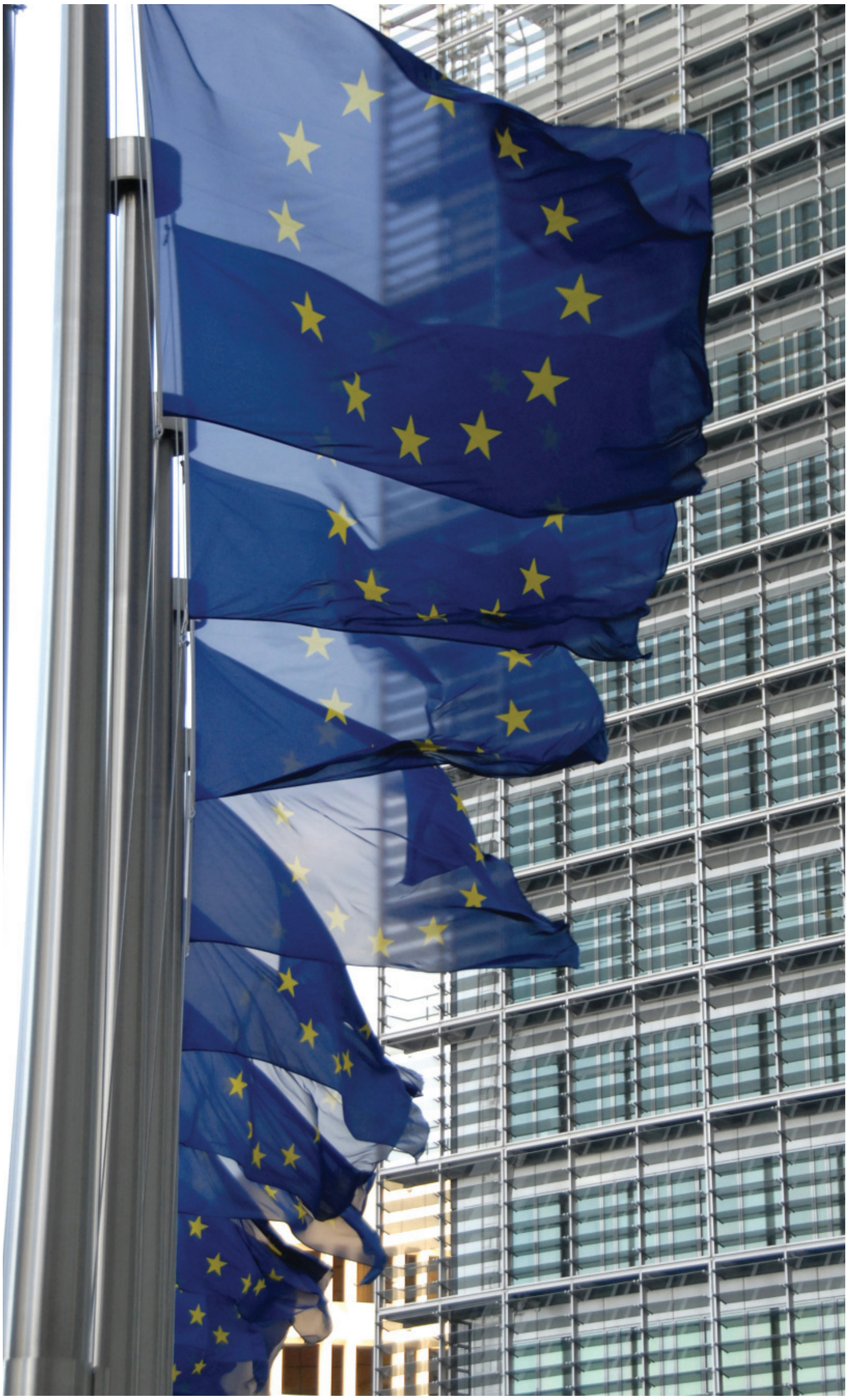
FOCUS EUROPE



Carrying on

The tax regime for carried interest unit holders in France has fallen victim to an unsatisfying raft of reforms for French managers of foreign investment funds. Laurent Borey wades through the complexities

Eight-year-old French administrative guidelines have created a specific tax regime for holders of 'carried interest' units or shares issued by a *fonds commun de placement à risques* (FCPR) or a *société de capital risque* (SCR).

According to the guidelines, the amounts received in respect of these units or shares could benefit, under conditions, from the favourable capital gains tax regime set out in article 150-0A of the French tax code (based on current rates, an 18 per cent taxation plus social contributions at a 12.1 per cent rate).

By enacting this regime into law and extending its scope to certain gains realised, directly or indirectly, by French holders of carried interest shares or units in certain foreign investment entities, the French Finance Bill for 2009 attempted to harmonise the tax regime for French managers of foreign investment funds with the system applicable to their counterparts in French funds such as FCPRs.

Disparities in treatment still exist, which may place French managers of foreign investment funds in a significantly less favourable tax position

Disparities

However, in practice this goal was not fully achieved as disparities in treatment still exist, which may place French managers of foreign investment funds in a significantly less favourable tax position. These disparities result from both the limited scope of eligible foreign investment entities in which French residents can subscribe carried interest shares or units while benefiting from the corresponding favourable tax regime, and the different tax treatment provided by the new regulations depending on the nature of the 'distribution' made by the fund.

The 2009 Finance Bill did not universally extend the pre-existing favourable carried interest regime to all foreign investment entities in which French holders subscribe carried interest shares or units. Indeed, to benefit from the favourable tax regime, French managers of foreign funds must have subscribed their carried interest units or shares in so-called European venture capital investment structures (EVCIS). That involves:

- setting up in an EU member state or in another European Economic Area country that has entered into a double taxation treaty with France, including an administrative assistance provision to fight fraud or tax evasion;
- having as its main purpose investment in non-listed companies. Draft administrative guidelines related to the Finance Bill (which should be issued shortly by the French tax authorities) specify that the entity must invest in equity or in securities giving access to the share capital of non-listed companies (a condition also applicable to French funds).

French managers holding carried interest units or shares issued by a US investment fund (for example, a Delaware partnership), or an investment fund located in certain low-tax jurisdictions (Guernsey, Bermuda) cannot benefit from the capital gains tax regime with respect to the flows deriving from their carried interest units or shares.

Therefore, under French law, the corresponding gains should be subject to personal income tax at the standard progressive rates in the country. This taxation at progressive standard rates should also apply to French managers holding carried interest units or shares in a European investment fund whose main purpose does not comply with the law/administrative guidelines' additional requirements.

This situation should not be confused with that of a French manager holding carried interest units or shares in a French or European investment fund through a non-eligible investment entity (for example, a Cayman or a Guernsey partnership). In this situation, the manager indirectly holds carried interest units in an eligible investment fund and should benefit from the favourable carried interest tax regime. The existence of the intermediary entity should not change this analysis to the extent that the entity is treated as being tax-transparent in its country (this condition being provided by the draft administrative guidelines).

Less favourable

This treatment is obviously significantly less favourable than the one applicable to French managers of French funds, who can benefit from a flat 30.1 per cent tax rate (including social contributions).

The French administrative guidelines of March 2002 provided that the favourable carried interest regime (namely, taxation as capital gain) could apply to 'all amounts' attributed to French holders of carried interest units or shares issued by a French FCPR or SCR.

As far as French FCPRs were concerned, these amounts could be received either through asset distributions – namely, distributions by the FCPR of cash deriving from the sale of its assets – or through distributions of income received by the FCPR, in other words, interest and dividends. Whatever the origin of the amounts paid out by the FCPR, the unit holder could benefit from the flat rate offered by the capital gains regime.

The 2009 finance bill, as well as the related draft administrative guidelines, now makes a distinction depending on the nature of the 'distribution'. This means that:

• asset distributions by French FCPRs, as well as distributions corresponding to capital gains realised by EVCIS, can benefit from the favourable capital gains tax treatment at the level of the unit or share holder;
• income distributions made by FCPR or EVCIS to their carried interest unit or shareholders are subject, under conditions, to standard individual income tax as income from movable capital.

Experience shows that the flows up-streamed by FCPRs to their carried interest unit holders generally stem from capital gain derived by the FCPR (namely, asset distributions) so that, as a rule, French managers of French FCPRs should benefit from the capital gain tax regime.

On the other hand, many EVCIS usually invest indirectly via intermediary foreign structures that benefit from the protection of international tax treaties (a protection that is not always available to the EVCIS itself). For these EVCIS, the standard exit scenario is a sale by these intermediary entities of their investment, followed by a transfer of the corresponding cash to the EVCIS through dividend distributions, liquidation, or through a repurchase/redemption of complex financial instruments.

There are strong uncertainties as to whether the amounts received from EVCIS by French management teams can qualify as 'distributions corresponding to capital gains' derived by the EVCIS, as the EVCIS has not technically derived any gain from a disposal of assets. Therefore, in the hands of the French unit or shareholder, these amounts may be subject to standard income tax as income from movable capital (unless specific circumstances entitle said holder to benefit from a fixed withholding tax rate).

Tax rates

Even if all the conditions for the application of the favourable tax regime are met, the standard position of a French manager holding carried interest units in a EVCIS may be a taxation at the progressive rate of French personal income tax, whereas a French manager in a French FCPR or SCR would typically benefit from a flat 30.1 per cent rate on virtually all of its carried interest units.

Although the recent reform of the French carried interest regime constitutes a significant innovation in favour of French managers of foreign investment funds, certain situations are still not included. In addition, even for situations falling under the scope of the new rules, the standard modalities of cash up-streams in foreign investment structures may in practice lead to a less favourable tax treatment for these managers as compared with their counterparts holding carried interest units in French funds.

In this context, when structuring future carried interest plans in foreign investment funds or even, in certain circumstances, restructuring existing plans, particular attention should be paid to this new set of rules, which are applicable, as far as foreign investment vehicles are concerned, to units or shares issued from the end of June 2009.

It is also worth noting that the French draft social security financing bill for 2010 introduces a new filing obligation for SCR, management companies of FCPR or SCR, EVCIS, and companies rendering services to FCPR, SCR or EVCIS according to which all of these entities will have to indicate, on an annual basis, the amount of income distributed to the holders of carried interest units or shares as well as the identity and address of the beneficiaries of this income.

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GERMANY

On-line flutters

Germany and its federal states have so far adopted an almost puritanical approach to on-line gambling, but, reports Wulf Hambach, pressure is building for legislative reform

The Interstate Treaty on Gambling (ITG), which came into force at the beginning of January 2008, forms the centre of Germany's gaming legislation, and has been the trigger for hundreds if not thousands of court cases causing divergent decisions.

The treaty aims at the continuation of the state's monopoly and a general prohibition of the brokering of on-line games by 2011. To implement this prohibition, the treaty also provides for the issue of suspension orders to German internet service providers.

After having received the draft of the new state treaty, the European Commission started the notification procedure. In March 2007, the EU Commission issued an opinion against Germany in which it determined that the prohibition of the on-line operation and brokerage of gaming was not in compliance with the freedom of services according to Article 49 of the EC treaty.

Harsh criticism

However, this harsh criticism has not driven the federal state prime ministers nor regional parliaments to consider a revision. The draft came into force slightly more than two years ago without amendments and, as anticipated, the European Commission immediately started infringement proceedings with a letter of formal notice issued on 31 January 2008.

Apart from the general legal considerations regarding the lack of suitability or necessity of the

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proposed general prohibition of on-line gaming, there are also considerable technical factors that would hinder local restrictions on on-line services in Germany.

First, a general on-line prohibition coupled with blocking measures could be circumvented easily because of the decentralised structure of the internet. Second, it is technically impossible for the gaming operator to identify the exact location of the user.

This is particularly relevant regarding enforceability and could render the treaty as a toothless tiger that is trying to threaten banks, access providers and the e-gambling industry. Once blocking orders have been issued and the legality has been examined in court, the toothless tiger will realise its weaknesses.

Booming black market

The unenforceability of the internet gambling ban causes another danger that has recently re-appeared in Germany – the growth of the black market. At the end of November 2009, German soccer legend Franz Beckenbauer told the leading German sports magazine *Sportbild*: 'The [German] sports betting monopoly causes a growth of the black betting market in Germany. The goal should be to open up the market for fit, proper and licensed betting companies, as requested by the German Olympic committee.'

Thus, another pivotal argument used to justify the existence of a German betting monopoly – combating accompanying crime – seems to be falling apart. Newspapers across Europe are full of the recent betting scandal, which seems to be turning out to be the continent's worst-ever case of match fixing in soccer. German prosecutors revealed last month that as many as 200 games across Europe are thought to have been rigged. Games played this season in Germany, Belgium, Switzerland, Croatia, Slovenia, Turkey, Hungary, Bosnia-Herzegovina and Austria are now under suspicion.

It is believed that none of the suspicious games involved any of Europe's top leagues, such as those in Italy, Spain and England. The 32 German matches involve clubs extending from regional leagues up to the country's second division. Just four years after the 'Hoyzer betting scandal' – involving referee Robert Hoyzer – this is the next major organised criminal activity on Germany's black (betting) market.

As if he saw it coming, Austrian economist and illicit sales expert Friedrich Schneider recently researched the impact on the growth of the black market of banning private betting in Germany. His findings stressed that the drop in turnover in the public gambling sector in 2008 (between 12 to 30 per cent) was accompanied by a simultaneous growth of the black market.

Professor Schneider pointed out that those who intend to gamble on the internet will not be deterred by a written ban. The associated loss of jobs, tax revenue and added value for the German economy as a result of a lack of advertising proceeds led him urgently to recommend at least a partial liberalisation.

Reform afoot

Politicians are beginning to take serious steps towards legalising internet gambling. In a statement issued at the beginning of last September, the parliamentary leaders of the German Liberal Party, the FDP, called for a reform of the ITG, and stressed that experts in the fields of addiction, economics and law were all opposed to a ban on internet gambling as a suitable tool for regulating on-line gaming.

In particular, Detlef Parr, former member of the Bundestag and FDP expert for sports affairs, addiction and illegal drugs, stressed the need for reform and called for the ITG to be terminated by the federal states ahead of schedule so that suitable reform can be expedited.

> Once blocking orders have been issued and the legality has been examined in court, the toothless tiger will realise its weaknesses

This would decriminalise internet games such as sports betting and on-line poker for players and organisers, while continuing to protect players and simultaneously securing funding for charities.

Jörg Bode, the new Minister of Economy of the Federal State of Lower Saxony, and the FDP spokesman on gambling issues, opposes the current ITG and, in view of its ongoing evaluation, has demanded an in-depth study into the impact of the treaty.

Now, less than three months after the FDP statement, reform might be on the horizon, as the northern German state of Schleswig-Holstein officially announced its intention to terminate the ITG at the end of 2011. Therefore, according to newspaper reports, it is unlikely that the federal states will agree a new ITG for 2012.

Addiction dangers

It has long been argued that to combat addiction dangers, the treaty must prohibit on-line games of chance in Germany. However, experts maintain that prohibition is not a suitable measure to achieve that objective. Rather, it is argued, providers will simply relocate their business to other countries, resulting in loss of jobs and revenue for the federal states.

It is estimated that there are some 3,000 websites offering games of chance on the internet, and they are being used by an increasing number of people. Schleswig-Holstein strives to privatise games of chance and, at the same time, to co-operate with the providers to 'agree on sensible prevention measures'.

Since the introduction of the ITG in 2008, the federal states' revenue from gambling has dropped by 30 per cent, according to the Deutsche Lottoverband, the Association of German Lotteries. At that rate, total loss of turnover could be nearly €14 billion by the scheduled end of phase 1 of the treaty in December next year.

The obvious consequence is that the respective taxes and

IRELAND

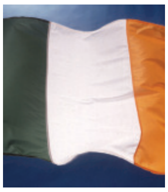
Taxing times

Ireland's recently published Finance Bill extends fiscal attractions for multi-national corporations and individuals alike. John Gulliver and Gavin O'Flaherty analyse the draft legislation and hail it as a potential lifeline for a struggling Irish economy

The Irish Finance Bill – published at the beginning of last month and scheduled for enactment in early April – contains draft legislation that further highlights fiscal attractions for enterprises and individuals aiming to conduct business throughout Ireland.

It is a fundamental feature of the tax strategy to ascertain the basis on which foreign executives will be taxed. The Bill extends the nationalities to whom it will apply (now including EU and European Economic Area nationals) and also provides an ability for executives relocating to Ireland to cap their Irish tax liability on employment emoluments by limiting the amount of such income that is deemed to be subject to Irish tax.

The limit is the greater of the amount of emoluments actually remitted into Ireland or an amount equal to €100,000 plus 50 per cent of the individual's emoluments in excess of €100,000. For example, an executive relocating from the UK to Ireland on a package of €300,000 would only be liable to tax (before any other allowances) on the greater of the amount spent in Ireland or €200,000. If the executive lives in Ireland on say €100,000 of income and does not bring any other part of his employment income into Ireland, his taxable income is decreased by about 30 per cent.



The net effect is that it is increasingly possible to use the Irish tax regime to have an effective tax rate on a group's income from intellectual property of 2.5 per cent or less

Additionally, the executive will be able to live in Ireland and avail of the remittance basis of taxation so that all income and gains made that are not Irish source or from Irish situate property are tax exempt, unless income or gains are brought into Ireland.

Transfer pricing

Most EU locations have a transfer pricing regime. This exists in each member state to ensure that multi-nationals pay their fair share of tax in each jurisdiction in which they conduct business.

To demonstrate that companies in Ireland are not being used for artificial profit manipulation purposes, Ireland has introduced a transfer pricing regime. This takes effect from 1 January 2011. Transactions entered into before 1 July 2010 will be grandfathered and will not come within the new rules. This means that when multi-nationals review their existing arrangements and enter into contracts before 1 July 2011, it will not be necessary to comply with the new Irish regime as long as the agreement endures.

Each EU member state has a particular tax regime in relation to intellectual property (IP). Each regime applies different tax laws to amortisation on IP and the ensuing royalty flows. Common parlance is to talk about each member states' IP box.

The Irish IP box allows a tax write-off for expenditure on IP over a period of 15 years, or if shorter, the accounts amortisation applicable to the IP. Royalty and licence flows are taxed at 12.5 per cent where it is part of a licensing trade carried on in Ireland.

The Finance Bill proposes:

- an extension of the definition of IP to include capital expenditure on the application for the grant or registration of IP, including patents, and the acquisition of secret processes or formulae or other secret information concerning industrial, commercial or scientific experience, whether protected or not by patent, copyright or a related right, including knowhow.
- relief for expenditure incurred before a licensing trade commences;
- an ability to obtain a tax write-off for IP impairment, and
- no clawback of allowances on IP disposed of after 10 years of use.

The net effect is that it is increasingly possible to use the Irish tax regime to have an effective tax rate on a group's income from IP of 2.5 per cent or less.

Developing a hub

The Finance Bill also seeks to encourage the development of a hub in Ireland for management companies of foreign undertakings for collective investment in transferable securities (UCITS) under the provisions of the EU's UCITS IV Directive. It seeks to remove a charge to Irish tax on the foreign EU fund merely by

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earmarked funds that gambling operators pay to the federal states will continue to decline, hurting the fiscal interests of the federal states and reducing support for charitable projects.

As the EU's leading economy, Germany should be a frontrunner in forming and using modern gambling legislation that is in accordance with the customers' wishes to play on websites that are controlled and safe to use, as well as being in accordance with EU law. Instead, elements of German society remain highly resistant to reform and stick to measures that resemble the internet censorship applied in China. As a result, Germany's gambling law is a target for the European Commission and the European Court of Justice.

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reason of the presence of an Irish management company.

Where funds are re-domiciling to Ireland, stamp duty has been a hurdle. The Finance Bill extends an exemption from stamp duty where an investment undertaking issues units to a foreign fund in return for its investment undertaking.

To make investment funds sold exclusively outside Ireland more attractive, and enable them to pay returns gross, the fund will no longer be required to obtain a non-resident declaration from each investor.

The Bill also aims generally to update tax legislation to reflect the nature and effect of the growing importance of Islamic Sharia finance.

There are also measures concerning double tax relief. A key feature of Ireland's double tax relief system is that foreign income passes through Ireland without attracting corporation tax by reason of its credit relief system.

Ireland operates a credit relief system for providing relief for overseas tax charged on, among other things, profits appropriate to pay dividends to an Irish corporate. Ireland taxes such foreign income at either 12.5 per cent or 25 per cent. The scope of the 12.5 per cent tax rate is extended to include dividends paid out of underlying trading profits of a company resident in a country that does not have a double tax treaty with Ireland. To obtain the 12.5 per cent rate, the non-resident payor must be owned by a quoted company.

Unilateral relief

The system of unilateral credit relief for royalties received from non-treaty countries has been extended. The relief is now available to all trading companies that incurred foreign withholding tax on royalties paid from non-treaty countries.

Moreover, under the Finance Bill, Irish branches of foreign corporations will be able to carry forward excess double tax relief credits. The Bill provides exemption from corporation tax on foreign dividends received by portfolio investor companies where the income is a trading receipt. This provision is likely to cause insurance groups and others that hold portfolio investments as part of their trade to invert under an Irish holding company.

Ireland has attracted favourable international comment for its approach to dealing with the country's budget deficit. Throughout, the Irish Government has shown absolute commitment to Ireland's 12.5 per cent corporation tax rate.

To avoid foreign challenges to Ireland's system of taxing trading companies, the Finance Bill also introduces a transfer pricing regime. In doing so, the government demonstrates to international trading partners that Ireland is not a location for profit manipulation. It ties in well with other features in the Bill that seek to eliminate Irish withholding tax on interest and income flows paid to countries where Ireland has double tax treaties (to include treaties that are awaiting full adoption) provided that the recipient is liable to tax in the territory in which he is resident.

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SPAIN

Remaining barriers

The Bolkestein Directive and its effect on commercial licences in Spain has been considerable, but, writes José Luis García-Manso, patchwork implementation across the country is causing problems

EU Directive 2006/123/CE – passed at the end of 2006 – was drafted with the intention of improving the single market for services within the EU and therefore to remove domestic barriers to the rendering of services – and the deadline for its implementation in all EU countries was 28 December 2009.

The law is generally referred to as the Bolkestein Directive, named after Frederick Bolkestein, the Dutch commissioner who promoted its implementation. And it has certainly affected the regulation of commercial licences in Spain.

Commercial licences were needed, in addition to municipal planning licences, to develop, enlarge, transfer and operate large retail areas, such as shopping centres. The commercial licences were granted by the regional governments but they were not granted in accordance with clear and objective criteria. In practice, regional governments controlled the implementation or enlargement of large retail areas to avoid jeopardising the businesses of small retailers.

The initial implementation of the Bolkestein Directive by the Spanish regions has not been uniform. Uniformity would certainly have been advisable, considering the aim of the directive is to consolidate a single market.

Five regions out of 17 – Aragon, Cantabria, Extremadura, Navarra and Castile-La Mancha – have not yet passed the regulations implementing the Bolkestein Directive, despite the passing of the deadline last December. The Valencia region has partially adapted its regulations to the directive and is currently preparing new regulations.

Only the Madrid region out of the dozen that have in some way adapted their regulations to the directive has completely abolished the commercial licence and any discretionary administrative control over the

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SPAIN

implementation or enlargement of new large retail areas. The implementation of new large retail areas in the Madrid region or the enlargement of existing areas is no longer limited by the potential impact of new retail areas in the retail sector of the surrounding areas.

Additionally, with this change in the law in the Madrid region, a shopping centre can change the use of its premises from leisure to retail use, providing it adheres to any limitations imposed by planning regulations. Up until the implementation of the Bolkestein Directive, the maximum area that could be used for retail premises in a shopping centre was limited by the threshold approved by the commercial licence and could not be exceeded. This may prove interesting for the improvement of the commercial mix of shopping centres and may help to solve the use of large vacant areas within shopping centres, such as closed cinemas or unprofitable leisure areas.

Vague criteria

Unfortunately, the other regions have not followed Madrid's example. The other 11 that have implemented the directive can be separated into two different categories.

The first includes those regions that have totally or partially maintained the existence of commercial licences but have changed the procedure for obtaining them and the criteria for their concession. These regions are Castile and Leon, Catalonia, Valencia, Galicia, The Balearic Islands, The Canary Islands, La Rioja, and Murcia. Although the new criteria has attempted to be more objective than the former – which was fairly vague – they do not seem objective enough and may still be used by regional governments to try to control the implementation of new large retail areas.

Here are just a few examples of the new, and by no means interrelated, questions to be applied when contemplating a large retail area project:

- What impact could the commercial centre have on public infrastructure?
- How will the centre be integrated within urban areas?
- Is public transport available?
- Are there measures to make family and work life compatible within the new commercial centre and what impact will the new project have on the increase in the quality of the employment?

Public interest

According to article 15.3(b) of the Bolkestein Directive, the requirements (restrictions) established for rendering a service (such as a retail activity) 'must be justified by an overriding reason related to the public interest'. It will be difficult to justify the new criteria as being in the general public interest. In addition, there are other new requirements that are an unnecessary repetition of general criteria for the development of any kind of construction, such as environmental or planning compliance.

The second category includes those regions that have abolished the commercial licences but have implemented controls over the installation or enlargement of new large retail areas through specific planning requirements, for example, compliance with general retail master plans that will be drafted, and whose approval falls within the regions' authority. These regions are Andalusia, the Basque country and Asturias.

This has been an opportunity to simplify the administrative procedures for implementing new retail areas and to avoid uncertainties by passing clear, objective and uniform regulations that has not been taken up by most of the Spanish regions. To a large extent, what we appear to have is merely the same dog with a different collar.

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LATVIA

Backing the banks

The Riga government last year pushed through a programme of economic reform to support the country's ailing banking sector in the global recession. Edgars Lodzins assesses the progress

The global economic crisis has made a significant impact on Latvia's economy since the end of 2007. The crisis triggered the near failure and takeover by the state of Latvia's largest domestically-owned bank, Parex, as well as intervention by the International Monetary Fund (IMF) in the form of a €7.5 billion financial assistance package to Latvia, including funding from the EU, the World Bank, the European Bank for Reconstruction and Development and a number of Nordic and individual European countries.

A key part of the economic reform programme agreed by the Riga government as part of the assistance package, comprised measures intended to stabilise the banking sector and to help household debtors. As a result, a series of amendments was made to the country's banking legislation last year.

To improve sector stability, legislation covering bank takeovers was adopted and the law on credit institutions amended, which saw the introduction of several provisions:

- an increase of credit institutions' capital, in case the state acquires or increases qualifying holdings in a credit institution;
- establishment of procedures for transfers of credit institution businesses;
- establishment of operational restrictions that the Financial and Capital Market Commission (FCMC) is entitled to impose on credit institutions; and
- imposition of restrictions on state-aided credit institutions.

During the nationalisation process of Parex Bank at the end of 2008, the Latvian government found itself faced with an absence of regulations stipulating the conditions and procedures for bank takeovers by the state. To resolve that conundrum, and prompted by the government, Latvia's parliament (the *Saeima*) adopted the Law on Bank Takeovers at the beginning of 2009 in urgency procedure.

Under that law, a bank takeover is permissible in exceptional cases where the stability of the banking system and the smooth operation of payment systems are seriously threatened or potentially threatened. It is achieved by alienating shares issued by the bank, the bank's assets, rights or liabilities for the fair amount of compensation.

A bank takeover may be voluntary or compulsory. Where an agreement is reached on a voluntary takeover, the takeover is considered by the government based on a proposal by the minister of finance and an agreement drafted in co-operation with the bank or its shareholders. Where no agreement is reached on voluntary takeover, the minister prepares a draft decision stating the reasons that a compulsory takeover of the bank is necessary. The government then submits the draft law on compulsory takeover to the Saeima.

Newly-issued shares

Pursuant to the amendments, if, at the request of the board of the credit institution, the Government decides to acquire or increase qualifying holdings in a credit institution, a supervisory council of the credit institution is entitled to increase equity capital (issue new shares) of the credit institution on behalf of the shareholders, but without convening a shareholders meeting. In such cases, the existing shareholders do not have any pre-emptive rights to acquire the newly-issued shares.

This provision was introduced to speed the possible government capital injection in the credit institution. Normally, an increase of equity capital takes more than a month, since a convening of the shareholders meeting should be announced at least 30 days prior to the planned meeting.

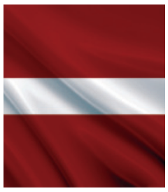
Transfer of the credit institution's business is subject to FCMC's prior consent. However, no consents of the credit institution's creditors or third parties are required. The credit institution should submit to the FCMC a proposal of business transfer together with an expert valuation of the assets and liabilities being transferred.

Punitive measures

The amendments also allow the FCMC to impose new measures in circumstances where the credit institution is deemed to be in breach of the law and/or FCMC regulations. Under the amendments, punitive measures can also be imposed if a credit institution's operations are threatening its own stability, solvency and safety – or the wider stability of the Latvian banking sector as a whole. In addition, measures can be taken if there is a risk of substantial loss to national economy, or if an excessive out-flow of deposits or other funds takes place.

The FCMC may impose measures including binding orders on the credit institution, establishing restrictions on rights and activities of the credit institution, including the right to suspend fully or partly the provision of financial services, restricting the performance of the bank's obligations, appointing an authorised FCMC representative to the credit institution with special powers to supervise it or levy a fine.

Those credit institutions that receive state aid are bound to fulfil their subordinated obligations to repay loans and calculate, accumulate or pay the interest or other remuneration due on these loans (among others). The restrictions were initiated mainly as a result of the former shareholders of the state-aided Parex Bank continuing to receive high interest on their deposits in the bank, which have been converted into subordinated capital.



A bank takeover is permissible in exceptional cases where the stability of the banking system and the smooth operation of payment systems are seriously threatened or potentially threatened

However, despite extensive public discussion, the Saeima decided the amendments should not be applicable retrospectively (ie, the restrictions should not apply to those credit institutions already receiving state aid or for which the authority has set restrictions on the fulfilment of deposit obligations). Thus, the restrictions will not apply to Parex Bank.

Amendments to the Consumer Rights Protection Law were also made to support household debtors. The law's provisions on unfair contractual terms will now be applicable to natural persons who are guarantors or providers of security for consumer mortgages.

Credit institutions will be prohibited from requiring any consumer who has not committed material violation of the contract:

- to provide additional security in cases where a mortgage has lost its value owing to changes in the property market;
- to cover the costs of a mortgage revaluation; or
- to accelerate repayment of a loan.

Household debt

The FCMC has also issued a set of guidelines for the credit institutions on out-of-court debt restructuring for household debts which are secured by mortgage and which are in line with international best practice. Last August, the government approved a support programme for troubled borrowers, but the funding has not yet been allocated and therefore the programme has not launched.

Generally speaking, Latvian banking legislation has been significantly changed as a result of the global financial crisis and thanks to the IMF and other international donors' support, banking legislation has improved by taking into account international standards of best practice.

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