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EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 26 March 2009

at the request of the Latvian Financial and Capital Market Commission

on a draft law amending the Law on deposit guarantees

(CON/2009/31)

Introduction and legal basis

On 23 March 2009 the European Central Bank (ECB) received a request from the Latvian Financial and Capital Market Commission (FCMC) for an opinion on a draft law (hereinafter the 'draft law') amending the Law of 3 June 1998 on deposit guarantees (hereinafter the 'Law on deposit guarantees'[1]).

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[2], as the draft law relates 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 draft law

The draft law will introduce certain changes to the operation of the Latvian Deposit Guarantee Fund (hereinafter the 'Fund'), and in particular it will:

(1) broaden the scope of the Fund's coverage as regards branches in Latvia of banks not registered in the European Union[3];

(2) clarify the scope of categories of depositors excluded from the Fund's protection[4];

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1 Published in *Latvijas Vēstnesis*, 162(1223) on 3 June 1998, as amended.

2 OJ L 189, 3.7.1998, p. 42.

3 See amended Article 2 of the Law on deposit guarantees (amendments to paragraph 2 and deletion of paragraphs 3 and 4(2)).

4 See amended Article 17 points (4) and (6) of the Law on deposit guarantees. The new categories of excluded depositors are (i) specified categories of persons involved in management, supervision or auditing of the Fund member; and (ii) depositors who have obtained individual conditions for their deposit holdings that facilitated the deterioration of the Fund member's financial situation. Such categories correspond to points 7 and 11 of the Annex I to the Directive 94/19/EC on deposit-guarantee schemes (OJ L 135, 31.5.1994, p. 5).

(3) introduce risk-based calculation of premiums paid to the Fund by its members, as well as a possibility for a special temporary increase of the Fund's premiums where deposit payouts have been made[5]; and

(4) enhance the Fund's deposit payout procedure, in particular by allowing for payments to be made through a selected commercial credit institution[6].

According to the FCMC[7], such amendments are necessary in order to address the present international and domestic financial situation and to take account of the regulatory regime introduced by Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay[8].

2. General observations

In its Opinion CON/2009/10 of 4 February 2009, the ECB has already commented on the special legislative measures proposed by the Latvian authorities to deal with the financial crisis, including the changes to the Law on deposit guarantees[9]. To the extent relevant, the observations made in Opinion CON/2009/10 also apply to the changes proposed by the draft law. The present opinion concentrates on the selected issues specified below and does not constitute a comprehensive assessment of the Law on deposit guarantees, nor of the implementation of Directive 2009/14/EC in Latvia. Nevertheless, the ECB takes this opportunity to reiterate that, when implementing Directive 2009/14/EC or otherwise amending the legal framework for operation of the national deposit-guarantee schemes, Member States should act in a coordinated manner to avoid significant differences in national legal frameworks having a counterproductive effect, by creating distortions in global banking markets[10].

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5 Risk-based calculation of the Fund premiums will apply from 1 January 2010; see amended Article 8 of the Law on deposit guarantees (new wording in paragraphs (2) to (2^2) and in paragraph (6)) together with the point 9 of the draft law.

6 See new Articles 13^1 and the paragraphs (1) to (4) added to Article 20 of the Law on deposit guarantees.

7 See consultation letter received by the ECB on 23 March 2009 from the FCMC.

8 OJ L 68, 13.3.2009, p. 3.

9 See paragraph 3.1 of ECB Opinion CON/2009/10 of 4 February 2009 at the request of the Latvian Financial and Capital Market Commission on draft amendments to certain legal acts in connection with the financial turmoil. All ECB opinions are available on the ECB website at www.ecb.europa.eu.

10 See paragraph 2.1 of ECB Opinion CON/2008/70 of 18 November 2008 at the request of the Council of the European Union on a proposal for a Directive of the European Parliament and of the Council amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay (OJ C 314, 9.12.2008, p. 1); paragraph 2.1 of ECB opinion CON/2008/61 of 28 October 2008 at the request of the Belgian Minister for Finance on a draft royal decree implementing the Law of 15 October 2008 on measures promoting financial stability and in particular establishing a State guarantee for the provision of credit in the context of financial stability, in relation to the protection of deposits and life insurance and amending the Law of 2 August 2002 on the supervision of the financial sector and on financial services; and paragraph 2.1 of ECB Opinion CON/2009/20 of 10 March 2009 at the request of the Central Bank of Cyprus and of the Cypriot Authority for the Supervision and Development of Cooperative Societies on certain draft regulations related to the Deposit Protection Scheme.

3. Specific observations

3.1 *Participation in the Fund*

The draft law broadens the scope of the Fund's coverage as regards branches in Latvia of non-EU banks[11]. Such branches will become mandatory and unconditional members of the Fund, unlike the branches in Latvia of credit institutions established in another Member State, which may participate in the Fund upon notification and on a 'supplementary cover' basis, i.e. to the extent that the deposit-guarantee scheme of the home Member State does not cover all the categories of deposits protected in Latvia or the amount of compensation offered by the home Member State's scheme is less than amount applicable under the Latvian provisions[12]. While such provisions are in line with the requirements of Article 4(2) of Directive 94/19/EC, they provide for different treatment of branches of EU banks and non-EU banks operating in Latvia. Under such provisions, the Fund will fully cover the guaranteed deposits held with the branches of credit institutions established in non-EU countries, while it will only top-up the coverage of deposits held with the branches of credit institutions established in the EU Member States.

3.2 *Sanctioning regime*

The draft law, together with the existing provisions of the Law on deposit guarantees, introduces a sanctions regime under which members of the Fund who do not comply with the financial obligations of Fund participation may, after one month's notice: (i) in the case of banks established in Latvia and branches in Latvia of non-EU banks, have their banking licence revoked; or (ii) in the case of branches in Latvia of credit institutions established in other Member States, have their Fund participation terminated[13]. The ECB understands that the intention behind the proposed sanction provisions is to establish an effective sanctioning system in relation to all categories of Fund members. However, the ECB draws the attention of the FCMC to Article 3(2) and (3) and Article 4(4) of Directive 94/19/EC that establish minimum rules for sanctions procedures in relation to non-compliant members of national deposit-guarantee schemes[14]. The ECB recommends that the Law on deposit guarantees, as amended by the draft law, should be aligned with the provisions of Directive 94/19/EC, in particular as regards the involvement in the sanction procedures of the relevant supervisory authorities and the required period of notice.

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11 Resulting from amendments to Article 2(2) and the deletion of Articles 2(3) and 2(4)(2) of the Law on deposit guarantees.

12 See new paragraphs (2)(2) and (4^1) in Article 2 of the Law on deposit guarantees.

13 See the current paragraphs (4) and (5) and the new paragraphs (6) and (7) in Article 12 of the Law on deposit guarantees.

14 The provisions require that appropriate measures should be taken to ensure compliance, in the first instance by the home supervisory authority of the relevant institution, in collaboration with the national guarantee-scheme of the institution or of its foreign branch, as relevant. Only if these measures fail to secure compliance, and after an appropriate period of notice of not less than 12 months, may the non-compliant institution or its foreign branch be excluded from the institution's home country guarantee-scheme or from the supplementary cover of the branch's host country guarantee-scheme, with the consent of the institution's home supervisory authority.

3.3 *Calculation of contributions to the Fund*

The draft law introduces the possibility that levels of contributions to the Fund by its members may be differentiated according to specified prudential criteria, such as the capital adequacy ratio of a Fund member, its liquidity and large exposures ratios, and the quality of its loan portfolio[15]. In its previous opinions on draft national provisions proposing changes to the calculation of contributions to national deposit-guarantee schemes, the ECB has welcomed the principle of risk-based premiums[16], while at the same time it has emphasised that sound funding arrangements are critical to the schemes' effectiveness and to the maintenance of public confidence in the banking system[17]. At present, Directive 94/19/EC does not prescribe any method for financing deposit-guarantee schemes, as long as: (i) the costs of financing are borne, in principle, by the credit institutions themselves; (ii) the financing capacity of the scheme is in proportion to credit institutions' liabilities; and (iii) the stability of the banking system of the Member State concerned is not jeopardised[18]. However, Directive 2009/14/EC provides that, by 31 December 2009, the European Commission must present a report concerning, *inter alia*, the harmonisation of the funding mechanisms of deposit-guarantee schemes and possible models for introducing risk-based contributions[19]. Any changes to national legal frameworks for the operation of the deposit-guarantee schemes will need to take into account the work initiated at Community level.

3.4 *Reduction of delays in the payout of guaranteed deposits*

As noted in previous ECB opinions[20], reducing delays in making payouts of guaranteed deposits may strengthen depositor confidence and play a key role in the effectiveness of deposit-guarantee schemes. At the same time, it is essential that a pragmatic approach should be taken to the reduction of payout delays, thereby preserving the credibility of the deposit-guarantee schemes. Moreover, it is important to establish efficient operational processes for verifying claims and reimbursing depositors, as well as for ensuring that sufficient funding is available. The ECB acknowledges the intention behind the draft law to provide for speedy payout procedures, in particular by imposing on Fund members a requirement to make daily updated lists of entitled depositors and of the amounts of guaranteed deposits[21]. Such measures appear to be in line with the objectives of Directive 2009/14/EC, which specifies that Member States should aim to ensure the continuity of banking services, in particular in periods of financial turmoil[22].

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15 See amended Article 8(2) of the Law on deposit guarantees.

16 See paragraph 3.2 of ECB Opinion CON/2008/51 of 17 October 2008 at the request of the Greek Ministry of Economy and Finance on a draft law on, *inter alia*, the establishment of the 'Depositors and Investors of Credit Institutions Compensation Fund'.

17 See paragraph 2.5 of the ECB Opinion CON/2007/26 of 27 August 2007 at the request of the Polish Minister for Finance on a draft law amending the Law on the Bank Guarantee Fund; see also the Financial Stability Forum, 'Guidance for Developing Effective Deposit Insurance Systems', September 2001, point V.4 ('Funding arrangements'), p. 26.

18 See recital 23 of Directive 94/19/EC.

19 See Article 12(1) of Directive 94/19/EC, as amended by Article 1(7) of Directive 2009/14/EC.

20 See paragraph 2.2 of Opinion CON/2008/70 and paragraph 2.2 of Opinion CON/2009/20.

21 See new Article 13^1 of the Law on deposit guarantees.

22 See recital 13 of Directive 2009/14/EC.

3.5 *Payments of guaranteed deposits through a commercial credit institution*

The new paragraphs (1) to (4) of Article 20 of the Law on deposit-guarantees provide the possibility that payments of the guaranteed deposits could be made: (i) through one or more selected commercial credit institutions, or (ii) by transferring the guaranteed deposits, to the extent protected by the Fund, to another credit institution. The draft law does not clarify the criteria for selecting the credit institution responsible for the payout procedures, the precise tasks to be assigned to such a credit institution, or its liability. In this context, the ECB refers to Article 10(1) of Directive 94/19/EC[23] which requires that '[d]eposit-guarantee schemes shall be in a position to pay duly verified claims by depositors in respect of unavailable deposits'. This means that it is primarily the responsibility of the national deposit-guarantee scheme to ensure that the guaranteed deposits are made available to entitled depositors in an orderly and timely manner, whatever the payment system chosen. It is therefore important to clarify the elements of the proposed provisions referred to above, and in particular to ensure that the credit institution appointed will have sufficient resources available to ensure orderly and timely payouts under the deposit-guarantee scheme. In addition, the responsibility of the commercial credit institution appointed should be limited to the technical payment of the guaranteed deposits and should not include the verification of the claimants' entitlement to payment, for which the national deposit-guarantee scheme is responsible.

3.6 More generally, the appointment of a commercial credit institution to act as payment administrator may raise concerns because of issues of distortion of competition and moral hazard, as well as issues related to the potential to increase pressures in the distribution of liquidity. In particular, if a specific commercial credit institution were pre-appointed for this function, this could be viewed as a guarantee from the government that the credit institution in question would remain viable. Similar concerns may be related to an alternative solution under the amended Article 20(1)(2) of the Law on deposit guarantees, whereby the service-providing credit institution may, in practice, acquire customer accounts from an institution in relation to which deposit-guarantee payments are activated. In view of the above, the ECB recommends strengthening the Fund's own technical capacities as opposed to providing for temporary outsourcing solutions as the principal method for ensuring that the payment of guaranteed deposits is properly organised[24].

23 As amended by Article 1(6) of Directive 2009/14/EC.

24 See the ECB opinions issued in the context of the present financial crisis, which emphasise the need to protect the operational capacity of the existing national deposit-guarantee schemes; see paragraph 3.10 of ECB Opinion CON/2008/48 of 15 October 2008 at the request of the Irish Minister for Finance on a draft Credit Institutions (Financial Support) Scheme 2008; and paragraph 2.2 of ECB Opinion CON/2008/69 of 17 November 2008 at the request of the Irish Minister for Finance on a draft Financial Services (Deposit Guarantee Scheme) Bill 2008.

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

Done at Frankfurt am Main, 26 March 2009.

[signed]

The President of the ECB

Jean-Claude TRICHET