EUROPEAN CENTRAL BANK

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ECB-PUBLIC

OPINION OF THE EUROPEAN CENTRAL BANK

of 19 October 2015

on the regulation of financial leasing and financial leasing companies' activities

(CON/2015/37)

Introduction and legal basis

On 4 September 2015 the European Central Bank (ECB) received a request from the Minister of Finance of Cyprus for an opinion on a draft law regulating financial leasing and financial leasing companies' activities (hereinafter the 'draft law'). On 28 September 2015 the ECB received a new version of the draft law from the Ministry of Finance.

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[1], as the draft law relates to the Central Bank of Cyprus (CBC) and to the rules applicable to financial institutions insofar as they materially influence the financial 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 purpose of the draft law is to regulate the provision of financial leasing services to the public and ensure the regulation and supervision of financial leasing services providers' activities. As noted in the explanatory memorandum accompanying the draft law, the draft law aims to provide natural persons and businesses with alternative ways of financing, thus contributing to the growth of the leasing services sector and generally the financial sector and the Cypriot economy as a whole.

1.2 The draft law provides that financial leasing services may be provided to the public by: (a) authorised credit institutions in Cyprus; (b) authorised credit institutions in other Member States of the European Economic Area (EEA) which are licensed to provide financial leasing services, and which provide such services through a branch or on a cross-border basis; (c) financial leasing companies which are subsidiaries of credit institutions established in EEA Member States, and which provide such services in Cyprus through a branch or on a cross-border basis; and (d) a new category of regulated entity – financial leasing companies registered in Cyprus, which shall be licensed by the CBC to provide such services under the draft law[2]. The draft law sets out the types

1 Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions (OJ L 189, 3.7.1998, p. 42).

2 See Article 4(1) a of the draft law.

of activities to be performed by those entities[3]. Furthermore, the draft law defines the supervisory and regulatory powers of the CBC with respect to financial leasing companies, including the power to take enforcement measures and impose sanctions, and puts in place a comprehensive legal framework regulating financial leasing service providers and the provision of financial leasing services.

1.3 The draft law provides that financial leasing contracts that are a result of the settlement or restructuring of credit facilities are subject to terms and conditions determined by the CBC[4]. In this respect, in relation to any leasehold described in the contract, the financial leasing must include, inter alia, the nominal and effective interest rate included in the rent, their calculation method and their amendment[5].

1.4 Pursuant to the draft law, a financial leasing company may provide both financial leasing services and ancillary services, including operating leasing services, the negotiation and purchase of movable or immovable property for the purpose of sale and lease-back transactions, services for the maintenance and safekeeping of property for leasing purposes, assignment of the manufacture or construction of buildings or premises for buying purposes in order to lease them, assignment of the improvement or maintenance of buildings or premises for leasing purposes, and any other relevant services which may be determined by the CBC. A financial leasing company is not allowed to provide any other services or conduct any other activities other than those necessary for the purposes of the provision of financial leasing services under the draft law, or to manufacture itself movable or immovable property[6].

1.5 Without affecting the duty of the CBC to keep information obtained under the draft law confidential, the CBC may use any of the information provided under the draft law for the purpose of the preparation of anonymous, aggregated statistical data, which the CBC may publish[7].

1.6 The draft law provides that the CBC has the power, pursuant to directives issued by the CBC, to require that financial leasing companies pay to the CBC all costs related to their supervision[8].

2. General observations

2.1 The ECB understands that the draft law may facilitate private debt restructuring by opening up the possibility to transform mortgage loans into real estate leases through sale and lease-back transactions, and potentially impact the resolution of non-performing loans in Cyprus. In this context, it is welcome that financial leasing activities are going to be subject to prudential supervision, also with a view to avoiding regulatory arbitrage.

2.2 The draft law expands the CBC's powers to supervise financial leasing companies, thus complementing the CBC's current responsibilities for the supervision of the leasing activities of

3 See Article 28(1) of the draft law.
4 See Article 27(3) of the draft law.
5 See Article 27(1)(d) of the draft law.
6 See Article 8 and Second Table of the draft law.
7 See Article 11(4) of the draft law.
8 See Article 11(5) of the draft law.

licenced credit institutions and the macroprudential supervision of the financial system for the purpose of safeguarding financial stability. The ECB underlines that, in the context of a proposed conferral of tasks on an ESCB member, it is necessary to assess such conferral against the prohibition of monetary financing under Article 123 of the Treaty. The ECB has developed the guidance set out in paragraphs 2.2.1 to 2.2.3 of this opinion, in the form of general and specific considerations, on the basis of which it may decide whether a new task conferred on an ESCB national central bank (NCB) is to be considered a central banking task or a government task for the purposes of assessing such conferral against the prohibition of monetary financing under Article 123 of the Treaty[9]. The concrete assessment of whether the CBC's task of supervising financial leasing companies is to be considered a central banking task or a government task is then undertaken in paragraph 3.1 of this opinion.

2.2.1 *General considerations*

First, the systematic categorisation of tasks assigned to NCBs as central banking or government tasks applies to genuinely new tasks that did not exist in the past or did not form an integral part of the central banking tasks already assigned to the NCB in the past. In recognition of the different Member States' legal frameworks, central banking traditions and national set-ups, the tasks currently discharged by an NCB as central banking tasks are not reviewed and re-categorised, but may be reassessed if they are subject to legislative amendments of substance.

Second, the principle of financial independence requires that the Member States may not put their NCBs in a position where they have insufficient financial resources to carry out their ESCB- or Eurosystem-related tasks, as applicable.

Third, central banking tasks comprise in particular those tasks that are related to the tasks listed in Article 127(2), (5) and (6) of the Treaty.

Fourth, new tasks conferred on an NCB which are atypical of NCBs' tasks, or which are clearly discharged on behalf of and in the exclusive interest of the government or of other public entities, should be considered as government tasks. In that context, a distinction should be drawn between liquidity- and solvency-related tasks of NCBs. While, for the purposes of the monetary financing prohibition, solvency support is a government task, liquidity-related tasks, the ultimate objective of which are to finance the economy, are central banking tasks.

2.2.2 *Specific considerations*

Banking supervision and macro-prudential tasks are central bank tasks when discharged by an NCB provided they do not undermine its independence in accordance with Article 130 of the Treaty.

An important criterion for qualifying a new task as a government task is the impact of the task on the institutional, financial and personal independence of the NCB. In particular, the following should be taken into account.

First, it should be assessed whether the performance of the new task creates inadequately addressed conflicts of interests with existing central banking tasks, and does not necessarily

9 See Opinion CON/2015/22. All ECB opinions are available on the ECB's website at www.ecb.europa.eu.

complement those existing central banking tasks. If a conflict of interest arises between existing and new tasks, there should be sufficient mitigation in place to adequately address that conflict. Complementarity between the new task and existing central banking tasks should not, however, be interpreted extensively, so as to lead to the creation of an indefinite chain of ancillary tasks. Complementarity should also be examined from the point of view of the financing of those tasks.

Second, it should be assessed whether without new financial resources the performance of the new task is disproportionate to the financial or organisational capacity of the NCB and may negatively impact on its capacity to properly perform existing central banking tasks.

Third, it should be assessed whether the performance of the new task does not fit into the institutional set-up of the NCB in the light of central bank independence and accountability considerations.

Fourth, it should be assessed whether the performance of the new task harbours substantial financial risks.

Fifth, it should be assessed whether the performance of the new task exposes the members of the NCB's decision-making bodies to political risks which are disproportionate and may also impact on their personal independence and, in particular, the guarantee of the term of office under Article 14.2 of the Statute of the European System of Central Banks and of the European Central Bank.

2.2.3 Any final assessment on the qualification of a task given to an NCB as either falling within the scope of a central banking task or a government task will be guided by the objective of ensuring the consistent application of the prohibition of monetary financing within the Eurosystem and the ESCB to the extent that it applies to its members.

3. Specific observations

3.1 *Conferral on the CBC of the task of supervising financial leasing companies*

The draft law designates the CBC as a supervisory authority for financial leasing companies thus broadening its current functions and activities. In the light of the guidance set out in paragraphs 2.2.1 to 2.2.3, it must be assessed whether the CBC's new tasks could constitute a breach of the monetary financing prohibition.

3.1.1 *Principle of financial independence*

The principle of financial independence requires NCBs to have sufficient means to carry out not only their ESCB-related tasks from an operational and financial point of view, but also their national tasks[10]. In this regard the ECB notes that the draft law provides that the CBC has the power to require that financial leasing companies pay to the CBC all costs related to their supervision[11]. The

10 See the ECB's 2014 Convergence Report, p. 25.

11 See Article 11(5) of the draft law. In accordance with Article 6(2)(d) of the Central Bank of Cyprus Laws of 2002 to 2007, the CBC exercises supervision of banks. Banks are allowed to provide financial leasing services by virtue of item 3 in Annex IV of the Business of Credit Institutions Laws of 1997 to 2015.

new tasks assigned to the CBC would not affect the resources the CBC allocates to the performance of its monetary policy tasks.

3.1.2 *Links to tasks listed in Article 127(5) of the Treaty*

Supervision over financial leasing companies can be considered a task related to those referred to in Article 127(5) of the Treaty, based on the understanding that it is complementary to the supervisory tasks exercised by the NCB, particularly where, as in this case, the CBC already carries out supervision of credit institutions, including their financial leasing activities[12], and has the task of ensuring the stability of the financial system[13]. Financial leasing is an instrument which has significantly gained in importance in the Union as an alternative to classical credit financing for consumers, small and medium-sized enterprises (SMEs) and large companies, as it also provides for the acquisition of property through the payment of instalments. Although not required under Directive 2013/36/EU[14], several EEA Member States have established a legal framework for the supervision of financial leasing companies on a solo basis[15] while others have introduced a registration requirement[16]. It is understood that these Member States have legislated in this area based on the assumption that the improper functioning of the financial leasing business as a consequence of poor management may lead to severe damage not only for customers, but for the economy as a whole. In view of these developments, point 3 of Annex 1 of Directive 2013/36/EU lists financial leasing as an activity that is subject to mutual recognition. Financial leasing activities may thus be carried out cross-border by credit institutions authorised and supervised by the competent authorities of another Member State, provided that such activities are covered by the relevant authorisation of the credit institution.

3.1.3 *Atypical tasks*

A number of Member States have conferred on their NCBs supervisory tasks related to the provision of financial leasing services and financial leasing companies. The ECB has generally accepted the allocation of such tasks to NCBs provided they do not interfere with the performance of the NCB's ESCB-related tasks[17]. The tasks of an NCB with regard to the supervision of financial leasing companies can therefore be regarded as being tasks not atypical of a central bank, particularly if, as in the case of the CBC, it has a statutory responsibility for bank supervision and financial stability[18]. Moreover, the complementarity between the supervisory tasks already discharged by the CBC and the new task of supervising financial leasing companies is reflected in

12 In accordance with Article 6(2)(d) of the Central Bank of Cyprus Laws of 2002 to 2007, the CBC exercises supervision of banks. Banks are allowed to provide financial leasing services by virtue of item 3 in Annex IV of the Business of Credit Institutions Laws of 1997 to 2015.

13 Article 6(2) (e) of the Central Bank of Cyprus Laws of 2002 to 2007.

14 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

15 These include Portugal, Spain, Iceland, Germany, Italy, Greece, Liechtenstein, France, Romania, Bulgaria and Malta.

16 These include Belgium, the Czech Republic, Estonia, Lithuania, Luxembourg and Sweden.

17 See Opinion CON/2009/57.

18 See Article 6(2)(d) and (e) of the Central Bank of Cyprus Laws of 2002 to 2007.

the common system of financing of the CBC's supervisory tasks via contributions from the supervised entities[19].

3.1.4 *Discharge of tasks on behalf of and in the exclusive interest of the Government or of other public entities*

The CBC is designated as the sole supervisory authority for companies providing financial leasing services in its own name and not on behalf of any other authority. There is no indication that in discharging its supervisory function the CBC acts exclusively in the interests of another public entity.

3.1.5 *Extent to which conflicts of interests with existing CBC tasks are addressed and the performance of tasks fits into the CBC's institutional set-up in the light of central bank independence and accountability considerations*

The conferral of these tasks on the CBC does not, prima facie, raise any issues of conflict of interest. The performance of these tasks fits smoothly into the CBC's institutional set-up, and does not raise any issues arising out of central bank independence and accountability considerations.

3.1.6 *Extent to which the performance of tasks is proportionate to the CBC's financial and operational capacity and its ability to perform its ESCB-related tasks*

As noted above, in order to remain financially independent, NCBs must have sufficient means to carry out not only their ESCB-related tasks from an operational and financial point of view, but also their national tasks. In this regard the ECB welcomes the fact that the draft law provides that the CBC's costs for supervision of financial leasing companies will be coved by the industry.

3.1.7 *Extent to which the performance of tasks harbours substantial financial risks*

The draft law contains provisions excluding or limiting the liability of the CBC as the authority responsible for the supervision of financial leasing companies for any act or omission or other breach of any legal obligation when exercising supervisory powers except if such an act or omission was not done in good faith or is the result of negligence. In contrast, the liability regime for the CBC when conducting its supervisory powers over credit institutions is excluded, unless it is shown that the act or omission was not done in good faith or was the result of gross negligence[20]. The ECB considers that it would be useful to align the CBC's liability under the draft law with the liability regime for the CBC when conducting its supervisory powers over credit institutions, given that potential liability issues could represent financial risks for the CBC.

3.1.8 *Conclusion*

The ECB considers that there are grounds for regarding the CBC's task of supervising financial leasing companies as a central banking task in the sense that it complements the CBC's existing bank supervisory functions. The fact that the performance of the new supervisory function will be

19 See Section 26(3) of the Business of Credit Institutions Laws of 1997 to 2015, which similarly empowers the CBC to require credit institutions to pay to it all the fees, related to their supervision and inspection in accordance with CBC directives.

20 Article 32(1) of the Business of Credit Institutions Laws of 1997 to 2015. See also Principle 2 of the 'Core Principles for Effective Banking Supervision' setting out that the supervisor and its staff should be protected against lawsuits for actions taken and/or omissions made while discharging their duties in good faith.

financed by supervised entities has a positive impact on the CBC's financial capacity to assume those tasks. However, the ECB considers that the draft law potentially creates financial risks for the CBC because it does not limit the CBC's liability, as a public authority, for damages caused in the course of the exercise of its new supervisory powers, in similar terms to the CBC's liability in connection with its bank supervisory tasks. It would be useful to align the CBC's liability under the draft law with the liability regime for the CBC when conducting its supervisory powers over credit institutions.

3.2 *Concerns over level playing field issues and opportunities for regulatory arbitrage*

The ECB welcomes the extension of the supervisory scope of national competent authorities to non-credit institutions providing services similar or equivalent to those provided by supervised credit institutions for level playing field reasons and to avoid regulatory arbitrage.

The ECB acknowledges that financial leasing companies are subject to minimum capital and other regulatory requirements. The ECB understands that the Cypriot authorities opted not to impose explicit limits on leverage and liquidity requirements at this stage so as to offer wider opportunities for financing to new leasing companies, with a view to facilitating private debt restructuring, as mentioned in paragraph 2.1. Nevertheless, the ECB considers that it would be useful to explicitly clarify limits on leverage and liquidity requirements for these new entities at some stage, and particularly in the event of the emergence of risks relating to regulatory arbitrage or of concerns about financial stability.

3.3 *Ancillary services*

The ancillary services to leasing activities covered in the draft law appear quite broad. The ECB considers that ancillary services should be carefully considered, in order to guarantee the financial nature of the entities authorised to perform leasing activities. In this sense, typical real estate services should be outsourced.

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

Done at Frankfurt am Main, 19 October 2015.

[signed]

The President of the ECB

Mario DRAGHI