

# Attila Korencsi, Melinda Lakatos and György Pulai: Regulation on the prohibition on monetary financing – obligations and opportunities\*

*The prohibition on monetary financing restricts the central bank financing of institutions within the public sectors of the EU and member states, thereby strengthening the budgetary discipline and the commitment to price stability as the primary objective of monetary policy. However, compliance with the prohibition does not mean that there is no leeway left for the efficient fulfilment of central bank functions. The exceptions specified in the law allow central banks to attain the objectives and fulfil the basic tasks of the European System of Central Banks. The regulations concerning the prohibition on monetary financing also apply to the non-euro area central banks – thus to the Magyar Nemzeti Bank as well – and compliance with such regulations is monitored by the European Central Bank. This article aims to provide a comprehensive overview of the key elements of the prohibition and the possibilities provided by the exceptions by presenting the central bank's lending practice, the purchase of debt instruments and the functions of the fiscal agent.*

*The European Central Bank and member state central banks cannot grant credit to the public sector of the EU and of the member states. The central bank funding of publicly-owned credit institutions other than central bank money supply is irreconcilable with the prohibition on monetary financing. In respect of debt instruments, the purchase of securities issued by the public sector on the primary market is prohibited, and purchasing on the secondary market may not serve the circumvention of the prohibition either. Central banks may act as fiscal agents for the state; but any role they assume must comply with market conditions.*

## SUMMARY

The prohibition on monetary financing, which restricts the central bank financing of the institutions belonging to the EU and member state public sector, strengthens budgetary discipline and the commitment to price stability, as the primary objective of monetary policy.

The prohibition on monetary financing is a European Union rule prescribing an obligation of adaptation; although it sets boundaries, compliance with the prohibition does not prevent central banks from effectively fulfilling their central bank functions. On the one hand, EU law sets out prohibition rules to be strictly observed, but on the other hand it also allows for exceptions, which allow central banks to efficiently achieve the goals and fulfil the basic tasks of the European System of Central Banks (ESCB).

The provisions pertaining to the prohibition on monetary financing also apply to Magyar Nemzeti Bank (MNB);

compliance is monitored by the European Central Bank (ECB); national central banks, including the MNB, must also submit reports on compliance annually.

In this article, we wish to give an overview of the key elements of the prohibition. We address the following topics: the central bank's lending practice, purchase of debt instruments and fiscal agent functions.

In case of **central bank lending**, the prohibition on monetary financing limits the financing of the public sector, the granting of emergency liquidity assistance to credit institutions and financial support to deposit insurance and investor compensation schemes. According to the prohibition, the ECB and member state central banks, including the MNB, may not grant overdraft facilities or any other type of credit to EU institutions, the member states' central government, regional or local public administration bodies or public undertakings. It is irreconcilable with the prohibition on monetary financing, if a central bank

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\* The views expressed in this article are those of the author(s) and do not necessarily reflect the official view of the Magyar Nemzeti Bank.

finances a publicly-owned credit institution outside of the scope of central bank money supply (i.e. using means other than the monetary policy instruments, lending related to payment and settlement systems or emergency liquidity assistance).

The granting of emergency liquidity assistance can be an important instrument for maintaining the stability of the financial system and preventing potential contagion impacting the banking system and money markets. At the same time, it must not aim at monetary financing; therefore this extraordinary form of credit is available only on a temporary basis and only for credit institutions deemed solvent.

The financing of deposit insurance and investor compensation schemes is essentially not a central bank function. Central banks may only assume a role under extraordinary circumstances similarly to the granting of emergency liquidity assistance, e.g. when the stability of the financial system is at stake.

The prohibition on monetary financing restricts the **purchase of debt instruments** in two respects. On the one hand, it prohibits the purchase of debt instruments issued by public sector institutions, as already mentioned in the section on central bank lending, in the primary market, except for certain cases of foreign exchange reserve management. On the other hand the purchase of debt instruments issued by the public sector on the secondary market – which is otherwise permitted – must not be used for circumventing the prohibition. In the latter case the ECB sets control threshold values – typically GDP-proportionate – and performs the annual audit of compliance with the prohibition based on them.

Finally, central banks may act as **fiscal agents** for the state; however, when doing so they must act under actual market conditions.

## CONTENT OF THE PROHIBITION ON MONETARY FINANCING

The purpose of the prohibition on monetary financing is to ensure that the maintenance of budgetary discipline and price stability as the primary goal of the monetary policy, is not compromised. This is necessary because financing of the EU and member state public sector institutions by central banks eases pressure on budgetary discipline. In

addition to the prohibition rules pertaining to monetary financing, which must be strictly adhered to, EU law also allows exceptions that enable central banks to fulfil their functions efficiently. Therefore, the prohibition is objective-oriented, and as such it is not excessive. This provides ample leeway in the application of monetary policy and financial stability instruments, and foreign reserve management. The prohibition on monetary financing is defined by Article 123 of the Treaty on the Functioning of the European Union (TFEU) in a way that it prohibits or restricts certain forms of financing. In the framework of the prohibition, the ECB and the member state central banks must not grant overdraft facility or any other credit to the following range of institutions, and neither shall they purchase debt instruments directly (on the primary market) from these institutions:

- EU institutions, bodies, offices or agencies;
- central governments, regional, local or public authorities, other bodies governed by public law, or public undertakings of the member states.

However, this rule shall not apply to publicly-owned credit institutions which, in the context of the supply of reserves by central banks, shall be accorded the same treatment by national central banks and the ECB as private credit institutions.

The instruments of central bank money supply – in the case of which the same rules apply to publicly-owned credit institutions as to private credit institutions – are as follows: (i) monetary policy instruments, (ii) intra-day credit granted for the smooth operation of the payment and settlement systems, and (iii) granting of emergency liquidity assistance to credit institutions struggling with temporary liquidity difficulties, subject to individual assessment.

The Statutes of both the ESCB and the ECB also allow the ECB and national central banks to act as fiscal agents for the EU and state institutions; thus the performance of financial agent functions is a legitimate function for central banks, and if it is pursued in accordance with market conditions, it does not conflict with the prohibition on monetary financing.

The detailed rules on the prohibition on monetary financing, prescribed in the TFEU, are determined by an EU regulation.<sup>1</sup> The MNB must also apply – based on the provisions of the

<sup>1</sup> Council Regulation No. 3603/93/EC (13 December 1993) specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b (1) of the TFEU.

TFEU, and the ESCB-ECB Statutes – the provisions pertaining to the prohibition on monetary financing.<sup>2</sup>

In view of the fact that the prohibition on monetary financing is set out in mandatory EU law (the TFEU and the regulation) directly applicable to all and in full, it is not necessary to incorporate these regulations into national laws. However, if national laws affect these directly applicable EU regulations, they shall not restrict the scope of the monetary financing prohibition, nor shall they extend the exemptions provided under EU law. The EU regulations on the prohibition on monetary financing are reflected in Hungarian law in the Act on Magyar Nemzeti Bank.

## MONITORING COMPLIANCE WITH THE PROHIBITION ON MONETARY FINANCING

According to the TFEU, the Governing Council of the ECB has competence to monitor the fulfilment of the obligations of national central banks arising from the TFEU and from the ESCB-ECB Statutes. Steps of the procedure followed when auditing the compliance with the prohibition on monetary financing:

- If the Governing Council of the ECB considers that a national central bank has failed to fulfil an obligation under the TFEU, it shall deliver a reasoned opinion on the matter after having provided the respective central bank with the opportunity to submit its comments;
- if the central bank concerned does not comply with the provisions of the opinion within the period specified by the Governing Council of the ECB, the latter may bring the matter before the European Court of Justice;
- if the European Court of Justice establishes that the central bank has failed to fulfil an obligation under the TFEU, the central bank must take necessary measures for fulfilling the judgement of the European Court of Justice; failure to do so could result in the imposition of a lump sum or penalty payment.

The ECB annually reviews and formulates its findings on whether national central banks comply with the prohibition on monetary financing.<sup>3</sup> National central banks, including the MNB, must complete a questionnaire at the beginning of every year on their activities related to the prohibition on monetary financing performed during the previous year. The ECB may ask additional questions and request explanations on the information supplied. The annual evaluation is performed in the context of dialogue between the ECB and the national central banks. The ECB also presents in its public annual report those cases that it deems alarming or worth mentioning in terms of the prohibition on monetary financing. The position of the ECB concerning the assessment of certain cases is also influenced by those consultation procedures, in the course of which the ECB expresses its opinion on certain national draft legislative provisions also assessing compliance with the prohibition on monetary financing. The ECB opinions formulated and published during the consultation procedures serve as important points of reference for the national authorities, as well as for the central banks in the area of legislation and application of the law.

The ECB – fulfilling its obligation prescribed in Article 140 of the TFEU – reports to the Council of the European Union at least every two year, and upon the request of any impacted member state, on the progress made by the member states with a derogation, i.e. those that have not yet introduced the euro, in the area of fulfilling their obligations concerning the implementation of the Economic and Monetary Union. The report discusses whether these member states have implemented a high degree of sustainable convergence, whether the national laws are compatible with the TFEU and whether the national central banks meet the legislative requirements of the integration in the Euro-system. In this so-called convergence report, the ECB also inspects whether the laws of the member state, being outside the Euro-system, comply with the prohibition on monetary financing prescribed in EU law.

In view of the fact that the audit performed by the ECB may be also divided into three larger areas, in the further parts

<sup>2</sup> According to Article 139 (1) of the TFEU, Hungary – in view of the fact that it has not yet introduced the euro – is a “Member State with a derogation”. Article 139 (2) of the TFEU lists, item by item, those provisions of the TFEU that do not apply to “Member States with a derogation”. However, these do not include Article 123 concerning the prohibition of monetary financing; consequently Hungary must comply with it.

The ESCB-ECB Statutes – following a similar logic – also order the prohibition of monetary financing, with the proviso that in Article 42.1 it does not specify Article 21 of the ESCB-ECB Statutes, prescribing the prohibition of monetary financing, as one not applicable to “Member States with a derogation”. This also means an obligation for Hungary and the MNB must observe the prohibition.

<sup>3</sup> For the sake of completeness, it should be noted that upon the annual evaluation of compliance with the prohibition of monetary financing, the ECB also audits the national laws pertaining to the compliance with the prohibition of privileged access, regulated in Article 124 of the TFEU and in EC Regulation 3604/93/EC – however, this topic falls outside the subject matter of this paper.

of this document we describe these in the context of the prohibition on monetary financing:

- central bank lending practice,
- the debt instruments available for purchase by the central banks, and
- the central banks' fiscal agent functions.

## CENTRAL BANK LENDING

### Prohibition of lending to the public sector

The public sector include the EU institutions, bodies, offices or agencies, as well as the central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of the member states.<sup>4</sup>

The ECB and the national central banks are not part of the public sector; accordingly, for example, if a central bank places a deposit with another central bank or with the ECB, it does not qualify as prohibited financing.

For the purpose of the prohibition on monetary financing, lending shall mean the granting of an overdraft facility or any other type of credit facility.

An overdraft facility is the provision of funds to the public sector resulting or likely to result in a debit balance.

The notion of "other type of credit facility" beyond the overdraft facility includes transactions concluded with the public sector resulting or likely to result in a claim against the public sector. Similarly, the central bank financing of the public sector's liabilities to third parties is also prohibited, as it falls under the category of "other type of credit facility".<sup>5</sup>

EU law does not list the transactions classified as "other type of credit facility" one by one, but as an example it may be emphasised that within the investment activity of central banks – i.e. besides cases of central bank money

supply – the following transactions are subject to the prohibition on monetary financing: placement of central bank deposits with public sector credit institutions (including the holding of accounts with them) or repo transactions with public sector credit institutions where in the first leg of the transaction the central bank provides the repo partner with cash when purchasing the securities. This is because in all these cases, the central bank accrues receivables from the public sector institution as a result of the transaction.

A central bank may not finance the activity of public sector bodies or the public sector's liabilities towards third parties. The central bank is also prohibited from granting advances for public sector payments.

On the other hand, according to the provision of EU law specifying the exceptions, the financing of the obligations towards the International Monetary Fund (IMF) or those arising from the implementation of medium-term financial assistance scheme, shall not qualify as a form of lending, if it generates such foreign receivables that bear all features of the reserve assets.

Intra-day credits granted by the central banks to the public sector – facilitating the smooth operation of the payment and settlement systems – shall not be deemed as ones conflicting with the prohibition, provided that they are limited to the respective day and cannot be extended to the next day. The central bank financing of the public sector is prohibited not only for traditional credit and loan contracts, but also for all other combined or atypical agreements.

It is prohibited to provide central bank financing to publicly-owned credit institutions, other than through means of central bank money supply. Irrespective of the form – whether atypical or a special scheme – of prohibited financing of publicly-owned credit institutions, the central bank only has leeway to proceed lawfully in the case of central bank money supply instruments. Monetary policy instruments are characterised by the fact that central banks announce them, subject to equal terms, to a specific range of the central bank's partners and any of the entities

<sup>4</sup> A public undertaking is an undertaking (economic organisation) in which the state or other authority has direct or indirect controlling interest on ownership basis, either based on financial share in the undertaking or pursuant to rules applicable to the undertaking. The controlling interest of the state authorities shall be presumed, if in respect of an undertaking it holds directly or indirectly: a) the larger part of the undertaking's subscribed capital; b) it controls the majority of the voting rights connected to the shares issued by the undertaking; or c) it may appoint more than half of the members in the undertaking's management, controlling or supervisory bodies. An undertaking may also qualify as public undertaking if none of the above-listed conditions – underlying the presumption – prevail, but the public sector exerts controlling influence on the given undertaking in any other way, based on the rules applicable to the undertaking.

<sup>5</sup> It should be noted that according to the EU regulation the receivables from the public sector as at 1 January 1994 also qualify as "other credit", except for the fixed-term receivables acquired by the central banks prior to this date. Thus such receivables may still exist, but they must show a decreasing, phasing out tendency.

belonging to the range of partners may avail itself thereof subject to the conditions announced in advance. Credit granted for the smooth operation of the payment and settlement systems may be also used by the participating credit institutions subject to pre-defined conditions and in an identical manner. The extraordinary assistance within central bank money supply, not announced in advance and in general, is always based on special consideration and it is the central bank's own decisions concerning the temporary financing of a credit institution still qualifying as solvent – regardless of whether these decisions concern cooperation in the reorganisation of the bank, the granting of emergency liquidity assistance or the assumption of any other central bank role serving the stability of the financial intermediary system.

### **Possibility of granting emergency liquidity assistance**

The Emergency Liquidity Assistance (ELA) granted to credit institutions qualifies as another function under the ESCB and ECB Statute which the national central bank may legitimately perform. The rules pertaining to the emergency liquidity assistance are included in the national laws. These national laws must also comply with the provisions pertaining to the prohibition on monetary financing. In Hungarian law, the emergency liquidity assistance which may be provided to credit institutions is regulated by the Act on the MNB.

If there is any circumstance due to which the operation of the credit institution jeopardises the stability of the financial system, MNB may grant emergency liquidity assistance to the credit institution. The decision on granting emergency liquidity assistance falls under the central bank's discretionary powers. As opposed to monetary policy instruments, the central bank never makes a general announcement of the emergency liquidity assistance; it always grants such after consideration the specific case, based on an individual decision.

The most important goal of emergency liquidity assistance is to prevent or mitigate the risk of potential contagion at the banking system and money market level. In a situation of temporary liquidity emergency faced by a credit institution, if warranted for the protection of financial system stability, the central bank may provide the liquidity necessary for the credit institution's daily operation in the form of emergency liquidity assistance. Use of emergency liquidity assistance typically arises when the credit

institution's access to the announced monetary policy instruments is no longer sufficient or adequate. In such a situation, the central bank assesses the option of providing emergency liquidity assistance to the credit institution based on individual judgement.

In view of the national regulatory background, the MNB provides emergency liquidity assistance only if all of the following conditions below apply:

- the emergency liquidity assistance is requested by a credit institution,
- the functioning of the credit institution jeopardises the stability of the financial system,
- the prohibition on monetary financing must be observed.

It results from compliance with the prohibition on monetary financing that emergency liquidity assistance may only be granted to credit institutions struggling with temporary liquidity problems, but not to insolvent ones. The funding of insolvent credit institutions is beyond the scope of emergency liquidity assistance. If insolvency of the credit institution occurs after credit has been granted and was not foreseeable prior to the emergency liquidity assistance, despite the due diligence review performed by the central bank, it is not regarded as a violation of the monetary financing prohibition. However, if the insolvency is foreseeable and can clearly not be prevented even with emergency liquidity assistance, no such assistance may be provided to the credit institution. This requires that the central banks perform a highly thorough assessment to fully gauge the condition of the credit institution. The position of the central bank is made much easier if it also has micro-prudential supervisory powers, giving it direct access to the information. Otherwise, supervisory authorities and central banks cooperate closely when a credit institution faces troubles.

Emergency liquidity assistance – its primary purpose being the management of temporary liquidity shocks – is typically a short-term credit, but it bears a penalty-type interest that is higher than the usual refinancing interest rate.

### **Financial support for insurance deposit and investor compensation schemes**

The financing costs of deposit insurance and investor compensation schemes are borne by credit institutions and investment companies.<sup>6</sup> Accordingly, the national laws that

<sup>6</sup> This is in harmony with recital (23) of Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes and recital (23) of Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor compensation schemes.

are compatible with the prohibition on monetary financing are ones that permit the financing of the public sector's national credit institution deposit guarantee scheme or investment companies' national investor compensation scheme by the central bank only if (i) the financing is short term, (ii) it addresses an emergency situation, (iii) the stability of the financial system is at stake, and (iv) the financing decisions are made by the central bank.

The Act on the MNB reflects these conditions. The MNB may grant urgent, extraordinary credit for a term no longer than three months to the National Deposit Insurance Fund – at its request, after giving individual consideration to the request and in cases that jeopardise the stability of the financial system as a whole and the smooth operation of payments – in line with the prohibition on monetary financing.

The fact that the term of the given credit may not exceed three months is geared towards ensuring the avoidance of regular prefinancing by the central bank. This maturity may not be prolonged. New central bank credit may only be applied for if there is once again an emergency situation jeopardising the stability of the financial system and the smooth operation of the payments. If a compensation scheme is constantly in an emergency situation, the credit granted by the central bank is not a solution anyway, because central bank credit only functions as a temporary assistance and the central bank does not assume the permanent financing of the compensation scheme.

Should a compensation scheme be linked to the central bank based on the management, organisation or any other connection point, then the regulation must ensure that the operation of this organisation, including the fund meant to pay the compensations, is not financed by the central bank regularly.

Similarly to the emergency financial assistance, the temporary credit granted to compensation schemes must not jeopardise the performance of the central bank's monetary policy functions or the functions arising from its ESCB membership.

## PURCHASE OF DEBT INSTRUMENTS

### Possibility of acquiring debt instruments on the primary market

According to the general rule set out in the provisions of EU law, central banks may not acquire debt instruments (debt securities, commercial papers, certificates of deposit) on the primary market (upon issue).

However, the following purchases – with the sole objective of managing foreign exchange reserves – shall not qualify as violation of the prohibition on monetary financing:

- the purchase of marketable debt instruments from the public sector of another member state in the primary market by the central bank of a non-euro area member state; and
- the purchase of marketable debt instruments from the public sector of a non-euro area member state in the primary market by the ECB or the central bank of a euro-area member state.

Accordingly, the MNB – as a non-euro area central bank – may purchase marketable debt instruments on the primary market from the public sector of another member state for the sole purpose of managing foreign exchange reserves. However, the foreign exchange reserve management purpose also means that the debt instruments of another member state denominated in forint may not be purchased in the primary market. Furthermore, the MNB may not purchase debt instruments issued by an EU institution, body, office or agency (e.g. European Investment Bank) in the primary market, even for the purpose of managing foreign exchange reserves, as EU law specifying the exception permits only the acquisition of member state issues in the primary market.

### Possibility of acquiring debt instruments on the secondary market

The purchase of debt instruments issued by the public sector in the secondary market does not violate the prohibition on monetary financing, but such purchases shall not be used by the central banks to circumvent the prohibition on monetary financing. Thus, purchase on the secondary market is permitted; however this opportunity should only be used bearing in mind the purpose of the prohibition on monetary financing. The sole purpose of managing foreign exchange reserve is compatible with the prohibition on monetary financing. If the purchase of securities takes place expressly for the purpose of restoring monetary transmission or attaining the primary objectives of the central bank and not for financing the budget or reducing its burdens, it does not qualify as circumvention of the prohibition either.

Since EU law does not define in an objectively measurable way when a secondary market purchase qualifies as circumvention of the prohibition, the ECB monitors whether certain central banks abuse the opportunity on the basis of

the – typically GDP-proportionate – valuation threshold defined by it. Breach of the threshold values does not necessarily represent a violation of the prohibition, but in this case the ECB makes an enquiry at the given central bank as to the circumstances of the purchase on the secondary market, i.e. it asks for explanation and proper justification, and based on that it assesses whether or not there is an issue of circumventing the prohibition.

It is not typical of national central banks to purchase above the threshold values. If the ECB establishes a breach of the threshold value by a central bank after having made proper comments and potential adjustments, the ECB may implement increased oversight. If the respective central bank fails to meet the criteria in the following year as well, the ECB may increase the frequency of the reporting obligation to quarterly or monthly and ask for detailed information concerning the relevant transactions.

## FISCAL AGENT FUNCTIONS

Pursuant to Article 21.2 of the ESCB-ECB Statutes, the ECB and the national central banks may act as fiscal agents for public sector institutions.

Traditionally – almost since the establishment of the first central banks – the role of “national central bank” and “bank of the state” has been inseparable from the operation of the central banks; therefore it would be unjustified if due to the prohibition on monetary financing this traditional central bank role ceased to exist and the state had to rely solely on market players. On the one hand, central banks have a special public law status; therefore, despite the business activities they perform they cannot be considered as market players in the ordinary sense; however, on the other hand, in view of the prohibition on monetary financing, market conditions must be reflected in their relations with the public sector as well.

Regulation 3603/93/EC also emphasises in the recital concerning the possibility of performing fiscal agent functions, that “the function of fiscal agents exercised by the central banks should not be impeded”. Accordingly, the fiscal agent functions may be performed lawfully, but within a framework that guarantees compliance with the prohibition on monetary financing.

The holding of the coin stock, issued by and credited to the public sector, by the ECB or the national central banks shall not be treated as a prohibited form of lending, if the amount of the assets thus accumulated remains at less than 10 per cent of the coins in circulation. This rule is not relevant in Hungary, as the legal tender – including coins – is issued by the MNB.

If a central bank receives a cheque for collection from the public sector issued by a third party and the central bank credits the cheque’s amount to the public sector’s account before it receives the cheque amount, the prohibition on monetary financing is not violated if the usual deadline specified by the respective central bank for the collection of cheques has already expired since the receipt of the cheque, but the time difference is negligible, the cheque is for a small amount and the central bank receives it shortly afterwards.

The Act on MNB specifies several functions that the MNB may perform subject to complying with the prohibition on monetary financing.

The MNB may hold accounts for the public sector organisations specified in legislation, may accept deposits from them or provide other banking services to them.

Based on the instruction of the state, or in respect of the securities owned by the state – not including shares – the MNB may act on the securities market as an agent for the state.

Based on the instruction of the state, the MNB may participate in the state’s foreign exchange borrowing transactions and securities issues abroad, as well as in functions related to the management of the state’s foreign receivables.

The MNB may conclude forward and hedging transactions with the state or as its agent under market conditions.

The transactions listed above must not be geared towards shielding the state from market conditions; therefore precautions must be taken to ensure that each transaction is concluded under actual market conditions.