehn called for the completion of the Economic and Monetary Union (EMU) to address the current structural problems of the EU's decision-making framework in providing financial assistance, for the involvement of the European Parliament to strengthen accountability, for the enhancement of the external representation of the euro area and for the revitalization of the Cypriot reunification process.

In the subsequent exchange of views, MEPs focused their interventions on the limits of the intergovernmental method (Mr Gauzès (EPP, FR)), on the confusion and delay surrounding the negotiation on the Cypriot adjustment programme, (Ms Ferreira (S&D, PT)), on the validity of the ECB's Emergency Liquidity Assistance (ELA) to Cyprus (Mr Sjkylakakis (ALDE, EL)), on the risk of similar situations arising in cases of countries with large banking sectors (Mr Bokros (ECR, HU) and Mr Langen (EPP, DE)), on the validity of the ECB's economic forecasts on Cyprus (Mr Lamberts (Greens/EFA, BE)), on the exact amount needed for bank recapitalization and the privatization of the Cypriot energy sector (Mr Chountis (GUE/NGL, EL)), on the consequences of market fragmentation regarding credit access (Mr Sánchez Presedo (S&D, ES) and Mr Zalba Bidegain (EPP, ES)), and on progress regarding BASEL III requirements (Mr Simons (S&D, DE)).

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[1] Copies of both statements can be found in Annex I and II.

In response, both Mr Rehn and Mr Asmussen reiterated the need to rethink the Eurogroup's and Troika's working methods and underlined the importance of establishing a banking union. Both confirmed that a considerable part of the responsibility for the length of the negotiations and the surrounding confusion lay with the Cypriot authorities. Mr Asmussen accepted that the Troika would be disbanded once the European Stability Mechanism (ESM) became a full blown institution and that there would be a return to a EU based method with accountability. He explained that the ECB had not provided recommendations to Cypriot banks since it still did not have a supervisory role. Mr Rehn noted that the working methods of the Eurogroup were not ideal and questioned the requirement for unanimity. Mr Asmussen told MEPs that rules concerning the ELA to the Cypriot banking sector were fully applied. He pointed out that the size of the banking sector was not the only determining factor to establish the risks of a banking meltdown and agreed on the need to also observe the structure of assets and liability and the pace of expansion of banks' balance sheets. Mr Rehn accepted that there were excessive macroeconomic unbalances in Slovenia. He stressed the challenges faced by certain small countries to supervise their large domestic financial/banking sectors. Mr Asmussen added that the Slovenian banking sector only represented 150 per cent of the country's GDP and that no other situation in the EU could be compared to that of Cyprus. Mr Asmussen stood by the forecasts on Cyprus but warned that ongoing structural reforms could lead to a revision of economic forecasts. Mr Rehn told the committee that under the Memorandum of Understanding (MoU) part of the Cypriot energy sector would be privatized but that income from future gas exploitation had been left out of the agreement. Mr Rehn mentioned that the easing of the pace of the adjustment programmes and fiscal consolidation in some countries had been possible thanks to the decisive actions of the ECB to stabilise the European financial and banking sectors, to the enhanced credibility of the Member States' fiscal policies and to progress in the economic governance field. Both Mr Asmussen and Mr Rehn agreed that market fragmentation and impaired monetary transmission mechanisms were a serious issue. Mr Asmussen underlined the ECB's incapacity to force banks to lend to the real economy. Yet he noted an improvement in the monetary transmission mechanism which was reflected in TARGET2 balances. Mr Rehn said that the EU had to work on restoring the financial situation and to build the banking union in order to resolve the current liquidity trap and to provide credit access to households and SMEs.

4. Date of next meeting

The next meeting will be held in Brussels on 20 May 2013.

Speech by Mr Rehn , Vice-President of the European Commission,

European Parliament, ECON Committee, Brussels, 8 may 2013

Vice-President Olli Rehn FINAL

Cyprus

Madam Chair, Honourable Members,

Thank you for the opportunity to discuss the economic support programme for Cyprus with you.

The programme was agreed in March and the first disbursement is expected by mid-May. It will enable Cyprus to avoid a disorderly default which would have had dramatic ramifications for the Cypriot people.

The key questions are: Why did Cyprus find itself in such a grave financial situation that it had to request a support programme? Why did it take nine months from the request to an agreement on the programme? And what are the key elements of the programme to support Cyprus?

The problems of Cyprus built up over many years. At their origin was an oversized banking sector that thrived on attracting foreign deposits with very favourable conditions. The banking problems were aggravated by poor practices of risk management. Lacking adequate oversight, the largest Cypriot banks built up excessive risk exposures.

The Commission warned Cyprus about its accumulating problems early on. Warnings and advice to tackle the banking problems and consequent economic and fiscal imbalances were included in the recommendations under the first European Semester in June 2011.

Then, in November 2011, we communicated to the Cypriot authorities that a financial assistance programme would be unavoidable, unless the persistent economic problems were immediately addressed.

Eventually, Cyprus asked for financial assistance, but only in June 2012.

It is unfortunate that it took Cyprus more than half a year to accept the gravity of the situation and the unsustainability of its business model. And it is similarly unfortunate that it took Cyprus another nine months to reach an agreement with the Eurogroup.

Let me recall that the Commission's role in ESM programmes, which are based on an inter-governmental Treaty, is to act on behalf of the euro area Member States, including when negotiating a Memorandum of Understanding as a member of the Troika.

The Commission's objective during the process of agreeing a support programme for Cyprus has been three-fold: to help Cyprus to the path of sustainable growth; to preserve financial stability in Cyprus and in Europe; and to protect the integrity of the euro and the single market.

The Commission worked hard for a more gradual adjustment of the Cypriot banking system and real economy, while aiming to ensure debt sustainability and adequate financing.

However, indecisiveness, delays and a very firm financial constraint severely limited the options available. The euro area member states were ready to commit support up to 10 billion euros. Cyprus was hence expected to mobilise substantial internal resources to cover the remainder of its financing needs through a range of fiscal measures and by sharing the burden with the creditors of its banking sector.

By March, the economic situation had deteriorated so badly that the scenario of the more gradual economic adjustment was not on the cards anymore. Especially, the state of the banks worsened rapidly.

Soon it became clear that the second biggest bank, Laiki, had to be resolved immediately. The risk of a complete collapse of the entire banking system – and thus a sweeping loss of deposits and savings and a disorderly default of the sovereign – was about to materialise. That would have been a disaster for Cyprus and for the Cypriot people.

One critical step taken at that time was the ring-fencing of Greek operations of the Cypriot banks, which the Troika partners encouraged. The successful execution of this operation has been essential for ensuring confidence and financial stability in Europe.

Now the focus is on the implementation of the financial assistance programme, which will support Cyprus in correcting its excessive economic imbalances. Its goal is to reform the banking sector through deep restructuring, to ensure the health of public finances, and to create the conditions for recovery of growth and job creation.

The programme will lead to a smaller but more resilient and transparent banking sector. Reforming the legal framework for anti-money laundering and ensuring its effective implementation is a key part of the programme, and a necessary condition for ESM funding.

The Commission stands by the Cypriot people to help them through these tough times and to rebuild their economy. We will provide technical assistance to Cyprus through a Support Group. I trust that we can count on your support in mobilising the available resources for Cyprus, as quickly and as effectively as possible.

Madam Chair, Honourable Members,

In conclusion, I would suggest that there are four lessons to be learnt.

First, there must be absolute clarity about secured deposits. In this respect, the Eurogroup and Cyprus took rapid corrective action and underlined that secured deposits indeed are secured in Europe.

Second, we need a banking union to prevent the development of unsustainable banking sectors like in Cyprus.

Third, when it becomes inevitable that a country is in need of financial assistance, it is essential that action is taken as soon as this is recognised. Delays are very costly to the economy and society.

Fourth, we have to recognise the structural problems of our decision-making in providing financial assistance. This calls for the completion of the EMU: we should bring the inter-governmental arrangements into the Community framework, take care of accountability by involving the Parliament, and strengthen the external representation of the euro area, so that we stand united and speak united within the IMF and G20.

Madam Chair,

Let me end with a semi-personal remark. I worked hard for five years as Commissioner for enlargement to facilitate the reunification of Cyprus. I regret that there has been no decisive progress. Today, it is worth recalling that the reunification of the island would give a major boost to the economic and social development of Cyprus. Now it is indeed high time to revitalise the process leading towards reunification.

Thank you for your attention.

ANNEX II

Speech by Mr Asmussen , Executive Director of the European Central Bank,

Introductory Statement by Jörg Asmussen

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

8 May 2013 – Brussels

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.

1. 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.

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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

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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.

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 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.

2. 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.

3. 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.

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