OPINION OF THE EUROPEAN CENTRAL BANK
of 19 December 2008
at the request of Latvijas Banka
on draft amendments to the Regulation on the use of Latvijas Banka’s monetary policy instruments
(CON/2008/89)

Introduction and legal basis

On 8 December 2008 the European Central Bank (ECB) received a request from Latvijas Banka for an opinion on draft amendments to the Regulation on the use of Latvijas Banka’s monetary policy instruments (hereinafter the ‘draft amendments’).

The ECB’s competence to deliver an opinion is based on Article 105(4) of the Treaty establishing the European Community and the fifth indent of Article 2(1) and Article 2(2) 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, as the draft amendments relate to payment and settlement systems and instruments of monetary policy. 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 amendments

The main objective of the draft amendments is to amend Latvijas Banka’s rules on eligible collateral in order to comply with Guideline ECB/2007/2 of 26 April 2007 on a Trans-European Automated Real-time Gross settlement Express Transfer system (TARGET2) in relation to Latvijas Banka’s intraday credit operations in euro. Under the draft amendments, Latvijas Banka’s risk control measures are amended to further harmonise Latvijas Banka’s monetary policy operational framework with that of the Eurosystem.

In addition, the draft amendments correct the deviant spelling of the name of the single currency in Latvian throughout the text of the Regulation on the use of Latvijas Banka’s monetary policy instruments (hereinafter the ‘Regulation’). Finally, due to the financial turmoil and the downgrading of Latvia’s sovereign issuer rating, Latvijas Banka intends to lower the minimum issuer and issue rating requirements for eligible securities in its credit operations.

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2. **General observations**

2.1 Although non-participating Member States retain their powers in the field of monetary policy, it is nevertheless beneficial for them to gradually achieve consistency with Eurosystem standards so that credit institutions operating in their territories can become acquainted with the requirements that will apply once these Member States have adopted the euro. Such gradual harmonisation prior to the adoption of the euro will contribute to the smooth integration of the national central bank into the Eurosystem. Accordingly, the draft amendments further align the Latvian framework for the use of monetary policy instruments with that of the Eurosystem.

2.2 The ECB previously commented on the Regulation and other regulations in the field of monetary policy instruments. In its opinions, the ECB emphasises the need to further align the Latvian minimum reserves regime with Eurosystem standards and makes the point that Latvian credit unions should also be subject to reserve requirements. The ECB notes that all comments previously made on the Latvian minimum reserves regime still remain valid.

2.3 The ECB welcomes the draft amendments to Latvijas Banka’s rules on eligible collateral aimed at implementing Guideline ECB/2007/2. This opinion is, however, without prejudice to any future ECB assessment of the implementation of Guideline ECB/2007/2 by Latvijas Banka.

3. **Specific observations**

3.1 *Spelling of the single currency*

The ECB welcomes that paragraph 1.2 of the draft amendments eliminates the discrepancy between the name of the single currency in Latvian in the Regulation (‘eiro’) and the name of the single currency in Latvian as established under Community law (‘euro’).

3.2 *Definition of ‘related undertakings’*

Paragraph 1.1 of the draft amendments defines ‘related undertaking’ as (i) a company in which a counterparty, either directly or indirectly, owns 20% or more of its total capital; (ii) a company, which, either directly or indirectly, owns 20% or more of the total capital of a counterparty; or (iii) a company, in which the company mentioned [in item ii above], either directly or indirectly, owns 20% or more of its total capital. Although the definition does not literally mirror the ‘close link’ definition contained in Guideline ECB/2000/7 of 31 August 2000 on monetary policy instruments and procedures of the Eurosystem, it is essentially consistent with ECB requirements.

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3 See ECB Opinion CON/2006/49 of 23 October 2006 at the request of Latvijas Banka on a draft regulation for the use of Latvijas Banka’s monetary policy instruments and ECB Opinion CON/2007/12 of 30 April 2007 at the request of Latvijas Banka on draft amendments to the Regulation on the use of Latvijas Banka’s monetary policy instruments and the Regulation on Latvijas Banka’s securities settlement system. See also ECB Opinion CON/2006/11 of 23 February 2006 at the request of Latvijas Banka on draft amendments to the Regulation on calculating and fulfilling the minimum reserve requirements for banks.

3.3 Prohibition of the use of subordinated debt

Paragraph 1.9 of the draft amendments contains a new provision concerning the prohibition of the use of subordinated debt as collateral and states that, as regards eligible securities, rights to receive their principal and interest payments cannot be subordinated to the rights of other debt securities holders of the same issuer. This provision is in line with Guideline ECB/2000/7. It should be noted that the ECB has recently taken steps to further expand, on a temporary basis, the collateral framework and enhance the provision of liquidity. The Eurosystem will add subordinated debt instruments when they are protected by an acceptable guarantee to the list of assets eligible as collateral in its credit operations. This provision will remain in force until the end of 2009.

3.4 Lowering the rating requirements

Paragraph 1.12 of the draft amendments lowers the minimum issuer and issue rating requirements and provides that the credit rating of securities and of the issuer of securities for long-term liabilities in lats or foreign currencies must be equal to or higher than at least one of the following ratings: BBB– (Fitch Ratings), Baa3 (Moody’s Investors Service), and BBB– (Standard & Poor’s). The ECB notes that this amendment introduces a discrepancy with Guideline ECB/2000/7 which provides for a single A credit rating threshold. However, it should be noted that as part of the interim measures taken to further expand the collateral framework, the ECB lowered the credit threshold for marketable and non-marketable assets from A- to BBB-, with the exception of asset-backed securities, until the end of 2009.

To the extent that lowering the rating requirements is related to the downgrading of Latvia’s sovereign issuer rating, the ECB would point to Article 102 of the Treaty which prohibits NCBs from taking measures granting privileged access by the public sector to financial institutions if such measures are not based on prudential considerations. Furthermore, the rules on mobilisation or pledging of debt instruments enacted by the NCBs must not be used as a means of circumventing the prohibition on privileged access. In this respect, lowering rating requirements should normally be motivated by the need to adjust the list of eligible collateral indiscriminately for both private and public issuers. The ECB would appreciate that such intention as regards the proposed measures be made clear.

3.5 Liquidity categories

The introduction of liquidity category III in paragraph 1.16 of the draft amendments, which includes other debt securities of credit institutions, and the addition to liquidity category II in paragraph 1.15 of the draft amendments of covered bonds and debt instruments issued by corporate issuers is inconsistent with the current categorisation set out under Guideline ECB/2000/7. According to Guideline ECB/2000/7, only jumbo covered bonds (with a volume of at least 5 billion €) can be included in liquidity category II. However, this provision will remain in force until the end of 2009.

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5 Guideline ECB/2008/18 of 21 November 2008 on temporary changes to the rules relating to eligibility collateral.

EUR 1 billion, for which at least three market makers provide regular bids and ask quotes) are included in category II. Traditional covered bank bonds and debt instruments issued by corporate issuers fall within category III.

3.6 Additional valuation markdown

The ECB notes that introducing an additional valuation markdown of 5% in case of theoretical valuation of Latvijas Banka’s eligible assets in paragraph 1.18 of the draft amendments is in line with the valuation markdown of 5% for theoretically priced instruments under Guideline ECB/2008/13 of the European Central Bank of 23 October 2008 amending Guideline ECB/2000/7 on monetary policy instruments and procedures of the Eurosystem\(^7\). Guideline ECB/2008/13 applies from 1 February 2009.

3.7 Exclusion of covered bonds from the ‘close link’ prohibition

Paragraph 1.6 of the draft amendments provides that the prohibition of close links does not apply to covered bonds. The exemption of covered bonds in Guideline ECB/2000/7 only applies to covered bank bonds issued in accordance with the criteria set out in Article 22(4) of Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)\(^8\), or cases in which debt instruments are protected by specific comparable legal safeguards. The ECB understands that in Latvia only the debt instruments issued in accordance with the Law on mortgage bonds would comply with Article 22(4) of Directive 85/611/EEC and be treated as covered bonds. The draft amendments should clarify that only the instruments issued under the Law on mortgage bonds are exempted from the prohibition of ‘close links’.

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

Done at Frankfurt am Main, 19 December 2008.

[signed]

The President of the ECB
Jean-Claude TRICHET

\(^7\) Not yet published in the Official Journal.