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Having something in reserve

Liquidity obligations in the Austrian banking sector were under the European Commission spotlight for four years before the case was dropped recently. TIBOR VARGA and BERNHARD RIEDER assess the implications

The European Commission has recently discontinued an infringement procedure against Austria over liquidity reserve obligations for local credit co-operatives and savings banks, bringing to a close an action that had been running since 2004.

The case had its origins in section 25 of the Austrian Banking Act (*Bankwesengesetz*). Under that legislation, credit institutions must ensure that they can honour their payment obligations at all times, and section 25 contained several details regarding this obligation.

In particular, section 25 stipulated that credit institutions affiliated to a central institution shall hold a liquidity reserve at their central institution that is 10 per cent of the savings deposits and 20 per cent of other euro deposits, but not more than 14 per cent of their total euro deposits. According to this provision, local credit co-operatives (*Primärbanken*) and savings banks had been forced to hold their reserves with their central institution and thus had not been free to place their liquid resources with other European financial institutions.

It has been the subject of some discussion among Austrian experts whether the obligation to hold reserves with a central institution is permissible under constitutional law. In particular, a violation of the principle of equal treatment has been argued.

> The Commission requested that Austria remove restrictions on the investment of co-operative sector banks' liquidity reserves

Constitutional Court

The Austrian Constitutional Court decided in 1993 that the obligation does not violate Austrian constitutional law and is therefore permissible. In that ruling, the Constitutional Court held the restriction on placing liquid resources with certain financial institutions to be justified. It said that the pooling of the liquidity balances the disadvantages of smaller credit institutions as regards liquidity.

In 2002, the European Commission formally requested that Austria remove these restrictions on investment of banks' liquidity reserves in the co-operative banking sector. Furthermore, in 2004, the European Commission decided to refer Austria to the European Court of Justice because of these restrictions, in relation to both the co-operative banking sector and the savings bank sector.

The European Commission argued that although it is legitimate – and even compulsory under EU law – to ensure that banks have sufficient liquidity to meet their payment obligations at all times, the obligation to hold a substantial part of the liquidity reserve with a common central banking institution is disproportionate. It argued that this is because it would be neither suitable nor necessary for attaining the objective pursued and consequently constitutes an unjustified restriction on the unconditional freedom of capital movement set out in article 56 of the EC Treaty.

Moreover, it cannot be justified by any imperative requirement in the general interest. Thus, the European Commission deemed the provision to be a breach of the free movement of capital under article 56.

Amended legislation

As a result, on 1 January 2008 the Austrian Banking Act was amended. Although under the new law banks are still required to participate in a system of joint liquidity compensation and keep a particular liquidity reserve, this reserve may now also be kept with any bank in the EU, provided this bank assumes the obligation to provide liquidity to the local banks in case of need.

According to the new law, local banks may decide which institution the liquidity reserve is held with. They may entrust, as a group, another bank either in Austria or another EU member state with the liquidity tasks in question. The newly established possibility that funds may be withdrawn from the central institutions shall also induce these institutions to offer appropriate conditions.

As a result, under the new provisions, credit institutions affiliated to a central institution may hold a liquidity reserve not only at their central institution but also at banks in other member states. Consequently, after the removal of the restriction underlying the infringement procedure, the Commission closed the case.

Section 25 of the Banking Act has no direct European legal basis, even though Directive 2006/48/EC contains 46 references regarding the relevance of liquidity.

However, there are moves in the EU to enact regulations on the liquidity of credit institutions. Indeed, the Committee of European Banking Supervisors received the call from the Commission for technical advice (CfA No 8) on liquidity risk management in March 2007. The committee sent the first part of its technical advice to the Commission in August 2007, and the second part in September 2008. Practitioners would be well advised to keep an eye on future developments. ■

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Tibor Varga and Bernhard Rieder are lawyers at Vienna-based law firm Dorda Brugger Jordis