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EUROPEAN CENTRAL BANK

EUROSYSTEM

**OPINION OF THE EUROPEAN CENTRAL BANK**

**of 2 April 2009**

**at the request of the Lithuanian Ministry of Finance**
**on a draft law on financial sustainability**

**(CON/2009/32)**

## Introduction and legal basis

On 25 March 2009 the European Central Bank (ECB) received a request from the Lithuanian Ministry of Finance for an opinion on a draft law on financial sustainability (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 rules applicable to financial institutions insofar as they materially influence 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 of the draft law

1.1 The aim of the draft law is to enable the Lithuanian State to protect essential public interests and to take measures to strengthen financial stability and the credibility of the banking system.

1.2 The draft law provides for four categories of measures to strengthen financial stability: (a) State guarantees; (b) redemption of bank assets; (c) State involvement in a bank's capital; and (d) taking shares in a bank in the public interest. The draft law is intended to apply to banks and branches of foreign banks established in Lithuania.

1.3 The draft law provides for a general legal framework allowing the Government or an institution authorised by it to apply one or several of the new measures when the conditions for their application are met. Detailed rules for the implementation of the four categories of measures are to be adopted by the Government.

1.4 The draft law is of a permanent nature – its validity is not limited in time.

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1 OJ L 189, 3.7.1998, p. 42.

## 2. General observations

2.1 The ECB has issued a number of opinions at the request of the competent Member States' authorities on national measures adopted in response to the global financial crisis[2]. The ECB therefore invites the Ministry of Finance to take into account the relevant observations made in its recent opinions on similar draft legislative provisions in other Member States, some of which are repeated again below.

2.2 The ECB also draws attention to the guidance provided by the Ecofin Council to the Member States in the conclusions of its Meeting of 7 October 2008[3] as well as the Declaration issued by the Heads of State of the euro area on 12 October 2008 (hereinafter the 'Declaration')[4]. In particular, the ECB stresses that any initiatives put in place by the competent national authorities to restore confidence in the financial markets should be coordinated and should aim to implement the common principles in question, in a spirit of close cooperation with other Member States and the Community institutions[5]. The principles contained in the Declaration as well as the conclusions raised by the Ecofin Council were endorsed by the European Council of 15 to 16 October 2008[6].

2.3 As the draft law provides for a general legal framework and the detailed rules of its implementation will be laid down by the Government, the ECB expects to be consulted on any new draft legislative provisions should they materially influence the stability of financial institutions and markets.

2.4 With these general observations in mind, and against the background of the guidance previously given by the ECB and the Community institutions in this regard, the ECB has the following observations to make on the draft law.

## 3. Specific comments

3.1 *Entities eligible for the application of the new measures*

3.1.1 As regards the entities to which the measures to strengthen financial stability provided for in the draft law could be applied, the ECB understands that subsidiaries are also covered under 'banks

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

3 See 'Immediate Responses to Financial Turmoil', Ecofin Council Conclusions of 7 October 2008, available on the former French Presidency's website at www.ue2008.fr. The Ecofin Council recommended that: (i) interventions should be timely and the support should in principle be temporary; (ii) the interests 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 through the State aid rules; and (viii) negative spill-over effects should be avoided.

4 The text of the Declaration is available on the former French Presidency's website at www.ue2008.fr. The Member States agreed to: (i) ensure appropriate liquidity conditions for financial institutions: (ii) facilitate the funding of banks; (iii) provide financial institutions with additional capital resources to continue to ensure the proper financing of the economy; (iv) allow for an efficient recapitalisation of distressed banks, (v) ensure sufficient flexibility in the implementation of accounting rules; and (vi) enhance cooperation procedures among European countries.

5 See ECB Opinion CON/2009/12 of 9 February 2009 at the request of the Cypriot Ministry of Finance on a draft law amending the Laws of 2002 and 2004 on the management of revenues and expenditure and on the accounting system of the Republic and other related matters.

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

and branches of foreign banks established in Lithuania'[7]. The ECB emphasises that any distortion in the level playing-field as regards the treatment of domestic financial institutions and subsidiaries of foreign institutions should be avoided[8].

3.2 *Involvement of Lietuvos bankas*

3.2.1 The ECB understands that the draft law will be implemented and the new measures will be applied by the Government or another executive institution authorised by it. Lietuvos bankas's role in relation to the new measures will only be limited to a consultative one, i.e. advising the Government or the institution authorised by it in respect of specific measures and/or providing its findings on the situation of a particular bank.

3.2.2 The ECB appreciates that these provisions recognise Lietuvos bankas's expertise in the fields relevant to the stability of the financial market. In this respect, the ECB notes that any involvement of Lietuvos bankas in application of the measures to strengthen financial stability must be compatible with the Treaty provisions[9]. First, the ECB expects that functions to be performed by Lietuvos bankas in the context of implementation of the new measures will be conducted in manner that is fully compatible with Lietuvos bankas's institutional and financial independence[10] to safeguard the proper performance of its existing tasks under the Treaty and the Statute of the European System of Central Banks and of the European Central Bank. Second, the ECB also expects that Lietuvos bankas's involvement in the procedure provided for in the draft law will not go beyond an advisory function and that it will in other respects 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) [now Articles 101 and 103(1)] of the Treaty[11]. In this respect, the ECB understands that the measures to strengthen financial stability will be exclusively financed from budgetary and similar State resources[12]. In the same vein, this observation also concerns Article 3(1)(1) of the draft law, referring to the measures that Lietuvos bankas may apply to resolve problems relating to a bank's liquidity or solvency. In this respect, it is noted that any possible measures undertaken by Lietuvos bankas should only relate to liquidity

7 Article 1(2) of the draft law.

8 See paragraph 3.1 of ECB Opinion CON/2008/55 of 20 October 2008 at the request of the Austrian Ministry of Finance on draft legal measures to ensure the stability of the Austrian financial market.

9 In this context also see paragraph 3.7 of ECB Opinion CON/2008/68 of 13 November 2008 at the request of the Finnish Ministry of Finance on a draft government proposal for laws amending the Law on the Government Guarantee Fund and the Law on credit institutions.

10 For more information on Lietuvos bankas' institutional and financial independence see recent ECB Opinion CON/2009/26 of 24 March 2009 at the request of Lietuvos bankas on behalf of the Ministry of Finance of Lithuania on a draft law amending the Law on Lietuvos bankas as regards the rules on the distribution of the profits of Lietuvos bankas.

11 OJ L 332, 31.12.1993, p. 1. See also paragraph 3.2 of ECB Opinion CON/2008/52 of 17 October 2008 at the request of the Spanish State Secretary for Economic Affairs on a Royal Decree-Law creating a Fund for the acquisition of financial assets and on a Royal Decree-Law adopting urgent financial and economic measures in relation to the concerted European action plan of the euro area countries and paragraph 3.7 of ECB Opinion CON/2008/68.

12 Articles 10 and 11 of the draft law.

support provided to solvent institutions in order to comply with the prohibition on monetary financing.

3.3 *Circumstances under which the new measures could be applied*

3.3.1 The draft law provides that the measures to strengthen financial stability could be applied when the bank concerned 'faces liquidity problems or is insolvent, or there is a real threat that it will have liquidity problems or will become insolvent, and that the measures, which may possibly be applied by Lietuvos bankas pursuant to legal acts are insufficient to resolve the problems related to the bank's liquidity or solvency'[13]. In this context, the ECB would welcome clarification, as, according to the guidance previously given by the ECB and the Community institutions in this regard, only one measure could be applied to insolvent banks, namely taking shares in a bank in the public interest.

3.3.2 The ECB also recommends that the consulting authority clarifies the coverage of the proposed measures under the draft law. Indeed, in line with previous opinions[14], attention should be drawn 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 and the parameters of and limitations to the exercise by the Lithuanian authorities of their powers when deciding whether to activate the support measures contained in the draft law.

3.4 *Relationship of the draft law with monetary policy*

3.4.1 The ECB reminds the consulting authority that, in line with the Declaration, Member States have to act in a coordinated manner to avoid that significant differences in national implementation could have a counter-productive effect, creating distortions in global banking markets. Against this background, the ECB has the following remarks.

3.4.2 First, the ECB understands that State guarantees may be issued to cover all types of liabilities of domestic financial institutions and national guarantee schemes. However, the ECB notes that the draft law does expressly exclude interbank deposits from its material scope of application. The ECB welcomes this provision as such guarantees could entail a substantial distortion in the various segments of the money market by potentially increasing short-term debt issuance activity across Member States, thus impairing the implementation of the single monetary policy of Lietuvos bankas, and possibly altering the transmission of monetary policy decisions.

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

13 Article 3(1)(1) of the draft law.

14 See paragraph 3.1.2 of ECB Opinion CON/2009/18 of 9 March 2009 at the request of *Riigikogu* on a draft law on stabilising measures for the Estonian financial system.

institutions and avoiding market distortions; and (c) ensuring consistency with the management of liquidity by Lietuvos bankas. In line with the Declaration, the ECB also notes that the governments should make available a Government guarantee of new medium term (up to five years) bank senior debt issuance and that guarantees must be limited in time. In this respect, the ECB reminds the consulting authority that the draft law should lay down not only the maximum maturity of a bank's liabilities that are guaranteed by the State, but also the minimum maturity, currently recommended to be three months.

3.4.4 Third, as regards the pricing of the State guarantees, the ECB notes that it also appears crucial to ensure the harmonisation of the price determination of such guarantees within the euro area and the European Union where a level playing-field is of essence. In this respect, the ECB's contribution to the harmonisation and coordination across the EU of the price determination of State guarantees[15] is helpful. In particular, it is important to ensure that the price of the State guarantee is risk-based and market-oriented and determined on the basis of the costs of a corresponding guarantee in the market. In this respect, the ECB notes that Article 4(3) of the draft law introduces a direct reference to the ECB's recommendations on government guarantees on bank debt. While appreciating that the draft law includes such provisions, for reasons of legal certainty, the ECB recommends deleting the specific reference to its recommendations on government guarantees on bank debt, which do not constitute a legal act and which may be subject to revision[16].

3.4.5 Fourth, the ECB also reminds the Lithuanian authorities that it is important to ensure that the 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.

3.4.6 Finally, the draft law provides that the measures to strengthen financial stability must be applied for a 'limited' time and that, once applied, they will have to be reviewed under the procedure and terms prescribed by legislation regulating State aid[17]. The ECB reminds the consulting authority that open-ended schemes are not line with the Declaration. In particular, the Declaration clearly draws attention to the need for any domestic support schemes, and for the framework that provides for them, to be temporary in nature, even if these can be extended or renewed[18]. Accordingly, the ECB recommends that more specific provisions on the time limits of the support measures are

15 The reference is to the Recommendations of the Governing Council of the European Central Bank on the government guarantees for bank debt of 20 November 2008, available on the ECB's website at www.ecb.europa.eu.

16 See also paragraph 3.2 of ECB Opinion CON/2008/67 of 13 November 2008 at the request of the Spanish Ministry for Economic Affairs and Finance on a draft order implementing Royal Decree-Law 7/2008 authorising State guarantees.

17 Article 3(2)(4) of the draft law.

18 '… 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 …' taken from the Declaration.

inserted in the draft law, as well as provisions establishing means aimed at redeeming the new measures.

3.5 *Conditions for State capital investments*

3.5.1 In line with the Declaration, the ECB reiterates that uncoordinated decisions among Member States should be avoided as they may have a negative impact on the integrity of financial markets and lead to significant differences in the treatment of financial institutions between Member States. This remark also applies to the measures related to State capital investments.

3.5.2 The ECB thus takes the opportunity here to reiterate the points made in its previous opinions. In this respect the ECB notes that the recapitalisation measures considered in Member States are aimed at strengthening the 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. Against this background, the ECB has the following observations.

3.5.3 First, 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. Against this background, the ECB published recommendations of the Governing Council of the ECB on the pricing of recapitalisations (hereinafter the 'Recommendations on recapitalisations')[19]. The ECB highlights 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 should not result in an excessive increase in the cost of capital.

3.5.4 Second, as far as the redemption of bank assets is concerned, the ECB reiterates that this measure should not be applied to the insolvent banks. The ECB also draws attention to the fact that a mechanism for fixing a fair price for the assets should be established for this measure, in accordance with the guidance provided by the European Commission[20] and by the ECB[21].

3.5.5 Third, as regards taking shares in a bank in the public interest, the ECB understands that no limits are set with reference to the amount of shares that the Government may take and, therefore, that such a measure could also result in the takeover of a credit institution. Furthermore, the ECB also notes that the adoption of such a measure is provided for 'solely in exceptional cases'[22]. In line

19 See the Recommendations of the Governing Council of the European Central Bank on the pricing of recapitalisations issued on 20 November 2008, available on the ECB's website at www.ecb.europa.eu.

20 See the Communication from the Commission 'On the Treatment of Impaired Assets in the Community Banking Sector', available on the Commission's website at www.ec.europa.eu.

21 See the ECB's 'Guiding principles for bank asset support schemes', available on the ECB's website at www.ecb.europa.eu.

22 Article 8(1) of the draft law.

with previous opinions[23], the ECB stresses that due to their far reaching effects on market participants, it should be ensured that such measures are only used as a last resort, that the disturbances to the level playing-field are minimised and that the State's role is limited in time.

The ECB also draws particular attention to the appropriate pricing of the shares.

Moreover, in respect of an exit strategy, pursuant to Article 9 of the draft law, expropriation is meant to be temporary. The ECB notes that the conditions for re-privatisation provided in this article are unclear. As mentioned in previous ECB opinions, it is important to ensure that the State's involvement is limited in time and that companies are reprivatised without undue delay as soon as they are stabilised and their operations are sustainable.

3.5.6 Fourth, in line with the Declaration, the ECB also emphasises that harmonisation regarding the expiry of national financial support schemes across the EU and in particular within the euro area is of crucial importance, including for State capital investments in financial institutions. In this context, it is stressed that capital investments under the draft law must expressly provide for the temporary nature of the Lithuanian State's intervention. More generally, concerning the issue of the application of State aid rules to measures taken by the Member States in connection with financial institutions in the context of the ongoing financial crisis, the ECB also draws the consulting authority's attention to the importance of ensuring that the proposed arrangements comply with the relevant Community law provisions and with the criteria recently laid down by the Commission in its guidance on compliance by financial sector support schemes with EU State aid rules[24] and to the need to ensure that the State's role as shareholder resulting from a possible recapitalisation under the draft law is limited in time. In this respect, and in accordance with the Recommendations on recapitalisations, consideration should be given to setting out terms for the redemption or conversion of the instruments, either on the basis of a period of time or development of market conditions, in order to retain the temporary nature of State involvement and discourage financial institutions from maintaining such involvement for an extensive period of time.

3.6 *Provisions on confidentiality*

3.6.1 Article 12 of the draft law, providing for the protection of the confidential information provided by the banks, does not expressly establish a list of subjects to which such an obligation to maintain the confidentiality of information is applied. The ECB notes that for the sake of clarity this obligation should also apply to Lietuvos bankas, without prejudice to supervisory information and to the extent what is required under the Memorandum of Understanding on cooperation between the financial supervisory authorities, central banks and finance ministries of the European Union on cross-border financial stability of 1 June 2008[25].

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23 See e.g. paragraph 3.2.2 of ECB Opinion CON/2009/24 of 17 March 2009 at the request of the German Ministry of Finance on a draft law on the further stabilisation of the financial market.

24 See e.g. paragraph 3.8 of ECB Opinion CON/2008/68 of 13 November 2008 at the request of the Finnish Ministry of Finance on a draft government proposal for laws amending the Law on the Government Guarantee Fund and the Law on credit institutions.

25 The text of the Memorandum of Understanding is available on the ECB's website at www.ecb.europa.eu.

3.7 *Implementation of 'EU legal acts'*

3.7.1 As laid down in its Article 1(4), the draft law is meant to provide for the implementation of two 'EU legal acts', namely[26] the Communication from the Commission on 'The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis' of 13 October 2008 and the Communication from the Commission on 'The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition'.

The ECB notes that from a legal point of view, the term 'implementation' does not seem appropriate in respect of the abovementioned Communications from the Commission, since they cannot be properly defined as 'legal acts' and are not a source of Community law. However, the ECB understands that the intention is to follow and respect these documents in the draft law. In this context, the ECB draws again attention to the new Communication from the Commission 'On the Treatment of Impaired Assets in the Community Banking Sector', which applies from 25 February 2009 and which also should be taken into consideration.

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

Done at Frankfurt am Main, 2 April 2009.

[signed]

*The President of the ECB*

Jean-Claude TRICHET

26 See the Annex to the draft law.