



OPINION OF THE EUROPEAN CENTRAL BANK

of 24 June 2009

on the distribution of Latvijas Banka's profits

(CON/2009/53)

Introduction and legal basis

On 12 June 2009 the European Central Bank (ECB) received a request from Latvijas Banka for an opinion on a draft law amending the Law on Latvijas Banka as regards the distribution of Latvijas Banka's profits (hereinafter the 'draft law'). Latvijas Banka has requested the ECB's opinion before the submission of the draft law to the Latvian Parliament.

The ECB's competence to deliver an opinion is based on Article 105(4) of the Treaty establishing the European Community and the third 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 provisions¹, as the draft law relates to Latvijas Banka. 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 main objective of the draft law is to amend Article 18¹(2) of the Law on Latvijas Banka increasing the payment for the use of State capital from 15% to 50% of Latvijas Banka's profits for the reporting year.

2. General observations

2.1 Member States are obliged to safeguard the institutional and financial independence of their national central banks (NCBs), thus ensuring the proper performance of their tasks under the Treaty and the Statute of the European System of Central Banks and of the European Central Bank (hereinafter the 'Statute of the ESCB'). In particular, the compatibility of the Law on Latvijas Banka with the requirements of Article 108 of the Treaty and the provisions of Article 7 of the Statute of the ESCB concerning central bank independence is of utmost importance, as

¹ OJ L 189, 3.7.1998, p. 42.

Latvijas Banka's primary objective of price stability is best served by a fully independent institution with a precisely defined mandate².

- 2.2 With regard to financial independence, a Member State may not put its NCB in a position where it has insufficient financial resources to carry out its ESCB or Eurosystem-related tasks. The NCB must also, at all times, have sufficient financial means to carry out its other functions, i.e. to perform its national tasks, to meet its international obligations and properly cover its administrative and operational expenses³.
- 2.3 The ECB recognises the current financial situation in Latvia as well as the need to rebuild Latvia's macroeconomic stability and enhance its credibility. However, it notes that the use of central bank financial resources may be counterproductive from the credibility point of view if confidence in the financial stability and independence of the NCB is undermined.
- 2.4 In addition to the issue of financial independence, national rules on the distribution of NCBs' profits must comply with the monetary financing prohibition laid down in Article 101(1) of the Treaty and Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b(1) [now Articles 101 and 103(1)] of the Treaty⁴. As referred to in previous ECB opinions⁵, to comply with the monetary financing prohibition, it is of crucial importance that the distribution of profits, by instalments or in full, does not imply advances on future or provisional profits but is rather the result only of profits that are fully realised, accounted for and audited, which in turn requires due calculation of profits and losses.

3. Specific comments

- 3.1 According to the current wording of Article 18¹ of the Law on Latvijas Banka, Latvijas Banka transfers to a State general budget account indicated by the State Treasury: (i) part of its profits for the reporting year, which is calculated by applying the tax rate established by the Law on corporate income tax (currently 15%); and (ii) payment for the use of State capital forming 15% of the profits for the reporting year. Under the draft law the payment for the use of State capital will be increased to 50% of the profits for the reporting year.
- 3.2 With regard to profit allocation rules, an NCB's Statute may prescribe how profits are to be allocated. However, even though amendments to such rules are possible, it is important to shield the rules related to the distribution of profits from third-party interests and to ensure a legal framework that provides a stable and long-term basis for the central bank's functioning⁶. Furthermore, according to the principle of financial independence, as stressed by the ECB in its

² See ECB Opinion CON/2007/14. All ECB opinions are available on the ECB's website at www.ecb.europa.eu.

³ See the ECB's Convergence Report May 2008, p. 20.

⁴ OJ L 332, 31.12.1993, p. 1.

⁵ See e.g. Opinion CON/2008/82.

⁶ See Opinion CON/2007/14.

convergence reports as regards financial provisions or buffers, an NCB must be free to create independently financial provisions to safeguard the real value of its capital and assets⁷. In this regard, it is recalled that the economic purpose of central bank capital and reserves is to ensure that the central bank will always and in all circumstances have at its disposal the necessary financial resources to conduct monetary policy. However, the ECB notes that, according to Article 19 of the Law on Latvijas Banka, Latvijas Banka will use the reserve capital to cover possible losses. The need to ensure a long-term perspective as regards the distribution of profits should be borne in mind. Indeed, it is of utmost importance to allow sufficient provisions of reserves during years of profits to allow Latvijas Banka to face possible losses without weakening its financial means to implement its monetary policy.

The ECB further notes that in principle it is not optimal for the central bank to create reserves only after transferring a large portion of its profits to the Treasury. Should Latvijas Banka run into a situation of negative equity in the future (i.e. losses exceeding currently accumulated reserves), it would be hard to rebuild it out of the stream of future 'net' earnings under such an arrangement. Although Latvijas Banka still had positive capital and reserves at the end of 2008, prudence is required to ensure stable and sufficient financial resources in the long term.

- 3.3 Moreover, the ECB notes that the current calculation of the total rate of Latvijas Banka's profit distribution involves, apart from the fixed part set by the draft law at 50% of the reported profits, also the additional part linked to the tax rate established by the Law on corporate income tax. Potential amendments to the Law on corporate income tax would result in changes to Latvijas Banka's total contribution to the State budget. While in principle both calculation methods are admissible, the ECB considers that for the sake of legal certainty, and to achieve a better safeguard of Latvijas Banka's financial independence, the maximum contribution of Latvijas Banka to the State budget should rather be determined by a single fixed rate of Latvijas Banka's annual profits, set in the Law on Latvijas Banka. Alternatively, if the current twofold calculation of the total rate of Latvijas Banka's profit distribution is maintained, the ECB recommends that, in view of Latvijas Banka's obligations under the Treaty and the Statute of the ESCB, any changes to its financial obligations towards the State should be decided in cooperation with the Council of Latvijas Banka, taking into account its specific central bank tasks.

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

Done at Frankfurt am Main, 24 June 2009.

[signed]

The President of the ECB

Jean-Claude TRICHET

⁷ See the ECB's Convergence Report May 2008, p. 21.