



OPINION OF THE EUROPEAN CENTRAL BANK

of 23 October 2009

on the distribution of Lietuvos bankas's profits

(CON/2009/83)

Introduction and legal basis

On 14 October 2009 the European Central Bank (ECB) received a request from the Lithuanian Ministry of Finance for an opinion on a draft law amending Article 23 of the Law on Lietuvos bankas as regards the rules on the distribution of the profits of Lietuvos bankas (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 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 Lietuvos bankas. 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 draft law provides that Lietuvos bankas should contribute 70 % of its profit for the financial year to the State budget, instead of 50 % of its profit, as currently provided for in the Law on Lietuvos bankas. The contribution to the State budget is to be made only after making a deduction to cover any losses carried forward from previous financial years.
- 1.2 According to Article 23(3) of the Law on Lietuvos bankas as it currently stands, the profit for a financial year is to be allocated as follows: first, to cover losses carried forward from previous financial years; second, to contribute to the State budget 50 % of the profit of Lietuvos bankas for the financial year in question, after making any deduction to cover losses carried forward from previous financial years; and third, until the authorised capital reaches 200 million litas, the remaining profit is allocated in equal parts between the authorised capital and the reserve capital, thereafter any residual amount is allocated to the reserve capital.

¹ OJ L 189, 3.7.1998, p. 42.

2. General observations

- 2.1 On 24 March 2009 the ECB adopted Opinion CON/2009/26 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 (this draft law hereinafter the 'March draft law'). The March draft law provided that Lietuvos bankas should contribute, extraordinarily, 100 % of its profit for the financial year 2008 to the State budget, instead of 50 % of its profit, as provided for in the Law on Lietuvos bankas. If the March draft law had been adopted, Lietuvos bankas would have had no funds to transfer to the authorised and/or reserve capital for 2008.
- 2.2 In Opinion CON/2009/26 the ECB noted that, first, the March draft law raised concerns regarding its compatibility with the institutional independence of Lietuvos bankas to the extent that it could have been construed as an instruction to Lietuvos bankas; and, second, it also raised concerns about the financial independence of Lietuvos bankas, as all its profit was to be contributed to the State budget. The ECB concluded that an ad hoc change to the rules on the distribution of profits, which reflected a particular financial need of the main shareholder and which took all the profits from the central bank, was a cause of particular concern and was not compatible with the Treaty or the Statute of the European System of Central Banks and of the European Central Bank (hereinafter the 'Statute of the ESCB'). The ECB notes that its remarks were taken into account.
- 2.3 The draft law proposes to increase the part of the profits of Lietuvos bankas to be transferred to the State budget from 50 % to 70 %, which is not an ad hoc change but an amendment of the permanent rule. The ECB's remarks on the financial independence of Lietuvos bankas and the requirement to comply with the monetary financing prohibition expressed in Opinion CON/2009/26, and in other subsequent opinions, remain valid.
- 2.4 *Central bank financial independence*
- 2.4.1 Each Member State is obliged to safeguard the institutional and financial independence of its national central bank (NCB), thus ensuring the proper performance of its tasks under the Treaty and the Statute of the ESCB². In particular, the compatibility of the Law on Lietuvos bankas with the requirements of Article 108 of the Treaty and the provisions of the Statute of the ESCB on central bank independence is of utmost importance, as Lietuvos bankas's primary objective of price stability is best served by it being a fully independent institution with a precisely defined mandate³.
- 2.4.2 The concept of financial independence should be 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 (understood both operationally in terms of manpower, and financially in terms of appropriate financial resources) to fulfil its mandate⁴. Therefore, a Member State may not put its

² Opinion CON/2009/53, paragraph 2.1. All ECB opinions are published on the ECB's website at www.ecb.europa.eu.

³ Opinion CON/2009/26, paragraph 2.1.

⁴ The ECB's Convergence Report May 2008, pp. 20-21; and ECB Opinions CON/2008/9, CON/2008/10, CON/2008/34, CON/2008/82, CON/2009/4, CON/2009/26, and CON/2009/53.

NCB in a position where it has insufficient financial resources to carry out its ESCB-related tasks⁵. NCBs must also have sufficient financial means to carry out their other functions at all times, i.e. they must be able to perform their national tasks, to meet their international obligations and properly to cover their administrative and operational expenses⁶.

2.4.3 The ECB also reminds the consulting authority that Articles 28.1 and 30.4 of the Statute of the ESCB (the latter applies to Member States that have adopted the euro) provide for the possibility of further calls being made on the NCBs to make contributions to the ECB's capital and to make further transfers of foreign reserves⁷. The principle of financial independence requires that compliance with these provisions would leave an NCB's ability to perform its functions unimpaired.

2.5 *The monetary financing prohibition*

2.5.1 National rules on the distribution of an NCB's profits must comply with the monetary financing prohibition laid down in Article 101(1) of the Treaty and 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 Treaty⁸.

2.5.2 As referred in ECB Opinion CON/2009/59 of 14 July 2009 on the taxation of the Banca d'Italia's gold reserves, those provisions prohibit central bank (ECB or NCB) credit facilities in favour of Community institutions or bodies or in favour of the Member States or their public sector bodies, as well as direct central bank purchases of debt instruments from such entities. With a view to preserving the integrity of the central bank's balance sheet, the monetary financing prohibition is of key importance to ensuring the primary monetary policy objective of price stability⁹, which must not be impeded. Therefore, the prohibition must be interpreted extensively to ensure its strict application¹⁰. Thus, even though Article 101(1) of the Treaty refers to 'credit facilities', i.e. with the obligation to repay such credit, this prohibition may also apply *a fortiori* to other forms of funding, i.e. without the obligation to repay, since Article 101 of the Treaty has the overall aim of public financial discipline and of prohibiting NCBs from financing the public sector. Both the ultimate objective and the spirit of these provisions must be taken into account in their interpretation¹¹.

⁵ The ECB's Convergence Report May 2008, p. 20; and Opinion CON/2009/53, paragraph 2.2.

⁶ Opinion CON/2009/26, paragraph 2.3; and Opinion CON/2009/53, paragraph 2.2.

⁷ The ECB's Convergence Report May 2008, p. 20.

⁸ OJ L 332, 31.12.1993, p. 1.

⁹ Article 105(1) of the Treaty; and Article 2 of the Statute of the ESCB.

¹⁰ The ECB's Convergence Report May 2008, p. 22.

¹¹ Opinion CON/2003/27, paragraph 9.

3. Specific comments

- 3.1 The draft law modifies the rules on the allocation of Lietuvos bankas's profits in the current financial turmoil. While, according to the consulting authority, the aim of the draft law is to enhance the stability and credibility of the Lithuanian financial system, the ECB stresses that it is, in any circumstances, particularly important to secure and strengthen the independence of Lietuvos bankas, and even more so in periods of crisis. Moreover, overcoming the current financial turmoil depends on the ability of central banks to carry out their functions independently¹².
- 3.2 With regard to profit allocation, an NCB's statutes may prescribe how its profits are to be allocated. Even though amendments to such rules are possible, they should not be changed frequently. It is important to protect the rules relating to the distribution of profits from third-party interests and to ensure a legal framework that provides a stable and long-term basis for the central bank's functioning¹³.
- 3.3 As the ECB noted in its Convergence Report of May 2008¹⁴, the distribution of its profits is one of the areas of financial independence where an NCB is most vulnerable to outside influence. In this context the ECB understands that the draft law will reduce the financial means available to Lietuvos bankas for allocation to its authorised and/or reserve capital. According to the principle of financial independence (as stressed by the ECB in all its convergence reports, including the Convergence Report of May 2006 regarding Lithuania), with regard to making financial provisions or buffers an NCB must be free to decide independently on making financial provisions to safeguard the real value of its capital and assets.
- 3.4 The economic purpose of central bank capital and reserves is to ensure that the central bank will always and in all circumstances have at its disposal the necessary financial resources to conduct monetary policy. According to Article 23(2) of the Law on Lietuvos bankas, Lietuvos bankas uses the reserve capital to cover possible losses of a financial year. There must be regard for the long-term perspective of the distribution of profits. It is of the utmost importance to make sufficient provisions of reserve capital during years of profit to allow Lietuvos bankas to face possible losses without weakening its financial means for implementing its monetary policy¹⁵.
- 3.5 In principle it is not optimal for a central bank to create reserves only after transferring a large portion of its profits to the State budget¹⁶. Should Lietuvos bankas experience negative equity in the future (i.e. losses exceeding accumulated reserves), it would be hard to rebuild it out of the stream of future profits under such an arrangement. Although Lietuvos bankas had positive net equity at the end of 2008 and expects it to be positive also at the end of 2009, prudence is required to ensure stable and sufficient financial resources in the long term.

12 Opinion CON/2009/26, paragraph 3.2.

13 Opinion CON/2007/14, paragraph 2.2; and Opinion CON/2009/26, paragraph 3.4.

14 The ECB's Convergence Report May 2008, p. 21.

15 Opinion CON/2009/53, paragraph 3.2.

16 Opinion CON/2009/53, second subparagraph of paragraph 3.2.

3.6 The ECB recommends that, in view of Lietuvos bankas's obligations under the Treaty and the Statute of the ESCB, any changes to its financial obligations towards the State should be decided in cooperation with the Board of Lietuvos bankas, taking into account its specific central bank tasks¹⁷.

It is not clear from the consultation letter whether the consulting authority initiated the draft law in cooperation with Lietuvos bankas, after careful and cautious assessment of the current status of Lietuvos bankas's reserve capital, including projections of negative scenarios. Since an NCB is best placed and has all the necessary tools to evaluate these circumstances and to make forecasts, any new regime for the allocation of profits to the State should be made in close coordination with Lietuvos bankas.

3.7 The data available to the ECB shows that, relatively, the net equity (including capital and reserves) of non-Eurosystem NCBs is much lower than that of the Eurosystem NCBs; the data also shows that the ratio between risk-bearing assets and net equity is several times higher in non-Eurosystem NCBs than in the Eurosystem NCBs (the higher the ratio is in absolute terms, the lower the ability of a central bank to cover the risk of adverse asset price movements or defaults). The ECB understands that Lietuvos bankas is still in the process of building up its reserve capital to a level corresponding to that of the Eurosystem NCBs.

4. Final observations

4.1 Summarising the above arguments, the ECB concludes that the reduction of the financial means available to Lietuvos bankas for allocation to its reserve capital could hamper Lietuvos bankas from continuing the process of building up its reserve capital to a level corresponding to that of the Eurosystem NCBs. It could undermine Lietuvos bankas' financial independence as, in the worst scenario, if the reserve capital of Lietuvos bankas were not sufficient to cover possible losses, there could be a threat that Lietuvos bankas would not autonomously be able to avail itself of sufficient financial resources to fulfil its mandate. This could impair its independent functioning. Each Member State must ensure that its NCB has sufficient financial resources to carry out its ESCB-related tasks.

4.2 Moreover, any amendment to the rules on the distribution of Lietuvos bankas's profits should only be initiated in coordination with Lietuvos bankas, which is best placed to provide an expert assessment of the amount or ratio of the reserve capital necessary to cover its possible needs or losses related to its operational activities, including performance of its ESCB-related tasks. Only once such a detailed impact assessment has been made, can the ECB make a final analysis of compliance with the monetary financing prohibition.

¹⁷ Opinion CON/2009/53, paragraph 3.3.

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

Done at Frankfurt am Main, 23 October 2009.

[signed]

The President of the ECB

Jean-Claude TRICHET