EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 9 March 2009

at the request of *Riigikogu*
on a draft law on stabilising measures for the Estonian financial system

(CON/2009/18)

Introduction and legal basis

On 25 February 2009, the European Central Bank (ECB) received a request from Riigikogu (Estonian Parliament) for an opinion on a Law amending the Law on the State budget, the Law on participation in legal persons in private law by the State and the Law on the rules of procedure and internal rules of *Riigikogu* (hereinafter the 'draft law').

The ECB's competence to deliver an opinion is based on Article 105(4) of the Treaty establishing the European Community and the 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 provisions[1], as the draft law relates to financial institutions and materially influences 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 main features of the draft law

1.1 The draft law has two main objectives: (a) to secure the stability and functioning of the Estonian financial system, in particular the banking sector, including a level playing-field for banks located in other states with branches located in Estonia; and (b) to avoid or to limit the transfer of risks into the real economy and to secure the sustainable growth of the economy.

1.2 The draft law provides for the use of Stabilisation Reserve funds for the handling or prevention of a financial crisis that could cause difficulties or serious failures related to liquidity or solvency of credit institutions operating in Estonia or substantial failures in payment and settlement systems (hereinafter a 'financial crisis'). Substantive draft measures, applicable in cases of financial crisis, include the following: (a) the Government may acquire issued debt obligations in any form; (b) State guarantees can be granted to any person; and (c) the State may establish or acquire a company even without a majority holding in the company.

1 OJ L 189, 3.7.1998, p. 42.

1.3 Procedural aspects of the draft law provide for fast-track allocation of Stabilisation Reserve funds in case of financial crisis by *Riigikogu* on a proposal by the Government and short deadlines for access to State budget resources in case of financial crisis. Pursuant to a transitional provision, fast-track proceedings in *Riigikogu* in case of financial crisis may be used until 1 July 2010 for the acquisition of a shareholding or other financial assets, the grant of a State guarantee, lending and borrowing or the acquisition of other obligations and use of the Stabilisation Reserve funds.

2. General observations

2.1 The ECB was consulted on the draft law on 25 February 2009 and requested to issue an opinion by 11 March 2009, i.e 10 days before the planned adoption of the draft law. Given the turbulence in the international financial markets, the ECB has been flexible and has responded to consultation requests within a shorter time limit. In the present case, however, the ECB could have been consulted earlier, in particular since legislative proceedings began in *Riigikogu* in relation to the draft law on 18 December 2008. In ECB Opinion CON/2008/14 at the request of *Riigikogu* on a draft law amending the law on Eesti Pank[2], the ECB noted that Article 4 of Council Decision 98/415/EC requires Member States to ensure that the ECB is consulted at an appropriate point in time to allow the consulting authority to take its opinion into consideration before deciding on the substance of the draft legislative provisions. The ECB also noted that the obligation to consult the ECB at an appropriate stage in the Estonian legislative process must be respected in the future and that administrative procedures should be in place to ensure timely consultation whenever such a consultation is mandatory.

2.2 The ECB has recently issued several opinions with regard to measures taken by Member States in the context of the financial turbulence. It has emphasised the importance of a common approach aimed at restoring confidence in the financial markets and compliance with the Declaration on a concerted European action plan of the euro area countries of 12 October 2008 (hereinafter the 'Declaration')[3]. On that occasion, the heads of the euro area countries confirmed their commitment to act together in a decisive and comprehensive way to restore confidence and the proper functioning of the financial system, with the aim of restoring appropriate and efficient financing conditions for the economy. They agreed on common principles to be followed by the European Union and euro area governments, central banks and supervisors to avoid national measures adversely affecting the functioning of the single market and the other Member States. Such coordinated approach includes initiatives aimed at all of the following: (i) ensuring appropriate liquidity conditions for financial institutions; (ii) facilitating the funding of banks, which is currently constrained; (iii) providing financial institutions with additional capital resources so as to

2 All ECB opinions are available on the ECB's website at www.ecb.europa.eu.

3 Available on the website of the French Presidency at www.ue2008.fr.

continue to ensure the proper financing of the economy; (iv) allowing for an efficient recapitalisation of distressed banks; (v) ensuring sufficient flexibility in the implementation of accounting rules given current exceptional market circumstances; and (vi) enhancing cooperation procedures among European countries[4].

2.3 Moreover, the ECB notes that the explanatory memorandum to the draft law refers to the guidance provided by the Ecofin Council to the Member States in the conclusions of its meeting of 7 October 2008[5]. The Ecofin Council recommended that: (i) interventions should be timely and the support should in principle be temporary; (ii) the interest of taxpayers should be protected; (iii) existing shareholders should bear the due consequences of the intervention; (iv) the Government should be in a position to bring about a change of management; (v) management should not retain undue benefits; (vi) governments may have, *inter alia*, the power to intervene in remuneration; (vii) legitimate interests of competitors must be protected, in particular the State aid rules; and (viii) negative spill-over effects should be avoided. The European Council also endorsed these principles for all Member States on 16 October 2008[6]. Against this background, the ECB highlights that all initiatives put in place by national governments to restore confidence in the financial markets should be aimed at implementing such common principles, in the spirit of close cooperation with other Member States and EU institutions.

2.4 The ECB notes that the draft law does not mention any central bank involvement. Given how important it is in the context of the measures under consideration to decide whether a situation actually constitutes a 'financial crisis', the ECB would recommend that the decision-making process in this respect should be specified and that use should be made of the macro-prudential analysis carried out by Eesti Pank.

If Eesti Pank's expertise is requested in practice, e.g. to benefit from its macro-prudential analysis as described above, the ECB expects that such involvement will comply fully with the prohibition on monetary financing laid down in Article 101(1) of the Treaty, read in conjunction with 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[7]. Moreover, the ECB expects that any expertise or advisory tasks performed by Eesti Pank in connection with State support measures will be carried out in a manner fully compatible with Eesti Pank's institutional and financial independence, thereby safeguarding the proper performance of its tasks under the Treaty and the Statute of the European System of Central Banks and of the European Central Bank[8]. Furthermore,

---

4 See the Brussels European Council of 15-16 October 2008, Presidency Conclusions, available at www.consilium.europa.eu.

5 See 'Immediate responses to Financial Turmoil', Ecofin Council Conclusions of 7 October 2008, available at www.ue2008.fr.

6 See the Brussels European Council of 15-16 October 2008, Presidency Conclusions, paragraph 3.

7 OJ L 332, 31.12.1993, p. 1.

8 See paragraph 3.3 of ECB Opinion CON/2008/79 of 27 November 2008 at the request of the Greek Ministry of Economy and Finance on a draft law on enhancing liquidity of the economy to address the impact of the international financial crisis and on a draft decision on its implementation. Also paragraph 3.10 of ECB Opinion CON/2008/81 of 1 December 2008 at the request of the Hungarian Ministry of Finance on a draft law on strengthening the financial intermediary

the ECB also expects that the support measures envisaged in the draft law will be exclusively financed from the State budget and that, to the extent that their funding may require State borrowing, this will not include pre-financing or refinancing of the State budget by Eesti Pank[9].

3. Specific observations

3.1 *Implementation of the support measures*

3.1.1 The draft law provides for temporary fast-track proceedings of *Riigikogu* in the event of a financial crisis for certain listed measures on a proposal by the Government. The specific deadline applicable to these proceedings is 1 July 2010. The draft law does not specify termination or expiry of the draft financial crisis measures. In accordance with the general conditions applicable to the grant of a State guarantee, a measure is approved and terminated by a resolution of *Riigikogu*, which must set the commencement and expiry dates. In respect of Government lending, the respective agreements will be prepared by the Ministry of Finance. The ECB repeats that any open-ended scheme is not in line with the Declaration and should be avoided. In particular, the Declaration clearly draws attention to the need for any domestic support schemes to be temporary in nature, even if they can be extended or renewed[10]. The ECB recommends that provisions on the temporary nature of the support measures are clearly inserted into the draft law, as well as provisions establishing means aimed at terminating/redeeming the abovementioned measures.

3.1.2 In addition, the draft law does not specify any conditions, rules or limitations applicable to persons and/or entities to whom/which financial crisis measures are to be provided, except that the measures are 'for solving or preventing a financial crisis'. In this context, the ECB strongly recommends that the consulting authority should clarify the coverage of the proposed support measures under the draft law. It also draws attention to the importance of putting a transparent, predictable framework in place by defining the terms and conditions for financial institutions to have recourse to it in cases of financial crisis only and the parameters of and limitations to the exercise by the Estonian authorities of their powers when deciding whether or not to activate the support measures and on the conditions subject to which they should be activated.

---

system and paragraphs 3.2.2 and 3.2.3 of ECB Opinion CON/2009/3 of 8 January 2009 at the request of the Slovenian Ministry of Finance on a draft decree laying down criteria and conditions for the implementation of State capital investments and for the conversion of State claims into capital shares under Article 81.a of the Law on public finance.

9 In this regard see, for instance, the following: paragraph 3.3 of ECB Opinion CON/2008/88 of 19 December 2008 at the request of the Slovenian Ministry of Finance on a draft decree laying down criteria and conditions for granting guarantees under Article 86.a of the Law on public finance; paragraph 3.2.3 of ECB Opinion CON/2008/92 of 22 December 2008 at the request of the Slovenian Ministry of Finance on a draft decree laying down criteria and conditions for granting loans under Article 81.a of the Law on public finance and paragraph 3.2.3 of ECB Opinion CON/2009/3.

10 'In all cases, these actions will be designed in order to avoid any distortion in the level playing-field and possible abuse at the expense of non beneficiaries of these arrangements. As a consequence the scheme will be limited in amount, *temporary* (emphasis is ours) and will be applied under close scrutiny of financial authorities …' (Declaration, *supra* fn. 3). Also see Communication from the Commission, The Application of State Aid Rules to Measures Taken in Relation to Financial Institutions in the context of the current global financial crisis, available at www.eur-lex.europa.eu, paragraph 24.

3.2 *Selection of beneficiary institutions*

The definition of 'financial crisis' in the draft law refers to credit institutions operating in Estonia. However, except for the exclusion of certain persons specified in § 40^2(3) of the Law on the State budget, the draft law does not specify who is eligible to be granted a State guarantee in a financial crisis, and in particular whether subsidiaries of foreign banks are also covered. The ECB draws attention to the Declaration which states, *inter alia*, that Member States' actions should 'avoid any distortion in the level playing-field' and that 'all the financial institutions incorporated and operating in [euro area] countries and subsidiaries of foreign institutions with substantial operations [should] be eligible' to benefit from the actions in question. The ECB has previously stated that 'arrangements that may be seen as providing preferential treatment to specified institutions should be avoided'[11]. The ECB also draws attention to the Commission's guidance on the eligibility criteria for beneficiary institutions[12].

3.3 *Relationship with the central bank's monetary policy*

3.3.1 The ECB reminds the consulting authority that, in line with the Declaration, Member States have to act in a coordinated manner to avoid the possibility of significant differences in national implementation having a counter-productive effect and creating distortions in global banking markets. In the interests of ensuring a level playing-field, it is crucial to harmonise the form of State guarantees, both within the euro area and the EU. In particular, the ECB repeats that uncoordinated decisions among Member States should be avoided as they may involve a fragmentation of the euro area money market. In this regard, the ECB draws attention to a set of recommendations issued by its Governing Council on 20 October 2008 concerning the appropriate framework for the granting of government guarantees on bank debt issuance[13]. Against this background, the ECB has the following remarks.

3.3.2 First, the ECB understands that, under the draft law, State guarantees may be issued to cover all types of liabilities of domestic financial institutions and national deposit-guarantee schemes. The ECB therefore notes that the draft law does not exclude from its material scope of application, expressly or by implication, interbank deposits, subordinated or collateralised liabilities such as covered bonds[14]. The ECB reiterates the need to avoid State guarantees covering interbank

---

11 See paragraph 3.4 of ECB Opinion CON/2008/48 of 15 October 2008 at the request of the Irish Minister for Finance on a draft Credit Institutions (Financial Support) Scheme 2008.

12 See Communication from the Commission, The Application of State Aid Rules to Measures Taken in Relation to Financial Institutions in the context of the current global financial crisis, paragraph 18, specifying that 'The eligibility criteria of financial institutions … must be objective, taking due account of their role in the relevant banking system and the overall economy, and non-discriminatory so as to avoid undue distortive effects on neighbouring markets and the internal market as a whole. In application of the principle of non discrimination on the grounds of nationality, all institutions incorporated in the Member State concerned, including subsidiaries, and with significant activities in that Member State should be covered by the scheme.'

13 See the Recommendations of the Governing Council of the European Central Bank on government guarantees for bank debt, 20 October 2008, available on the ECB's website at http://www.ecb.europa.eu/pub/pdf/other/recommendations_on_guaranteesen.pdf.

14 The ECB notes that the explanatory memorandum to the draft law states that Estonian banking is dominated by subsidiaries and branches of the major Scandinavian banks and that, due to the high concentration of the banking sector, it was not considered practical to guarantee interbank loans as in other Member States.

deposits, in particular, as these could entail a substantial distortion in the various national segments of the money market by potentially increasing short-term debt issuance activity across Member States.

3.3.3 Second, the ECB understands that, by extension, State guarantees for loans taken out by banks may be granted. In this respect, the ECB repeats that such arrangements for the granting of government guarantees on bank debt should, in their practical implementation, aim at: (i) addressing the funding problems of liquidity-constrained solvent banks by improving the functioning of the market for bank debt of longer term maturity; and (ii) preserving the level playing-field among financial institutions and avoiding market distortions.

3.3.4 Third, as regards the pricing of the State guarantees, it is crucial to ensure harmonisation and coordination of the price determination of such guarantees within the euro area and the EU where a level playing-field is of the essence. In particular, it is important to ensure that the price of a State guarantee is risk-based and market-oriented and determined on the basis of the costs of a corresponding guarantee in the market.

3.3.5 Fourth, it is important to ensure that beneficiary financial institutions may not profit from undue use of their guaranteed status to engage in a heightened level of activities which distort the market and facilitate abnormal balance sheet growth. In this regard, the ECB reiterates the importance of establishing appropriate safeguards such as limits on the marketing of financial products or on expansion of activities on the basis of State guarantees.

3.3.6 Fifth, under the draft law, the Government may acquire assets from financial institutions. In this respect, the ECB has a number of observations which are important from a monetary policy perspective. Although such measures should help to restore confidence in the Estonian banking system, it is important that the price applied for the acquisition of financial institutions' assets should be determined in a coordinated manner within the EU. The ECB notes the importance of the price determination of these transactions.

3.4 *Conditions for State capital investments*

3.4.1 In line with the Declaration, the ECB reiterates that uncoordinated decisions amongst Member States should be avoided, as they may lead to significant differences in the treatment of financial institutions across Member States. This remark also applies to measures related to State capital investments.

3.4.2 The ECB takes the opportunity to restate the points made in its previous opinions. In particular, the ECB draws *Riigikogu's* attention to the specific recommendations made by its Governing Council on recapitalisations[15] (hereinafter the 'Recommendations on the pricing of recapitalisation'). In this respect, the ECB notes that the aim of any recapitalisation measures should be to strengthen the

15 Recommendations of the Governing Council of the European Central Bank on the pricing of recapitalisations, 20 November 2008, available on the ECB's website at http://www.ecb.europa.eu/pub/pdf/other/recommendations_on_pricing_for_recapitalisationsen.pdf.

capital position of fundamentally sound financial institutions in order to improve the functioning and stability of the banking system and to ensure the proper financing of the economy. In particular, a consistent approach should be used in defining the conditions for recapitalisations and the pricing of the instruments intended to provide Tier 1 capital to financial institutions. The ECB underlines the importance of appropriate pricing for recapitalisations in terms of the goals of enhancing the stability of the financial system, facilitating a return to normal market conditions and ensuring the proper financing of the economy. In the Recommendations on the pricing of recapitalisations, the ECB stresses that the pricing conditions for capital support should be risk-based and market-oriented, determined by taking into consideration the specific risk of both the specific instrument chosen for injecting capital and the institution concerned. Specific features of the instruments for capital injections, such as preference shares, should be appropriately chosen so that, while encouraging an early end to the State's capital support of banks, they do not result in an excessive increase in the cost of capital.

3.4.3 Moreover, in line with previous ECB opinions[16], it should be ensured that such measures are in accordance with the requirements of Community competition law, in particular State aid rules, and that the State's role as shareholder is limited in time. In this respect, in accordance with the Recommendations on the pricing of recapitalisations, it must be stressed that terms should be set for the redemption or conversion of the instruments either on the basis of a period of time or the development of market conditions so as to retain the temporary nature of the State's involvement and discourage financial institutions from maintaining such involvement for an extensive period of time.

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

Done at Frankfurt am Main, 9 March 2009.

[signed]

The President of the ECB

Jean-Claude TRICHET

16 See e.g. paragraph 3.1.3 of ECB Opinion CON/2009/3.