



OPINION OF THE EUROPEAN CENTRAL BANK
of 7 September 2012
on a capital increase of the Banque centrale du Luxembourg
(CON/2012/69)

Introduction and legal basis

On 7 August 2012, the European Central Bank (ECB) received a request from the Banque centrale du Luxembourg (BCL) for an opinion on a draft law providing for a capital increase of the BCL and amending the Law of 23 December 1998 on monetary status and on the Banque centrale du Luxembourg, as amended (hereinafter the ‘BCL Law’), (hereinafter the ‘draft law’).

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 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 provisions¹, as the draft law relates to the BCL. 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

The draft law provides for an increase of the BCL’s capital, by the creation of an authorised capital up to EUR 1 500 million, EUR 900 million of which will be paid up. A grand-ducal regulation may increase the paid-up capital within the limits of the authorised capital by methods such as the incorporation of reserves. Article 4 of the BCL Law, as currently drafted, refers to the initial amount of BCL capital, EUR 25 million, which may be increased without limit by incorporation of reserves by grand-ducal regulation, on a proposal from the central bank². The BCL’s authorised capital was effectively increased up to EUR 175 million in 2009, on such basis. By virtue of the draft law, the incorporation of reserves would now be authorised only within the limits of the authorised capital. The explanatory memorandum to the draft law explains that the increase in authorised capital (up to EUR 1 500 million) and paid-up capital (up to EUR 900 million) is necessary to provide the BCL with an appropriate capital base in order for it to fully and independently discharge its financial obligations within a financial system that has evolved considerably in recent years. In this latter respect, reference is made to the capital contributions to be made by the BCL to the ECB and the Bank for International Settlements (BIS), the need to finance the arrangements with the International Monetary Fund (IMF),

¹ OJ L 189, 3.7.1998, p. 42.

² Law of 24 October 2008.

as well as the increased risks of the BCL's day-to-day activities in the light of increased foreign exchange risks and interest rate and credit risks.

2. General observations

- 2.1 The ECB welcomes the proposed increase of the BCL's authorised capital. The principle of financial independence requires a national central bank (NCB) within the European System of Central Banks (ESCB) to have sufficient means not only to perform its ESCB or Eurosystem-related tasks, but also its national tasks, e.g. financing its administration and own operations. Such financial independence is assessed from the perspective of whether any third party is able to exercise either direct or indirect influence not only over an NCB's tasks, but also over its ability to fulfil its mandate, both operationally in terms of manpower, and financially in terms of appropriate financial resources³. In this respect, financial independence primarily implies that an NCB should always be sufficiently capitalised⁴. In particular, the ECB is of the view that the higher the level of capital, reserves and provisions against financial risks is, the higher the safeguards against future losses are. For this reason, an NCB must be free to independently create financial provisions to safeguard the real value of its capital and assets. Furthermore, Member States may not hamper NCBs from building up their reserve capital to a level which is necessary for a member of the Eurosystem to fulfil its tasks⁵. As mentioned in the ECB's Convergence Reports 2010 and 2012⁶, any situation should be avoided whereby for a prolonged period of time an NCB's net equity is below the level of its statutory capital or is even negative, including where losses beyond the level of capital and the reserves are carried over. Any such situation may negatively impact on the NCB's ability to perform not only its ESCB or Eurosystem-related tasks, but also its national tasks. Moreover, such a situation may affect the credibility of the Eurosystem's monetary policy. Therefore, the event of an NCB's net equity becoming less than its statutory capital, or even negative would require that the respective Member State provides the NCB with an appropriate amount of capital, at least up to the level of the statutory capital, within a reasonable period of time so as to comply with the principle of financial independence. The financial independence of a central bank may also be strengthened by arrangements whereby the operational costs for the discharge of some of its tasks are borne by the entities concerned by such tasks⁷.
- 2.2 The ECB welcomes the increase of the BCL's capital, as the BCL initially had a relatively 'modest' capital of EUR 25 million⁸, considering: (a) the importance of the financial market in Luxembourg; and (b) that the BCL is the third largest national central bank within the

³ See the ECB's Convergence Report 2012, p. 26.

⁴ See the ECB's Convergence Report 2012, p. 25; See Opinion CON/2010/88. All ECB opinions are published on the ECB's website at www.ecb.europa.eu.

⁵ See the ECB's Convergence Report 2012, p. 27; see also, in this regard, Opinion CON/2008/34, paragraph 4.2.

⁶ See the ECB's Convergence Report 2010, pp. 21 and 22 and the ECB's Convergence Report 2012, pp. 25 and 26.

⁷ See paragraph 2 of Opinion CON/2012/35.

⁸ See the preparatory work on the draft law.

Eurosystem in terms of liquidity granted to credit institutions and the amount of collateral used for its monetary policy operations⁹. The Luxembourg authorities have been aware of this imbalance since the BCL's¹⁰ establishment and have, for this reason, previously introduced various mechanisms¹¹ intended to strengthen the BCL's financial position without a capital increase. However, despite this, the ECB has repeatedly recommended that the BCL's financial independence needs to be ensured¹². At a time of renewed need for the provision of additional liquidity to the banking sector and in order to cope with the disruption to segments of the money and financial markets that are hindering monetary policy transmission to the real economy, the BCL may need to take further additional risks on its balance sheet to continue to ensure price stability over the medium term. In this regard, it is critical at all times that the BCL possesses sufficient capital to conduct its functions and that it remains in a position to ensure the continued existence of financial buffers corresponding to the level of risks taken by it, by the replenishment of provisions and additional reserves, including retained profits, in order to constantly preserve an appropriate level of own funds.

3. Capital base effectively needed by the BCL

- 3.1 The ECB notes that, pursuant to the preparatory work on the draft law, one reason for the increase of the BCL's capital is linked to Luxembourg's arrangements with the IMF¹³. The ECB understands that, further to Resolution No 66-2 on the 'Fourteenth General Review of Quotas and Reform of the Executive Board' adopted on 15 December 2010, the Luxembourg's IMF quota might increase from SDR 418.7 million to SDR 1 321.8 million (a net increase of SDR 903.1 million). In its capacity as fiscal agent, the BCL would immediately contribute 25 % of such increase (SDR 225.78 million) to the IMF. In addition, Luxembourg has entered into a bilateral loan arrangement with the IMF, up to EUR 2.06 billion.
- 3.2 In addition to these contributions to the IMF arrangements, it is notable that the BCL already contributed SDR 65.7 million to the BIS in 2011 and will contribute EUR 8.7 million to the increased capital of the ECB.
- 3.3 In view of the above, the ECB recommends that the competent Luxembourg authorities closely cooperate with the BCL in order to determine the precise level of the capital increase. In this

⁹ See, in particular, paragraph 8 of Opinion CON/2005/12.

¹⁰ See Report of the Commission des Finances et du Budget (Commission of Finances and Budget in Luxembourg, 10.12.1998) on draft law No 4468/07, p. 2.

¹¹ Such mechanisms include the special BCL lien (see Article 27-1. (1) of the BCL Law), the term deposit by the State of an initial amount of EUR 575 million repayable at the rate of EUR 5 million per month and for which the State authorised the BCL to set aside the returns (see the preparatory work of the draft law: such agreement also contains provisions concerning the issue of Luxembourg euro coins and the State's guarantee in favour of the BCL in the event of losses linked to foreign exchange risks and other risks on transactions relating to the IMF and to other obligations deriving from international monetary cooperation agreements binding upon Luxembourg), as well as the reimbursement of the BCL's costs of compilation of balance of payments by virtue of the Law of 28 June 2000'.

¹² See paragraph 3 of Opinion CON/98/39, Opinion CON/2008/17, paragraph 3.2 of Opinion CON/2009/7 and paragraph 3.2.2 of Opinion CON/2009/46.

¹³ See page 1 of the explanatory memorandum to the draft law.

respect, it would be advisable to carefully consider the BCL's expected day-to-day and exceptional spending needs given the recent extension of the BCL's tasks, including possible emergency liquidity assistance, in the context of the current financial crisis. Such cooperation would serve to respect the BCL's financial independence, but it would also take account of the fact that the BCL is best placed to assess its required level of reserve capital¹⁴.

- 3.4 The ECB notes the distinction made in the draft law between authorised and paid-up capital, which could lead to ambiguity as to the type of 'capital' to which other provisions of the BCL Law refer. Furthermore, the ECB notes that the draft law restricts the flexibility that already exists in Article 4 of the BCL Law, whereby reserves might be incorporated by grand-ducal regulation, on the proposal of the BCL and without any limit, which the ECB has welcomed in Opinion CON/2008/17¹⁵. The reasons for now changing Article 4 are not transparent from the explanatory memorandum.

4. Replenishment of BCL reserves

- 4.1 As currently drafted, Article 31 of the BCL Law provides that 'the allocation of the profit to the BCL's reserve fund shall be compulsory so long as the total of the capital and the reserve fund falls short of the total of the BCL's assets which do not yield freely-available income, after deduction of liabilities which form the direct counterpart of such assets'.
- 4.2 This provision was added by the Government in November 1998 to the then draft BCL Law in reaction to a BCL opinion that strongly recommended an overall strengthening of the BCL's financial independence¹⁶. With respect to Article 31, the explanatory memorandum advised that 'in light of the unforeseeability of the future financial developments, the Government does share the view that is of utmost importance to provide for a possible carry-forward and payment of a loss and to encourage the BCL to build up reserves'. This provision was intentionally drafted to mean that the BCL reserves could be indefinitely built up as long as required by the BCL balance sheet, without limiting the amount of such reserves to a specific percentage of the nominal capital.
- 4.3 The ECB understands that the nominal increase of the paid-up BCL capital will restrict the BCL's ability to build up its reserves under Article 31, a measure which was carefully designed in 1998 under the assumption that the BCL would have a relatively modest capital. The possibility to build up and replenish reserves is very important considering, *inter alia*, the absence of provisions regarding the coverage of potential losses for the BCL¹⁷ and the ECB expects to be consulted on any amendment to Article 31 to introduce such a mechanism.

14 See the ECB's Convergence Report 2012, p. 27; see also paragraph 2.1 of Opinion CON/2010/88.

15 See paragraph 2.3.

16 See the BCL opinion addressed to the President of the Luxembourg Chamber of deputies on 6 November 1998, draft law 4468/2, 4469/2, ordinary session 1998/99.

17 See Opinion CON/98/39.

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

Done at Frankfurt am Main, 7 September 2012.

[signed]

The President of the ECB

Mario DRAGHI