



EUROPEAN CENTRAL BANK
EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK
of 10 November 2011
on the amendments to Lietuvos bankas' profit distribution rules
(CON/2011/91)

Introduction and legal basis

On 14 October 2011, the European Central Bank (ECB) received a request from Lietuvos bankas for an opinion on a draft law amending and supplementing Article 23 of the Law on Lietuvos bankas as regards the rules on the distribution of Lietuvos bankas' profit (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 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 Pursuant to Article 23(3) of the Law on Lietuvos bankas, profit for a financial year is allocated in the following order:

- (a) first, to cover losses carried forward from previous financial years;
- (b) second, 70 % is distributed to the State budget, after deducting losses carried forward from the previous financial years;
- (c) third, remaining profit is allocated equally between authorised and reserve capital, until the authorised capital reaches LTL 200 million;
- (d) fourth, residual profit is allocated to reserve capital.

1.2 The draft law amends the procedure for calculating Lietuvos bankas' profit contribution to the State budget, the profit distribution and loss coverage rules.

1.2.1 The draft law amends the reference period for calculating Lietuvos bankas' profit to be distributed to the State budget. Instead of basing the calculation on the preceding financial year, as provided for in the Law on Lietuvos bankas, it will be based on the average profit of the preceding three financial years.

¹ OJ L 189, 3.7.1998, p. 42.

- 1.2.2 The following are to be deducted before distribution to the State budget: (a) 30 % of the market value of Lietuvos bankas' real property transferred to the State Property Fund during the preceding financial year; and (b) if Lietuvos bankas' reserve capital is lower than five times the authorised capital, an amount equal to this difference.
- 1.2.3 Where the profit, based on the average profit of the preceding three years, is greater than the profit of the preceding financial year, the remaining part of Lietuvos bankas' distribution is to be paid to the State budget from Lietuvos bankas' reserve capital.
- 1.2.4 As in the case of the Law on Lietuvos bankas, remaining profit is allocated equally between authorised and reserve capital, until the authorised capital reaches LTL 200 million; thereafter residual profit is allocated to the reserve capital.
- 1.3 The draft law is expected to enter into force on 1 January 2012.

2. General observations

Any transfer of national central bank (NCB) resources to a Member State, either in the form of a profit distribution scheme or any equivalent form, needs to comply with the limitations imposed in this respect by the Treaty, in particular with the principle of central bank independence pursuant to Article 130 of the Treaty, and with the prohibition on monetary financing laid down in Article 123(1).

3. Central bank independence

- 3.1 Each Member State is obliged to safeguard the institutional and financial independence of its NCB, thus ensuring the proper performance of its tasks under the Treaty and the Statute of the European System of Central Banks and the European Central Bank (hereinafter the 'Statute of the ESCB')². The compatibility of the Law on Lietuvos bankas with the requirements of Article 130 of the Treaty and the provisions of the Statute of the ESCB on central bank independence is therefore of utmost importance, as Lietuvos bankas' primary objective of price stability is best served by a fully independent institution with a precisely defined mandate³.
- 3.2 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 to fulfil its mandate, both operationally in terms of manpower and financially in terms of appropriate financial resources⁴. A Member State may not put its 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

² Opinion CON/2009/53, paragraph 2.1 and Opinion CON/2009/83, paragraph 2.4.1. All ECB opinions are available on the ECB's website at www.ecb.europa.eu.

³ Opinion CON/2009/26, paragraph 2.1 and Opinion CON/2009/83, paragraph 2.4.1.

⁴ ECB's Convergence Report May 2010, p. 22.

⁵ ECB's Convergence Report May 2010, p. 21; Opinion CON/2009/53, paragraph 2.2 and Opinion CON/2009/83, paragraph 2.4.2.

perform their national tasks, to meet their international obligations and to properly cover their administrative and operational expenses⁶.

3.3 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 whose currency is 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 reserves. The principle of financial independence means that compliance with these provisions requires an NCB to be able to perform its functions unimpaired⁷.

3.4 Finally, NCB's profits may be distributed to the State budget only after any accumulated losses have been covered⁸ and financial provisions deemed necessary to safeguard the real value of the NCB's capital and assets have been created. Temporary or ad hoc legislative measures amounting to instructions to the NCBs in relation to the distribution of profit are not possible⁹.

3.5 *Stability of profit distribution rules*

3.5.1 The frequency of amendments to the rules on the distribution of Lietuvos bankas' profit raises specific concerns from the central bank independence perspective.

3.5.2 The amendments to the rules on the distribution of Lietuvos bankas' profit have been submitted for consultation three times since March 2009¹⁰. The ECB's Convergence Report of May 2010¹¹ noted that the distribution of NCB's profit is one of the areas of financial independence where an NCB is most vulnerable to outside influence. An NCB's statutes may prescribe how its profit is 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 profit from third-party interests and to ensure a legal framework that provides a stable and long-term basis for an NCB's functioning¹². Moreover, frequent amendments do not comply with the accounting principles of consistency, comparability¹³ and continuity.

3.6 *Treatment of losses*

Unlike the Law on Lietuvos bankas¹⁴, the draft law no longer explicitly ensures that profit is paid to the State budget only after accumulated losses from previous financial years have been covered. To the contrary, it is uncertain whether, notwithstanding Lietuvos bankas' profits or losses, it would

6 Opinion CON/2009/26, paragraph 2.3, Opinion CON/2009/53, paragraph 2.2, and Opinion CON/2009/83, paragraph 2.4.2.

7 ECB's Convergence Report May 2010, p. 21.

8 ECB's Convergence Report May 2010, p. 23.

9 ECB's Convergence Report May 2010, p. 23.

10 See Opinions CON/2009/26 and CON/2009/83.

11 ECB's Convergence Report May 2010, p. 22.

12 Opinion CON/2007/14, paragraph 2.2, Opinion CON/2009/26, paragraph 3.4, Opinion CON/2009/83, paragraph 3.2.

13 Guideline ECB/2010/20 of 11 November 2010 on the legal framework for accounting and financial reporting in the European System of Central Bank (recast) (OJ L 35, 9.2.2011, p. 31). Lietuvos bankas also follows the principles of consistency and comparability when preparing financial statements, as stated in its Annual Report 2010, pp. 95-96. The Annual Report is available on Lietuvos bankas' website at www.lbank.lt.

14 Article 23(3)(1).

still need to make contributions to the State budget, without first covering the uncovered losses for the previous financial years. This is incompatible with central bank financial independence. Therefore, the current provision of the Law on Lietuvos bankas, specifying that profit is paid to the State budget only after accumulated losses from previous financial years have been covered, has to be maintained in the Law on Lietuvos bankas.

3.7 *Creation of financial provisions*

- 3.7.1 The ECB reiterates that NCBs must be free to independently create financial provisions or buffers to safeguard the real value of their capital and assets¹⁵. This could ideally be achieved by creating provisions against certain risks arising from an NCB's activities, such as a provision for foreign exchange rate, interest rate, credit risk, gold price¹⁶ and other risks¹⁷.
- 3.7.2 The draft law raises specific concerns from the central bank independence perspective since profits may be distributed to the State budget only after any accumulated losses from previous years have been covered and financial provisions deemed necessary to safeguard the real value of the NCB's capital and assets have been created¹⁸.
- 3.7.3 In the same vein, in order to ensure the proper performance of its tasks under the Treaty and the Statute of the ESCB, the NCB needs to maintain adequate net equity to be covered against potential risks arising from the nature of its activities. In this context the ECB reiterates¹⁹ that 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 at non-Eurosystem NCBs than at the Eurosystem NCBs. The higher the ratio 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 net equity to a level corresponding to that of the Eurosystem NCBs.

3.8 *Legal status of Lietuvos bankas' assets*

- 3.8.1 Opinion CON/2010/42²⁰ noted the ECB's concern at the unclear legal status of Lietuvos bankas' assets. The ECB understands that the Lithuanian State is currently considered to be the legal owner of Lietuvos bankas' real property and that, as a result, there is a risk that Lietuvos bankas is only able to dispose of this property with governmental approval. This legal situation undermines both the institutional as well as the financial independence of Lietuvos bankas. From an institutional

¹⁵ ECB's Convergence Report May 2010, p. 23.

¹⁶ As regards the ECB, 'Taking into due consideration the nature of the ECB's activities, the Governing Council may establish a provision for foreign exchange rate, interest rate, credit and gold price risks in the balance sheet of the ECB. The Governing Council shall decide on the size and use of the provision on the basis of a reasoned estimate of the ECB's risk exposures' (Article 7 of Decision ECB/2010/21 of 11 November 2010 on the annual accounts of the European Central Bank (recast) (OJ L 35, 9.2.2011, p. 1)).

¹⁷ Caption 10 of Annex IV to Guideline ECB/2010/20.

¹⁸ ECB's Convergence Report May 2010, p. 23.

¹⁹ CON/2009/83, paragraph 3.7.

²⁰ Opinion CON/2010/42, paragraph 2.1.

perspective, State authorities could instruct Lietuvos bankas on the real estate assets held by it. Lietuvos bankas' financial independence would be undermined since it would no longer be entirely free to decide on the allocation of its resources and could be unable to secure sufficient means for the performance of its tasks²¹.

3.8.2 The ECB reiterates²² its understanding that this problem has arisen because no national law explicitly specifies whether Lietuvos bankas has the right to own the assets, or whether Lietuvos bankas can only manage and hold such assets on trust. The ECB also reiterates that the current legal status of Lietuvos bankas' real property is incompatible with the central bank independence requirement²³.

3.8.3 The draft law does not clarify the legal status of Lietuvos bankas' real property assets. The Law on Lietuvos bankas should specifically state that Lietuvos bankas legally owns the assets belonging to it, i.e. ensuring that the legal title and economic control of the assets will rest with Lietuvos bankas.

4. Monetary financing prohibition

4.1 National rules on the distribution of an NCB's profit must comply with the monetary financing prohibition laid down in Article 123(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) of the Treaty establishing the European Community²⁴. Those provisions prohibit central banks from providing overdraft facilities or any other type of credit facility to the public sector, which includes any financing of the public sector's obligations vis-à-vis third parties²⁵. In interpreting Article 123 of the Treaty, the ultimate objective and the spirit of the monetary financing prohibition must be taken into account, i.e. the overall aim of public finance discipline and the aim of prohibiting NCBs from financing the public sector. Against this background, the monetary financing prohibition may also apply to other forms of funding, i.e. without the obligation to repay²⁶. Moreover, the distribution of central bank profits which have not been fully realised, accounted for and audited does not comply with the monetary financing prohibition²⁷.

4.2 Proposed three-years average rule and contribution to the State budget from the reserve capital

4.2.1 The application of the proposed three-years average rule would result in a contribution by Lietuvos bankas' to the State budget which would be disconnected from the realised profit of the financial year under consideration. Moreover, if the contribution to the State budget, calculated according to the three-years average rule, is higher than the profit of the preceding financial year, the draft law

21 ECB's Convergence Report May 2010, p. 248.

22 Opinion CON/2010/42, paragraph 2.3.

23 ECB's Convergence Report May 2010, p. 248.

24 OJ L 332, 31.12.1993, p. 1.

25 See Article 1(1)(b)(ii) of Council Regulation (EC) No 3603/93.

26 ECB's Convergence Report May 2010, p. 24.

27 ECB's Convergence Report May 2010, p. 25.

provides that the remaining part of Lietuvos bankas' contribution is to be paid to the State budget from Lietuvos bankas' reserve capital. The proposed three-years average rule is therefore not compatible with the monetary financing prohibition.

4.2.2 Moreover, should the proposed rule apply to the distribution to be paid to the State budget before the financial year starting on 1 January 2015, the profit of the financial years, from which a contribution was already paid to the State budget on the basis of the legislative provisions in force at that time, would be taken into account again. It means that the same realised profit will be used more than once to calculate and distribute Lietuvos bankas' contribution to the State budget. This would in some cases²⁸ temporarily increase the level of the contribution due to the State budget and would amount to the distribution of Lietuvos bankas' profit which has not been fully realised, contrary to the monetary financing prohibition. For this reason, the draft law should not apply to the distribution of profit for the current financial year ending 31 December 2011 which in any case have to be excluded.

4.3 *Transfer of Lietuvos bankas' real property*

4.3.1 As stated in Opinion CON/2010/42²⁹, under the current legal situation, it is unclear whether Lietuvos bankas could independently sell its real property and keep the proceeds from the sale. If Lietuvos bankas cannot keep the proceeds, this raises doubts as to whether the current legislation is compatible with the monetary financing prohibition. To be compatible with the monetary financing prohibition, the transfer to the State of NCB assets, e.g. real property, must be remunerated at market value of the real property transferred to it and the transfer of the real property to the State should occur at the same time as the remuneration.

4.3.2 The draft law implies that Lietuvos bankas would transfer its real property to the State free of charge during the financial year. The transfer will then be compensated or netted at the time of profit distribution to the State budget, i.e. after the completion of the financial year. This belated compensation or netting is a form of credit to the public sector incompatible with the prohibition on monetary financing. To comply with the monetary financing prohibition, the calculation of the property's market value, the transfer of ownership and remuneration must all occur at the same time.

4.3.3 Moreover, if the calculated average profit of Lietuvos bankas for the preceding three financial years is insufficient to compensate for the property transferred to the State, it is unclear how the transferred property would be remunerated. This could also restrict Lietuvos bankas' right to independently decide on the sale of its property, since the prospects for Lietuvos bankas' profit accumulation for the financial year, due to the compensation for the transfer or property via netting only, are likely to obstruct a property transfer decision of Lietuvos bankas. If insufficient or no profit is generated during a financial year and Lietuvos bankas is not compensated for assets

²⁸ Lietuvos bankas' profits for the last three financial years amounted to approximately LTL 364 million in 2008, LTL 519,4 million in 2009 and LTL 90.5 million in 2010. Lietuvos bankas' Annual Report of 2010, p. 111.

²⁹ Opinion CON/2010/42, paragraph 2.2.

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transferred to the State during that financial year, another means of remuneration for the transferred assets has to be provided for.

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

Done at Frankfurt am Main, 10 November 2011.

[signed]

The President of the ECB

Mario DRAGHI