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EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 4 August 2008

at the request of the Swedish Ministry of Finance
on a report concerning the financial independence of Sveriges Riksbank

(CON/2008/34)

Introduction and legal basis

On 14 March 2008 the European Central Bank (ECB) received a request from the Swedish Ministry of Finance for an opinion on a report entitled 'The Riksbank's financial independence' (SOU 2007:51) (hereinafter the 'report'). The report sets out two alternative proposals for amendments to the Law on Sveriges Riksbank concerning changes to Sveriges Riksbank's capital structure and profit distribution.

The ECB's competence to deliver an opinion is based on Article 105(4) of the Treaty establishing the European Community and the third 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[1], as the proposals set out in the report relate to Sveriges Riksbank. 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. Background

1.1 Sveriges Riksbank is a public authority whose operational activities are governed by the Sveriges Riksbank Act (SFS 1988:1385) (hereinafter the 'Riksbank Law'). Sveriges Riksbank is a legal entity in its own right and has its own assets, consistent with the principle that there are economic and political reasons for a national central bank (NCB) to be independent. A comprehensive reform of the Riksbank Law undertaken in 1999 significantly strengthened Sveriges Riksbank's independence.

1.2 In the 1999 reform, however, financial independence was not a widely discussed issue, and to date there are no regulations guaranteeing Sveriges Riksbank's financial independence. This fact was highlighted when the Riksdag (Swedish Parliament) passed resolutions requiring Sveriges Riksbank to pay extraordinary dividends for the fiscal years 2000 and 2001. Critics of these decisions were of the opinion that Sveriges Riksbank's financial independence could be questioned if it was possible for the Riksdag to require funds from Sveriges Riksbank in this way.

1 OJ L 189, 3.7.1998, p. 42.

1.3 The ECB criticised the payment of these extraordinary dividends and has stated in its Convergence Reports that Sveriges Riksbank's financial independence should be reflected in the Riksbank Law. Already in the EMI's convergence report of 1998 it was pointed out that "if Parliament were to deviate from the objective criteria to which it has adhered in the past, this could affect the Bank's financial independence. A statutory safeguard clause should therefore be considered in order to ensure that Parliament's power may not impede the proper performance of the Bank's ESCB-related tasks."

1.4 On 27 April 2006 the Swedish Government appointed Director General Ingrid Bonde to head a Commission of Inquiry (hereinafter the 'Commission') to investigate issues relating to the structure of Sveriges Riksbank's balance sheet and capital and distribution of its profits. The Commission's mandate was also to submit proposals for statutory regulation of the principles according to which Sveriges Riksbank's profits should be distributed.

2. The Commission's proposals concerning the changes to Sveriges Riksbank's capital structure and profit distribution

2.1 Ms Bonde presented the report in June 2007. It contains two alternative proposals for Sveriges Riksbank's capital structure and profit distribution which, from a central government finance perspective, are considered equal:

(i) Alternative 1

Alternative 1 proposes that Sveriges Riksbank's right to issue banknotes and coins should be used to fund its operational activities. It views currency in circulation as cost-free capital which more than covers Sveriges Riksbank's needs as identified by the Commission. According to the Commission's calculations, Sveriges Riksbank needs cost-free capital of between SEK 60 and 74 billion. As at June 2007, currency in circulation is approximately SEK 110 billion.

Although, according to the Commission, currency in circulation should provide sufficient cost-free funding for Sveriges Riksbank's operational activities, the Commission nevertheless advises that Sveriges Riksbank should be provided with a relatively small amount of own capital, initially amounting to SEK 10 billion. Under this proposal, approximately SEK 50 billion could be transferred from Sveriges Riksbank to central government. If such a transfer to central government were to take place, the Riksbank would need to sell currency assets with a corresponding value. The distribution would need to take place over a long period of time, or be structured otherwise so as not to affect the exchange rate for the Swedish krona.

The size of Sveriges Riksbank's primary capital, which would be increased in line with changes in the consumer price index, would form the basis for calculating any distribution of profit by Sveriges Riksbank. Where the primary capital is less than the amount prescribed by law, no profit

distribution would be permitted. In all other cases, Sveriges Riksbank's entire profit would be distributed to central government.

(ii) Alternative 2

Alternative 2 is based on the principle that currency in circulation is not suitable as cost-free capital. Instead currency in circulation is deemed to be a debt to central government on which Sveriges Riksbank pays interest corresponding to a short-term risk-free interest rate in Swedish kronor, e.g. the repo rate.

Under this alternative, the cost of producing banknotes and coins, currently borne by Sveriges Riksbank, would be deducted from the interest payable to central government. Thus the capital needed to cover current costs would be lower under this alternative, because Alternative 1 also requires there to be assets producing a return to fund the costs of producing banknotes and coins.

Under this alternative, the Commission estimates the total capital requirement at SEK 52 – 63 billion, which is relatively close to Sveriges Riksbank's current level of own capital (SEK 58 billion).

This alternative is based on Sveriges Riksbank having own capital of SEK 60 billion. With regard to profit distribution, the same principle as in Alternative 1 would apply, i.e. all profit increasing own capital above the target level of SEK 60 billion would be distributed. As under Alternative 1, this capital would be index linked and written up in line with inflation. The balance sheet total would be approximately the same as it is currently.

2.2 On 8 February 2008, as a stage in the Swedish legislative process, Sveriges Riksbank issued a response to the report. It welcomed the Commission's proposals to strengthen its financial independence by regulating in law the size of its own capital and distribution of its profits. However, it pointed to some difficulties with the alternatives proposed by the Commission, especially Alternative 1.

Sveriges Riksbank therefore expressed its preference for Alternative 2, subject to some adjustments (indexation of capital on nominal gross domestic product and a significant safety margin). Moreover, regarding the Commission's proposal in Alternative 2 for the supply of banknotes and coins to form the basis for an annual fee to be paid by Sveriges Riksbank to central government, Sveriges Riksbank questioned the compatibility of this proposal with the prohibition on monetary financing laid down in the Treaty

3. General observations

3.1 The ECB welcomes the Swedish Ministry of Finance´s request for an opinion on the report at a stage in the legislative process when it should still be possible to integrate the ECB's views into any draft legislation. The ECB also strongly supports the Swedish legislator's intention to regulate the capital structure and profit distribution of Sveriges Riksbank.

3.2 Even though the ECB is positive regarding the Swedish legislator's intention to regulate the profit distribution of Sveriges Riksbank, several issues in the two proposals entail the risk of undermining Sveriges Riksbank's financial independence and are therefore of considerable concern to the ECB.

3.3 It is noted that Sweden was obliged to have brought into force the necessary adaptations to comply with the relevant provisions of the Treaty[2] and the Statute of the European System of Central Banks and of the European Central Bank (hereinafter the 'ESCB Statute') concerning central bank independence by the time of establishment of the ESCB on 1 June 1998.

3.4 Moreover, the ECB would like to emphasise that, although Member States with a derogation do not yet participate in economic and monetary union (EMU), they have a legal duty to adapt the statutes of their NCBs 'to ensure compatibility with the Treaty and the Statute in respect to Eurosystem-related tasks'[3]. In this respect, any legislative reform should aim to gradually achieve consistency with Eurosystem standards. In this case, it should facilitate the convergence of the Swedish legal framework, necessary for Sweden to become a full participant in EMU without the need for subsequent legislative reforms.

3.5 In particular, regarding Alternative 1, it is to be noted that pursuant to Article 106(1) of the Treaty, only the ECB and the NCBs are entitled to issue euro banknotes. Nowhere in the Treaty does it state that such euro banknotes are conceptually equivalent to cost-free capital owned by any individual NCB. Thus, the issuance of euro banknotes is not a right granted to an NCB by an individual Member State as assumed under Alternative 1, but a right granted jointly to the ECB and the NCBs by the Treaty under the authority of the ECB's Governing Council.

3.6 Furthermore, Article 105(2) of the Treaty defines holding and management of the official foreign reserves of the Member States as a basic task to be carried out through the ESCB. Whilst this Treaty provision[4] does not prohibit the sale of assets per se, including those assets denominated in foreign currency, the competence to take decisions on the composition of an NCB's assets needs to remain with the NCB. The adoption of legislation that would impose an obligation on an NCB to sell a Member State's official foreign reserves in contradiction with the assignment of this task to the NCB would be inconsistent with the Treaty, as it would deprive that NCB of one of its basic tasks under the Treaty and transfer from the NCB to the political authorities of the relevant Member State a competence that the Treaty clearly assigns to the NCBs.

3.7 With regard to Alternative 2, the Treaty provides no support for considering currency in circulation as an NCB's debt to the central government of an individual Member State. Such a proposal would defeat the concept of a single currency for all Member States and is therefore incompatible with Community law and the requirements of Eurosystem legal integration. As a consequence, the Commission's proposal to have Sveriges Riksbank pay a fixed fee to the Swedish Government as

2 Article 108 of the Treaty.

3 ECB Convergence Report May 2008, p. 26.

4 See also Article 108 of the Treaty

remuneration on such indebtedness is clearly inconsistent with the provisions of Article 32 of the Statute on monetary income allocation.

4. Specific observations

Central bank financial independence

4.1 The general concept of central bank independence, in particular in conjunction with the specific aspect of financial independence, requires that in performing its tasks, an NCB can independently assess the risks involved and has the power to decide on necessary precautions to take. The principle of financial independence also implies that an NCB must have sufficient means to perform not only its ESCB-related tasks but also its own national tasks (e.g. financing its administration and own operations). The ECB has stated in its Convergence Reports that a Member State may not impose reductions of capital on an NCB without the ex ante agreement of the NCB's decision-making bodies. This principle aims to ensure that the NCB retains sufficient financial means to fulfil its mandate under Article 105(2) of the Treaty and the Statute as a member of the ESCB.

4.2 Sveriges Riksbank's current statutory capital is SEK 1 billion, plus a reserve fund of SEK 0.5 billion and a contingency fund (the Riksbank's own capital amounted to around SEK 58 billion at the end of 2007). Under Alternative 1 Sveriges Riksbank's own capital would be SEK 10 billion, while under Alternative 2 it would be SEK 60 billion. The ECB is of the view that the higher the level of own capital, the better safeguards the capital provides against future losses.

4.3 The ECB has also stated in its Convergence Reports regarding financial provisions or buffers that an NCB must be free independently to create financial provisions to safeguard the real value of its capital and assets[5]. Although the Commission proposes in its report that primary capital should be adjusted upwards annually by a factor corresponding to the change in the consumer price index, neither of the proposed alternatives provides Sveriges Riksbank with a right to create financial provisions or buffers. Furthermore, the payment of an annual fee based on currency in circulation as provided for under Alternative 2, irrespective of real profits, would risk reducing the amount of cost-free capital available to Sveriges Riksbank and, consequently, the safety margin for unforeseen events requiring action by it in the performance of its tasks.

4.4 Therefore, neither Alternative 1 nor Alternative 2 as proposed by the Commission would be sufficient to ensure Sveriges Riksbank's financial independence leaving it able to accumulate reasonable reserves from earned income and create financial buffers to cover its risk exposures, thereby safeguarding the real value of its capital and assets.

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5 ECB Convergence Report May 2008, pages 20 and 21. See also ECB Opinions CON/2003/22 of 15 October 2003 at the request of the Finnish Ministry of Finance on a draft government proposal to amend the Suomen Pankki Act and other related acts and CON/2004/1 of 20 January 2004 at the request of the Economic Committee of the Finnish Parliament on the government proposal to amend the Suomen Pankki Act and other related acts.

The prohibition on monetary financing

4.5 Under Alternative 2, Article 3 of the draft Chapter 10 of the Riksbank Law would oblige Sveriges Riksbank to pay an annual contribution to central government calculated in accordance with an interest rate corresponding to the repo rate on the nominal amount of currency in circulation. Although Section 4 provides that no transfer to central government may take place if Sveriges Riksbank's primary capital is below the minimum level laid down in the Riksbank Law, the current drafting seems to imply that Sveriges Riksbank would still have to pay the annual contribution to central government even if its own capital were insufficient, i.e. before losses are accounted for.

4.6 The current drafting of Article 3 does not rule out the possibility of an intra-year anticipated profit distribution which Sveriges Riksbank would be obliged to pay to central government even if its profit and loss accounts showed a loss. The proposed Article 3 should therefore be adapted to ensure that no transfer of money to central government may take place before approval of Sveriges Riksbank´s profit and loss account. This would rule out a breach of the monetary financing prohibition under Article 101 of the Treaty as a result of a distribution of unrealised profits.

Costs and risks of operational activities

4.7 The report uses Sveriges Riksbank's current operating costs as a basis for calculating how much of its own capital is necessary to cover operating costs. In view of the changing structure of financial markets and the economy and in order to preserve Sveriges Riksbank's ability to adjust its operating costs and therefore to preserve its independence, however, it is important to retain flexibility regarding the level of operating costs which Sveriges Riksbank may need to finance in the future through returns on its capital. Hence, it is important that Sveriges Riksbank can retain a sufficient part of its earnings to enable it to meet future increases in its operating costs.

4.8 The report analyses the sources of risks that may lead Sveriges Riksbank to require capital in excess of the level needed to cover operating costs. One of the sources of risk identified in the report is credit risk incurred in operational activities. This includes credit risk stemming from Sveriges Riksbank's monetary policy operations, to which Sveriges Riksbank would be exposed if one of its monetary policy counterparties defaulted on its obligations and if the collateral against which it had granted credit lost value. The report takes the view that 'Sveriges Riksbank's credit risk in operational activities is not on such a scale as to affect its capital requirements'. While this view may have been borne out by past experience, it is important to recognise that the operational framework within which Sveriges Riksbank operates, in particular but not only as concerns monetary policy operations, may change in future. Sveriges Riksbank should therefore retain the flexibility to change such framework in proportion to the requirements of its mandate and in line with the changing structure of financial markets and of the economy. Hence, Sveriges Riksbank should have the authority to adjust that portion of its targeted level of capital which corresponds to credit risk incurred in operational activities. This implies that it is unadvisable to follow the

Commission's proposal to index the amount of required capital by reference to consumer price inflation.

Financial risk management

4.9 A large part of the financial risk to which Sveriges Riksbank is exposed stems from its foreign currency and gold holdings. The Commission argues that these should either be liquidated or hedged to eliminate currency and gold price risks, which are not necessary for the conduct of monetary policy in the current floating rate regime. Therefore the report does not contemplate any need for additional capital buffers to offset potential asset management losses. In relation to the Government and the Riksdag, the competence to assess financial risks and take decisions to provide for their coverage is subject to the independence requirement, and this competence should be clearly recognised in the Riksbank Law as pertaining to Sveriges Riksbank's decision-making bodies.

4.10 Credit and interest rate risks would however not be eliminated even if all assets were effectively denominated in Swedish kronor. Hence, the ECB considers that the estimate of the amount of capital required for Sveriges Riksbank to fulfil its tasks should still allow for potential losses stemming from its asset management activities. Moreover, the ECB considers that it would be problematic to convert all foreign reserves into Swedish public debt securities for several reasons. Sweden has a small, open economy and, even though the need for currency intervention under the current floating exchange rate regime is limited, Sveriges Riksbank must be well equipped to cope with possible future regime shifts. Complying with both the Central Bank Gold Agreement of 27 September 2004 and Article 101 of the Treaty[6], as well as considering the impact on exchange rate and domestic markets, could prove difficult and need careful consideration. Moreover, the total holdings of national public sector securities that would in such case be held by Sveriges Riksbank would amount to a very high percentage of the outstanding Swedish public debt, comparatively well above that held by any other NCB. Potentially, this could adversely distort the pricing of assets in the Swedish capital market, and might possibly also result in scarcity of collateral both for intraday credit systems and for Sveriges Riksbank's liquidity injecting operations. Finally, the liquidation of all its foreign reserves would deprive Sveriges Riksbank of one of its main central bank tasks (see paragraph 3.6 above). Hence, while it may indeed be advisable to reduce currency and gold exposures (either through outright sales or through the use of hedging on the derivatives markets) with the aim of reducing capital consumption, a complete elimination or neutralisation of the risk attaching to foreign assets would seem a bold step with few precedents in the international landscape.

6 In this respect the ECB takes particular note of the Commission's statement on page 106 of the report that 'It would be most advantageous if the Swedish National Debt Office could issue paper that the Riksbank exchanged for currency assets. However, taking into account the EU prohibition against direct government borrowing from central banks, it is not possible to conduct such a swap in the opinion of the Commission.'

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

Done at Frankfurt am Main, 4 August 2008.

[signed]

The President of the ECB

Jean-Claude TRICHET