



OPINION OF THE EUROPEAN CENTRAL BANK
of 10 September 2008
at the request of the Banque centrale du Luxembourg
on amendments to the draft law improving the legislative framework for Luxembourg as a
financial centre and amending the Law of 23 December 1998 on monetary status and on the
Banque centrale du Luxembourg
(CON/2008/42)

Introduction and legal basis

On 24 July 2008 the European Central Bank (ECB) received a request from the Governor of the Banque Centrale du Luxembourg (BCL) for an opinion on amendments (hereinafter the ‘draft amendments’) proposed by the Government to the draft law (hereinafter the ‘draft law’) improving the legislative framework for Luxembourg as a financial centre and amending the provisions on covered bonds in the Law of 5 April 1993 on the financial sector, the Law of 15 June 2004 on the company investing in risk capital, the Law of 23 December 1998 creating a commission in charge of prudential supervision of the financial sector and the Law of 23 December 1998 on monetary status and on the Banque centrale du Luxembourg (hereinafter the ‘BCL 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 and sixth indents 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 and 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 ECB commented on the draft law in its Opinion CON/2008/17². The draft amendments take into account some of the ECB’s comments and introduce certain new elements aimed at reinforcing the framework for financial supervision and clarifying issues related to financial stability.

¹ OJ L 189, 3.7.1998, p. 42.

² ECB Opinion CON/2008/17 of 15 April 2008 at the request of the Luxembourg Minister for the Treasury and the Budget on a draft law improving the legislative framework for Luxembourg as a financial centre and on a draft law relating to social insurance contributions.

1.2 The draft law introduces, *inter alia*, the following amendments to the BCL Law:

- (i) it clarifies the method to be used by the BCL to implement the minimum reserve requirements;
- (ii) to reinforce financial stability, the draft law: (a) sets out that the BCL will supervise the general liquidity situation on the markets as well as evaluate market operators for this purpose; (b) establishes that the BCL will cooperate at the national and international level with a view to ensuring financial stability; and (c) assigns to the BCL the power to grant, in exceptional circumstances, short-term liquidity assistance to its counterparts, also on the basis of a State guarantee provided to the BCL;
- (iii) it provides the legal basis for the BCL's participation in public institutions, undertakings or public or private associations.

2. General observations

A number of the draft amendments are proposed in response to recommendations made by the ECB in Opinion CON/2008/17, in particular those relating to minimum reserve requirements. However, a number of the ECB's recommendations, in particular with respect to the BCL's regulatory powers³, have not yet been taken into account. Therefore, the ECB would like to reiterate the comments made in Opinion CON/2008/17 and also presents a number of new issues raised by the draft amendments. This opinion concentrates on the aspects of the draft law concerning the BCL and its powers.

3. Minimum reserve requirements

3.1 Under the proposed amendments, Article 23 of the BCL Law will provide that 'the Central Bank shall be the depository for amounts that credit institutions are obliged to maintain by monetary control measures based on Article 19 of the Statute of the European System of Central Banks and of the European Central Bank' (hereinafter the 'ESCB Statute').

3.2 The ECB welcomes that the scope of application of this provision has been restricted *ratione personae*, i.e. to individual credit institutions, instead of to 'professionals of the financial sector' and *ratione materiae* with an exclusive reference to Article 19 of the ESCB Statute, as recommended in Opinion CON/2008/17. This national provision is without prejudice to the direct application of Article 19.1 of the ESCB Statute, Article 2 of Regulation ECB/2003/9 of 12 December 2003 on the application of minimum reserves⁴ and Article 2 of Council Regulation (EC) No 2531/98 of 23 November 1998 concerning the application of minimum reserves by the European Central Bank⁵.

4. The BCL's financial stability function

4.1 The ECB notes that under the draft amendments, certain new provisions will be included in the BCL Law, under which the BCL will be assigned specific competences in the area of financial

³ See paragraphs 4.1 to 4.5 of Opinion CON/2008/17.

⁴ OJ L 250, 2.10.2003, p. 10.

⁵ OJ L 318, 27.11.1998, p. 1.

stability, and in particular it will have the power to supervise liquidity management in the markets, engage in institutional cooperation and provide emergency liquidity assistance to the BCL's counterparts. The assignment of such new competences is welcome, as it will facilitate the BCL's effective performance of its financial stability role. In order to assist the BCL in fulfilling this new role, the ECB would like to make the following points.

Adaptations of the BCL Law in order to strengthen the BCL's financial stability role

4.2 It is important to stress the strong interdependencies between the BCL's new and current competences. As highlighted in the explanatory memorandum, it is important to supervise liquidity given the BCL's role in the provision of liquidity in both normal and crisis situations. In practice, to properly discharge its new competences, the BCL should be able to leverage its existing powers, both regulatory⁶ and statistical. However, the draft amendments falls short of acknowledging an explicit and formal financial stability task for the BCL, encompassing the broad range of central bank contributions to financial stability by monitoring, assessing and effectively supporting, by means of emergency liquidity assistance, the financial system in Luxembourg. Therefore, the ECB recommends that Article 2(5) of the BCL Law should be amended to expressly list all the BCL's tasks, including the task of contributing to financial stability⁷. This would allow the BCL to collect statistical information in the context of financial stability. In this latter respect, as the institutional structure of financial corporations is becoming increasingly complex, the scope of information and data extends to the financial corporations sector as a whole, which includes credit institutions, insurance companies and special purpose vehicles for securitisation activities. The ECB wishes nevertheless to stress, in line with its previous opinions⁸, that information collection and sharing in the area of financial stability should be consistent with Community law regulating the exchange of supervisory and statistical information and professional secrecy⁹, as well as with the BCL Law. In this regard, the ECB would like to remind the consulting authority of its recommendations in Opinion CON/2008/17 that regulatory powers include the enforcement of ECB legal acts, particularly in the collection, compilation and reporting of statistical data.

⁶ See in particular paragraph 4 of Opinion CON/2008/17.

⁷ See paragraph 7 of ECB Opinion CON/2001/10 of 25 May 2001 at the request of the Austrian Ministry of Finance on a draft Federal law establishing and organising the financial market supervisory authority [title shortened]; paragraph 2.2. of ECB Opinion CON/2008/39 of 1 September 2008 at the request of the Polish Minister for Finance on a draft law on the Financial Stability Committee.

⁸ See paragraph 3.2 of Opinion CON/2008/39.

⁹ In particular, Articles 44 to 52 of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (OJ L 177, 30.6.2006, p. 1); Article 13 of Council Regulation (EC) No 322/97 of 17 February 1997 on Community Statistics (OJ L 52, 22.2.1997, p. 1); Article 8 of Council Regulation (EC) No 2533/98 of 23 November 1998 concerning the collection of statistical information by the European Central Bank (OJ L 318, 27.11.1998, p. 8); and Article 3 of Council Regulation (Euratom, EEC) No 1588/90 of 11 June 1990 on the transmission of data subject to statistical confidentiality to the Statistical Office of the European Communities (OJ L 151, 15.6.1990, p. 1); Guideline ECB/1998/NP28 of 22 December 1998 concerning the common rules and minimum standards to protect the confidentiality of the individual statistical information collected by the European Central Bank assisted by the national central banks (OJ L 55, 24.2.2001, p. 72).

Central bank supervision of liquidity management

- 4.3 Under the draft amendments, the BCL will be responsible for ‘supervising the general liquidity situation on the markets as well as evaluating market operators for this purpose’. The draft amendments refer to a ‘coordination and cooperation procedure’ for performing this task, subject to agreements between the BCL and the Commission de surveillance du secteur financier (CSSF, Commission for the supervision of the financial sector) and the Commissariat aux assurances (Commission for insurance), which will be in accordance with the parties’ legal powers¹⁰.

In general, the ECB has consistently favoured the involvement of central banks in prudential supervision to support the Eurosystem’s task of contributing to the adequate monitoring of risks to financial stability in the euro area. This is of particular importance in a context in which the nature and scope of these risks are affected by the introduction of the euro and the enhanced integration of financial markets. In this respect, adequate access of central banks to prudential information and cooperation between financial supervisory authorities and central banks are essential. Furthermore, the recent market turmoil has confirmed the importance of liquidity supervision over financial institutions and, in particular, the central banks’ interest in banks’ liquidity risk management.

- 4.4 As emphasised by work in progress at EU level, central banks have to place a strong emphasis on the prevention of systemic liquidity crises, as in general, they rely on open market operations to implement their monetary policy decisions and to distribute liquidity to the financial system and thereby to the real economy. Banks’ liquidity risk management is an important issue for central banks because liquidity shocks at one bank can have knock-on effects and could disrupt the efficiency and stability of the money market in three ways. First, due to asymmetric information, a liquidity crisis at one bank can lead to increasing uncertainty in the wholesale and retail markets with respect to the liquidity situation of other banks, which in severe cases could lead to a drying-up of money market liquidity and/or to a bank run. In less severe cases, it could raise refinancing costs for other banks and increase uncertainty with respect to future cash-flows and market conditions, which would exacerbate liquidity management. Second, the large and increasing share of interbank exposures and money market instruments in banks’ funding can cause a knock-on effect, as liquidity problems at one bank directly translate into increasing liquidity pressure (e.g. due to reductions in cash-inflows and unexpected refinancing requirements) on its interbank counterparties. Third, asset fire sales can lead to a market meltdown under certain circumstances, which in turn decreases the counterbalancing capacity of all banks and consequently, their liquidity risk-bearing capacity. In the potential emergence of a liquidity crisis, central banks need to assess the scale of the liquidity problem and the potential systemic implications of liquidity stress. In order to make informed judgements, they need reliable, comparable and comprehensive information in a timely manner.

¹⁰ See proposed Article 2(4) of the BCL Law.

- 4.5 Against this background, the ECB welcomes the attribution to the BCL of specific liquidity management competences. Moreover, the ECB notes that the draft law should clarify the powers assigned to the BCL in order to fulfil the new competences, such as the possibility to collect information from supervised entities and to perform on-site inspections. The ECB underlines that it will be very important that the cooperation procedure, which according to the BCL Law will have to be agreed by the BCL and national supervisory authorities, be carefully designed to allow the efficient performance by each authority of its own responsibilities, without unnecessarily increasing the administrative burden imposed on financial operators.
- 4.6 The ECB also recommends including a provision in the BCL Law setting out the principles according to which costs related to supervisory tasks will be covered, without prejudice to the principle of financial independence.

Clarification of the BCL's institutional framework

- 4.7 The proposed Article 2(5) of the BCL Law states that ‘in view of its tasks relating to monetary policy and to the promotion of the smooth functioning of payment systems, as well as contributing to the good management of policies implemented by authorities concerning prudential supervision of credit institutions and the financial system’s stability, while respecting its independence and the parties’ legal powers, the Bank shall cooperate with the Government and with prudential supervision authorities at national level, as well as with other central banks at the Community and international level to contribute to ensuring financial stability, in particular within committees set up for this purpose’¹¹. As set out in the explanatory memorandum¹², this provision is aimed at implementing 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 (hereinafter the ‘MoU’)¹³.
- 4.8 As regards cooperation under the proposed Article 2(5) of the BCL Law, the ECB understands that the Government intentionally repeats the relevant Treaty provision in order to underline the importance of cooperation between all authorities involved at the national, Community and international level, in order to avoid a financial crisis endangering financial system stability¹⁴. However, when considering this provision in the broader context of Article 2 of the BCL Law (‘tasks and legal status of the BCL’), there is an imbalance between proposed Article 2(5) of the BCL Law, which lists all of the BCL’s tasks (including its contribution to financial stability) and Article 2(2) of the BCL Law, which simply states that ‘the main task of the BCL shall be to participate in the execution of the tasks of the ESCB with a view to achieving its objectives’. In addition, restricting national, Community and international cooperation to financial stability issues is inaccurate, given that such cooperation is relevant to all ESCB tasks. For the sake of clarity, the BCL’s tasks, including contributing to financial stability as set out in this opinion,

¹¹ See proposed Article 2(5) of the BCL Law.

¹² See paragraph 2 of the explanatory memorandum.

¹³ The text of the MoU is available on the ECB’s website at www.ecb.europa.eu.

¹⁴ See page 4 of the explanatory memorandum.

should be listed in Article 2(2) of the BCL Law. As to proposed Article 2(5) of the BCL Law, for the sake of accuracy, a distinction should be drawn between domestic cooperation, which could focus on financial stability, in respect of the parties's respective legal powers and independence and Community and international cooperation, which would encompass all of the BCL's tasks, including contributing to financial stability.

Provision of emergency liquidity assistance

- 4.9 The proposed Article 27-2 of the BCL Law provides that 'The Central Bank may in exceptional circumstances grant short-term loans to its counterparties while respecting its independence and the provisions prohibiting monetary financing. It shall grant loans on the basis of adequate collateral which may consist of a State guarantee under the conditions previously agreed between the State and the Central Bank. The Central Bank's privilege in Article 27-1(1) shall apply to these loans'¹⁵.
- 4.10 As regards the provision of emergency liquidity assistance, while it has no objection to support given by central banks in exceptional circumstances and on a case-by-case basis to temporarily illiquid credit institutions¹⁶, it is the ECB's view that 'national legislation foreseeing the financing by NCBs of credit institutions other than in connection with central banking tasks (such as monetary policy, payment systems or temporary liquidity support operations), in particular to support insolvent credit and/or other financial institutions, is incompatible with the monetary financing prohibition'¹⁷.
- 4.11 In view of the above, the ECB strongly welcomes the draft law, which establishes the legal basis for the possible extension of emergency liquidity assistance by the BCL in the form of short-term loans extended to its counterparts, while at the same time providing for appropriate legal safeguards of central bank independence and compliance with the monetary financing prohibition under Article 101 of the Treaty¹⁸. As regards this latter aspect, the ECB notes that the concrete formulation of certain elements of the draft provision needs to be clarified so that full compliance of the proposed Article 27-2 of the BCL Law with the monetary financing prohibition is achieved. First, instead of a general reference to the concept of monetary financing, the proposed provision should be drafted more precisely to refer explicitly to the prohibition on monetary financing as defined by Community law or directly to Article 101 of the Treaty¹⁹. Second, the part of the proposed provision allowing for State guarantees to be used as collateral in connection with emergency liquidity assistance should be complemented by the requirement that the supported credit institution remains solvent. Third, the proposed provision should unequivocally

¹⁵ See proposed Article 27-2.

¹⁶ See the ECB's 1999 Annual Report, p. 99 and the ECB's December 2006 Financial Stability Review, p. 17 available on the ECB's website at www.ecb.europa.eu.

¹⁷ See the ECB's May 2006 Convergence Report, p. 68; the December 2006 Convergence Report, p. 30; the May 2007 Convergence Report, p. 22 and the May 2008 Convergence Report, p. 24, which are available on the ECB's website at www.ecb.europa.eu.

¹⁸ See paragraph 4 of the explanatory memorandum.

¹⁹ See p. 240 of the ECB's May 2008 Convergence Report on Article 14 of the Law LVIII of 2001 on the Magyar Nemzeti Bank.

ensure the independence of the BCL in deciding on the extension of emergency liquidity assistance. To this end, when referring to the BCL's independence, the proposed provision should stipulate that the same scope of independence is assigned to the BCL as regards the extension of emergency liquidity assistance as is available under Article 5(2) of the BCL Law with respect to the performance by the BCL of its ESCB-related tasks²⁰. The ECB considers, in particular, that ensuring the full independence of the BCL in deciding on the extension of emergency liquidity assistance will establish appropriate conditions for the possible acceptance by the BCL of a State guarantee in connection with such extended emergency liquidity assistance. In deciding whether a State guarantee may be accepted, the central bank should, in particular, assess whether the guarantee is economically adequate for emergency liquidity assistance purposes as well as legally valid and enforceable under national law.

5. Central bank participation in public institutions, undertakings or public or private associations

- 5.1 Under the proposed Article 26-1 of the BCL Law, 'the Central Bank may take and dispose of participation in public institutions, undertakings or public or private associations²¹. The explanatory memorandum states that this amendment provides the legal basis for the BCL's participation in external organisations. The explanatory memorandum notes in this context that the BCL currently participates in the Society for Worldwide Interbank Financial Telecommunication (SWIFT), the Groupement d'intérêt économique pour la promotion et la gestion des systèmes de paiement au Luxembourg (SYPAL-Gie) and the Financial Technology Transfer Agency (ATTF) and may participate in future Eurosystem activities²².
- 5.2 The ECB notes with interest the abovementioned provision as an element which could further facilitate the evolution of the financial market infrastructure in Luxembourg, its integration within the European environment and further market harmonisation.

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

Done at Frankfurt am Main, 10 September 2008.

[signed]

The President of the ECB
Jean-Claude TRICHET

²⁰ Alternatively a reference to the same level of independence as provided for in Article 108 of the Treaty could be considered.

²¹ See Article 26-1 of the BCL Law, as introduced by the Article V(6) of the draft law.

²² See paragraph 3 of the explanatory memorandum.