



## **OPINION OF THE EUROPEAN CENTRAL BANK**

**of 26 January 2009**

**at the request of the Danish Ministry of Economic and Business Affairs  
on a proposal for a Law on State investments in credit institutions and a proposal for a Law  
amending the Law on financial stability**

**(CON/2009/6)**

### **Introduction and legal basis**

On 21 January 2009 the European Central Bank (ECB) received a request from Danmarks Nationalbank on behalf of the Danish Ministry of Economic and Business Affairs for an opinion on a proposal for a Law on State investments in credit institutions and a proposal for a Law amending the Law on financial stability (hereinafter together the 'draft laws').

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<sup>1</sup>, as the draft laws relate 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 proposals**

- 1.1 The draft laws are motivated by the current financial market crisis and together take the form of a banking package to strengthen the capital base of credit institutions and mortgage credit institutions (hereinafter the 'credit institutions'). The aim is to provide financial robustness to ensure financing for the activities of sound businesses and households, and at the same time to strengthen the confidence of businesses and households in the financial sector.
- 1.2 The draft laws will establish a regime under which credit institutions can apply for capital injections from the State. The capital injections will be provided in the form of tier-1 hybrid core capital subject to the conditions specified in the draft laws.

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<sup>1</sup> OJ L 189, 3.7.1998, p. 42.

- 1.3 The Law on financial stability of 10 October 2008 established a State guarantee scheme for simple creditors and depositors, and is currently limited to two years, expiring on 30 September 2010<sup>2</sup>. The proposal for a Law amending the Law on financial stability introduces a three-year extension/transitional State guarantee regime for credit institutions to beyond 30 September 2010 combined with phasing out of the guarantees over this period. Under the new transitional scheme, credit institutions may until 31 December 2010, on an individual basis, apply for a State guarantee for specific issues of new unsecured debt and for supplementary collateral requirements for issues of junior covered bonds of up to three years' maturity. Under the proposal, the State guarantee will also be open to mortgage credit institutions for their covered bonds business. In addition, the proposal also gives the Company for winding-up distressed banks (hereinafter the 'WUC') a wider range of instruments to facilitate the winding-up process. The proposal makes it clear that the general and unconditional State guarantee under the current Law on financial stability will expire on 30 September 2010<sup>3</sup>, to be replaced by the modified transitional regime laid down in the proposal and by the regime introduced by the proposal for a Law on State investments in credit institutions.
- 1.4 The proposal for a Law on State investments in credit institutions establishes a scheme under which the State will be allowed to provide credit institutions in Denmark with hybrid core capital (capital investment) and to issue underwriting guarantees. As a corollary to the supply of State lending and guarantees, the credit package restricts the financial legislation in a number of ways, *inter alia* by setting limits for the variable part of remuneration for board members of credit institutions making use of the State support scheme, as well as prohibitions or restrictions on dividend payments and on capitalisation of undertakings within a group other than credit institutions.
- 1.5 The proposal for a Law on State investments in credit institutions applies to Danish credit institutions and to subsidiaries of foreign credit institutions located in Denmark, but not to foreign subsidiaries of Danish credit institutions. According to the terms and conditions for investments of hybrid core capital, 'subsidiaries of foreign financial groups shall, as far as possible, use the capital provided to secure consolidation and lending in Denmark'.
- 1.6 The State capital injected as tier-1 hybrid core capital into credit institutions is intended as a temporary interest-bearing loan. The interest rate will be determined individually for each credit institution, on the basis of objective criteria on the assessed risk connected with the loan, and is estimated to be in the range of 9 to 12 % annually, and on average about 10 %. According to the general commentary on the draft law, it is intended that the terms will provide sufficient economic incentives for credit institutions to replace the State loans with private capital.
- 1.7 As an alternative to the injection of hybrid core capital, credit institutions will have the option of applying for a State guarantee underwriting the raising of private capital.

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<sup>2</sup> See paragraph 2.1 of this opinion and also ECB Opinion CON/2008/54 of 17 October 2008 at the request of the Danish Ministry of Economic and Business Affairs on a proposed Law on financial stability.

<sup>3</sup> See § 1(11) of the proposal.

## **2. General observations**

- 2.1 ECB Opinion CON/2008/54 could not be taken into consideration before the adoption of the proposed Law on financial stability on 10 October 2008. This new consultation concerns an amendment to the Law on financial stability and the ECB therefore reiterates the position it has previously communicated in ECB Opinion CON/2008/54. Moreover, to the extent that the current proposal for a Law amending the Law on financial stability does not properly address the issues raised in ECB Opinion CON/2008/54, and that these continue to be relevant in the light of subsequent developments, the ECB's views in that opinion remain valid.
- 2.2 In the general commentary on the draft laws, it is pointed out that: (i) whereas the State guarantees under the Law on financial stability were meant as a short term measure to unfreeze credit-giving, and were to end by 30 September 2010, developments on the financial markets still create insecurity as to whether and under which conditions it will be possible for credit institutions to raise capital when the State guarantee expires, meaning that there remains a need to secure the medium-term raising of liquidity; (ii) credit institutions have considerable funding difficulties and may be forced to reduce their lending, thereby worsening the economic downturn; and (iii) the Danish financial stability scheme was agreed before any coordinated action was agreed at European level among the euro area Member States by the Paris Agreement of 12 October 2008, which was later confirmed by the European Council. Since then several Member States have adopted schemes of up to five years duration, which the Law on financial stability does not allow, thereby putting Danish credit institutions at a disadvantage in raising capital.
- 2.3 Moreover and in particular in line with the Declaration of 12 October 2008<sup>4</sup> made at the summit of the euro area Member States in Paris, the ECB noted that EU Member States have to act in a coordinated manner to avoid significant differences in national implementation having a counterproductive effect, creating distortions in global banking markets. In particular, the ECB notes that uncoordinated decisions to guarantee interbank deposits in some Member States should be avoided as they may involve a fragmentation of money markets<sup>5</sup>.

## **3. Specific observations**

### *Draft law amending the Law on financial stability*

- 3.1 The ECB appreciates that the unlimited State guarantee will expire on 30 September 2010 as originally provided for in the existing Law on financial stability, and that the proposal for an

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<sup>4</sup> See the Declaration of 12 October 2008, available on the website of the French Presidency, [www.ue2008.fr](http://www.ue2008.fr).

<sup>5</sup> See paragraph 2.3 of ECB Opinion CON/2008/54. See other ECB opinions on interbank deposits (e.g. ECB Opinions CON/2008/46 of 8 October 2008 at the request of the Belgian Ministry of Finance on a preliminary draft law on measures promoting financial stability and in particular establishing a State guarantee for the provision of credit in the context of financial stability, 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 a Royal Decree-Law adopting urgent financial and economic measures in relation to the concerted European action plan of the euro area countries and CON/2008/76 of 25 November 2008 at the request of the Slovenian Ministry of Finance on a draft law amending the Law on public finance).

extension/transitional arrangement or phasing out after 30 September 2010 under the proposal for a Law amending the Law on financial stability will base such extension or transitional arrangement on the assessment of specific issues of unsecured debt instruments by each individual credit institution. However, the ECB reiterates its view, in line with its recent opinions, that the State guarantee under the existing scheme should not cover interbank deposits. Indeed, such guarantees have the potential to interfere with the conduct of a central bank's liquidity-providing operations, and therefore in this case the transmission of the monetary policy decisions of Danmarks Nationalbank.

- 3.2 The ECB notes that the transitional scheme will also apply to State guarantees for supplementary collateral required for the issuance by mortgage credit institutions of covered bonds, with the objective of creating a level playing field. Furthermore, regarding the three-year extension of the guarantee scheme, the ECB emphasises, in line with the Declaration of 12 October 2008, that harmonisation regarding the expiry of national financial support schemes across the EU is of crucial importance.
- 3.3 Whereas the State guarantee scheme for credit institutions will be limited to a three-year transitional scheme and also contains a considerable own risk element borne by the financial sector, the proposal for a Law on State investment in credit institutions does not contain similar explicit exit rules. According to the general commentary, State investment is only meant to be of a temporary nature, with sufficient economic incentives for the credit institutions to replace State capital with private capital. In line with previous ECB opinions<sup>6</sup>, it should be ensured that such measures are in accordance with the requirements of Community competition law, in particular State aid rules, and that the State's role is limited in time. In this respect, the draft Law on State investment in credit institutions should set out in more precise terms the incentives that will be put in place for the redemption or conversion of the instruments either on the basis of a period of time or the development of market conditions. This would serve to ensure the temporary nature of the State's involvement and discourage financial institutions from maintaining such involvement for an extensive period of time.
- 3.4 According to the proposal for a Law amending the Law on financial stability, credit institutions will pay a fee for the State guarantee to be determined individually for each credit institution<sup>7</sup>. Those credit institutions which are members of the Private Contingency Association already pay a fee for the currently available guarantee, and for the period after 30 September 2010 they will have to pay a fee to cover new issues.

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<sup>6</sup> 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.

<sup>7</sup> See Article 1(10) on § 16c(4) of the proposal.

*Draft law on State investments in credit institutions*

- 3.5 The proposal for a Law on State investment in credit institutions is very broadly formulated regarding the terms and conditions for agreements on such investment, and specifically leaves it to the Minister for Economic and Business Affairs to lay down detailed rules regarding the terms and conditions as well as rules for calculating the remuneration of such investment. The commentary on the proposal contains some guidelines and assumptions regarding the remuneration, but for reasons of legal clarity these should also be reflected in the text of the draft law itself.
- 3.6 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. In particular, 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 to reflect 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<sup>8</sup>. Against this background, the Governing Council of the ECB has formulated recommendations on the pricing of recapitalisations<sup>9</sup>. In particular, 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 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.
- 3.7 Furthermore, pursuant to Chapter 2 paragraph 3 of the proposal for a Law on State investments in credit institutions, credit institutions that receive capital investment in accordance with this law must, following the capital investment, have a core capital at the time of recapitalisation of at least 12 %. In this respect, the ECB acknowledges that this provision is compliant with the EU Council Conclusions of 20 January 2009 on Bank Capital which state that 'the provision of capital to the banking sector is not intended to create new, higher statutory capital requirements for the banking sector. Banks' capital requirements should continue to be assessed on a case-by-case basis, in line with existing EU regulation, based on their individual risk-profile and rigorous stress-testing. It should be recognised that capital provides a buffer both to withstand the challenging economic conditions and to maintain lending to creditworthy borrowers'<sup>10</sup>.

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<sup>8</sup> See e.g. ECB Opinion CON/2009/3 of 8 January 2009 at the request of the Slovenian Ministry of Finance on a draft decree laying down criteria and conditions for the implementation of State capital investments and for the conversion of State claims into capital shares under Article 81.a of the Law on public finance.

<sup>9</sup> 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](http://www.ecb.europa.eu).

<sup>10</sup> Cf the Council conclusions on bank capital, as adopted by the Council (ECOFIN) on 20 January 2009.

3.8 The ECB wishes to underline the importance it attaches to ensuring that the Law on State investments in credit institutions, and any subsequent executive orders, are in line with generally agreed principles for recapitalisation measures and preserve a level playing field as described above in line with the recommendations expressed in several recent ECB opinions.

*State guarantee and the prohibition on monetary financing*

- 3.9 ECB Opinion CON/2008/54 noted that the State will be the sole owner of the WUC<sup>11</sup>, which will be able to borrow to cover its financing needs<sup>12</sup>, and that the WUC should not be allowed to benefit from any type of lending or overdraft facilities from Danmarks Nationalbank to ensure compliance with the prohibition on monetary financing. Danmarks Nationalbank had confirmed that it did not intend to lend or provide any financing to the WUC<sup>13</sup>. It is noted that the provision of emergency liquidity assistance is a central bank function, which consists in giving support in exceptional circumstances and on a case-by-case basis to temporarily illiquid but solvent credit institutions<sup>14</sup>.
4. In the proposal for a Law on State investment in credit institutions, the Minister for Economic and Business Affairs can draw on the State's account with Danmarks Nationalbank for the payment of hybrid core capital to those credit institutions with which such an agreement is made. The cost will be included immediately in the current supply law<sup>15</sup>. The ECB understands that the express indication in the proposal that the cost of supplying hybrid core capital will be included immediately in the current supply law will ensure compliance with the prohibition on monetary financing.

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

Done at Frankfurt am Main, 26 January 2009.

[signed]

*The President of the ECB*

Jean-Claude TRICHET

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<sup>11</sup> See § 3 of the Law on financial stability.

<sup>12</sup> See § 3(2) of the Law on financial stability.

<sup>13</sup> See paragraph 3.2 of ECB Opinion CON/2008/54.

<sup>14</sup> See ECB Opinion CON/2008/42 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.

<sup>15</sup> See § 2(2) of the proposal for a Law on State investment in credit institutions.