ISSN 1691–1202

# FINANCIAL STABILITY REPORT 1 • 2003

LATVIJAS BANKA

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*Sources: the Central Statistical Bureau of Latvia, the Financial and Capital Market Commission, the Latvian Leasing Association and the Bank of Latvia.*

*Charts have been compiled on the basis of data provided by the Bank of Latvia (Charts 1–4, 7–36, 38, 39 and 42–50), the Central Statistical Bureau of Latvia (Charts 5 and 6),* Lietuvos bankas*,* Statistics Lithuania*,* Eesti Pank *and* Datastream *(Chart 37) and the Latvian Leasing Association (Charts 40 and 41).*

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## FOREWORD

Over the last ten years financial crises in transition economies and developing countries have demonstrated the significance of a stable and well-regulated financial sector. Several developed countries, e.g., Japan, Finland, Norway, Spain, Denmark and Sweden, also experienced financial shocks not so long ago. According to an assessment by the International Monetary Fund (IMF), the average cumulative loss in output growth was 14–15% of GDP in a banking crisis, depending on the development level of the respective national economy; in the event of a twin crisis, the loss in output would increase up to 17–19% of GDP. The recovery time for the national economy is three to five years on average.[1] In the longer term, financial crises have a negative impact on the country's budget and labour market as well. Therefore increasing attention is paid to ensuring financial stability and providing detailed analysis of the financial sector development.

Due to the efforts of the national central banks and supervisory institutions as well as the international organisations the World Bank and the IMF, a considerable progress has been achieved over the past ten years in strengthening the financial sector stability, thus preventing financial crises and their consequences. At the end of the 1990s, central banks of several countries, e.g., the Bank of England, *Österreichische Nationalbank*, *Sveriges Riksbank*, *Danmarks Nationalbank*, *Magyar Nemzeti Bank* and *Norges Bank*, commenced publishing financial stability reports where the major risks of the banking sector and the factors causing and measures mitigating them were assessed.

In May 1999, the IMF, in cooperation with the World Bank, launched the Financial Sector Assessment Program (FSAP) in order to help countries enhance their resilience to crises and cross-border contagion, and to foster growth by promoting financial system soundness and financial sector diversity. In February 2001, Latvia also joined the above programme. According to the assessment made by international experts, the Latvian banking sector was well capitalised, liquid and profitable. No essential instability sources were identified. International experts have given credit to Latvia's legislation regulating the financial sector as well as its supervision.

The primary objective of monetary policy of the central bank is to maintain price stability. Since 1991, when the Bank of Latvia resumed its operation, it has taken care to work towards that goal, ensuring both the stability of the exchange rate and interest rate stability of the national currency. The gradual decline in inflation in the mid-1990s was one of the key factors facilitating both the development of the banking sector and economic growth. Since early 1990s, considerable progress has been achieved in ensuring stability of the Latvian banking sector. Improvements in the banking legislation and the supervision of banks, harmonising them with the European Union (EU) requirements have substantially enhanced the performance of the banking sector. The introduction of the lats had an essential role in ensuring stability: with the inflation rate declining and the economic growth accelerating, the financial indicators of domestic enterprises improved and household income increased, thus reducing banks' risks. Improvement in the quality of banks' loan portfolio, a drop in interest rates and an increase in the number of customers demonstrated it: lending to households and small enterprises recorded a rapid growth.

This is the first issue of the Bank of Latvia's *Financial Stability Report*, prepared in close cooperation with the Financial and Capital Market Commission (FCMC). The goal of the report is to examine and assess the potential risks, which might

[1] IMF World Economic Outlook. Financial Crises: Causes and Indicators. – May, 1998.

adversely affect the Latvian financial system, paying particular attention to the banking sector, whose assets exceed 90% of total assets of the Latvian financial system, and the operation of leasing companies. The *Financial Stability Report* does not cover the financial position of individual financial institutions; it provides a macro-prudential analysis with the aim to assess the stability and vulnerability of the financial system in the context of the overall macroeconomic situation. The report consists of ten sections. Section 1 describes the external economic environment and the economic developments in Latvia; Section 2 covers the credit risk concentration on the domestic market. Section 3 addresses the banking competition and the development of interest rates. Section 4 reviews transactions of Latvian banks with non-residents and the related risks. Section 5 provides assessment of bank profitability. Section 6 provides an analysis of capital adequacy of banks and Section 7 examines bank liquidity. In Section 8 the financial vulnerability of the corporate sector and households is discussed, Section 9 covers the development of leasing companies, and in Section 10 the focus is on the operation of payment systems. The *Financial Stability Report* will be published semi-annually.

## 1. EXTERNAL ECONOMIC ENVIRONMENT AND ECONOMIC DEVELOPMENTS IN LATVIA

**One of the major external risks is the slow recovery of the euro area economy, although the economic slowdown in EU countries in recent years has not affected the Latvian exports and economy significantly.**

In the last two years, high instability and uncertainty were the main features of the global economy: the recession, which began in 2001, affected the major industrial countries and many developing and transition economies. Despite remaining imbalances in some areas of the economy, recent reports indicate that the global economy started to recover during the second half of 2003.

In the mid-1990s, the rapid development of the IT sector facilitated investors' interest, enabling corporations to borrow exclusively for the financing of large-scale projects. When overinvestments and their irrelevance to the market needs were identified, investors became more cautious and the funding possibilities of enterprises declined radically. Stock market was no longer stimulating the economy as equity prices collapsed, corporations were obliged to cut back on both borrowing and issuing shares, making capital accumulation more difficult. The economy plunged into recession, and the unwinding of the corporate sector's imbalances required time. Corporations were left with little reason to accumulate new equipment or labour, but with every reason to initiate price cuts to get rid of the excessive stocks. As the US has entered its cyclical downturn, the rest of the world has also begun to undergo recession. Moreover, structural problems have hindered cyclical development in the euro area countries and Japan. Several large imbalances in the world economy have yet to be corrected, e.g., the rigid labour market of the euro area countries, problems in the financial and the corporate sectors, and deflationary pressures in Japan, as well as the US external sector imbalances.

To preserve competitiveness and limit losses, corporations had to cut costs, scaling back on stock levels and employment. Substantial de-stocking resulted in stagnation of the manufacturing sector, whereas staff reductions impaired the situation on the labour market, negatively affecting consumer confidence. Over the last two years, among the many factors that had adverse effects on the consumer and producer confidence, were the September 11, 2001 attacks in the US, accounting scandals in the US in 2002, the Iraqi conflict in the spring of 2003, SARS, as well as volatility on the stock markets.

The relatively low inflation environment and economic slowdown have enabled the central banks of several countries to reduce the main refinancing rates aggressively (the latter have reached historic lows in the US, the euro area and Japan). Loosening of fiscal policy facilitated the economic recovery.

In July 2002, the euro exchange rate reached parity with the US dollar. Since then the euro has been strengthening against the US dollar, thus adversely affecting exports of the euro area countries.

In 2003, gradual recovery of the global economy began: in the second quarter, a solid increase in the private demand drove a more rapid growth in the US and Japan's economies. Nevertheless, in the first half of the year, the euro area economy still stagnated, contrasting with the results of the surveys pointing to a possible improvement at the end of 2003. The disorderly correction of the US external imbalances and the continued labour market stagnation still are the major risks for the US economic recovery. The economic growth of the euro area countries will largely depend on the recovery of the US economy, with the highest risk to future development associated with the potential appreciation of the euro against the US dollar. The growth of the global demand will have a positive effect on Japanese exports while the domestic demand is not yet strong enough to be the driving force of the economic recovery in Japan.

The global slowdown affected the economic development of the Central and East European countries as well, but the negative trends were not as pronounced in this group of countries as in the majority of developed economies. A decline in the foreign demand and a slowdown of export growth rates were partly offset by a pickup in the domestic demand caused by an increase in foreign investment and lending, which reflected positive developments in interest rates and in the banking sector. In several countries, an increase in real wages and loosening of the fiscal policy facilitated domestic demand considerably. The imbalance between the internal and external growth factors in several Central and East European countries impaired their current account balance considerably. The economic growth rate in the above countries might decline, should the global economic recovery not materialise and the stagnation in the most developed EU countries continue.

One of the major external risks of the Latvian national economy is the slow recovery of the euro area economy, which might reduce foreign demand. However, developments in recent years indicate that the economic slowdown in EU countries has not had a significant impact on Latvian exports, the economic growth, banks' profitability or quality of their assets.

The economic development in Russia is largely affected by the situation on the global energy and non-ferrous metal markets; in recent years it has been more favourable for the countries exporting the above resources. An increase in income from exports has considerably affected domestic demand, manifesting itself in a pickup both in investment and consumption. Russia has thus maintained a comparatively high GDP growth. The rapid development of the Russian national economy has facilitated economic growth in the rest of the CIS countries as well, mostly resulting from the strong trade links among the countries of this group.

In recent years, the economic situation has been favourable in Latvia. A rise in both domestic and foreign demand has fostered considerable economic growth, despite the slow economic activity of the major trade partners. With the level of investment increasing rapidly, the current account deficit increased over that of the previous periods. Improvement in terms of trade and appreciation of the euro had a positive impact on exports; but growth in imports also accelerated as a result of a considerably higher domestic demand. With the economic activity growing, unemployment decreased slightly. In the first half of 2003, the inflation rate recorded a slight increase that was mostly determined by a rise in food prices due to bad harvests, whereas the appreciation of the euro facilitated the price rise of goods imported from the euro area countries (clothing, footwear, food, etc.). The budget deficit was gradually reduced, but at the end of 2002 an unpredictably high Government expenditure led to an increase in the budget deficit. In the first half of 2003, the tightening of the fiscal policy resulted in a lower domestic demand; nevertheless, a rapid rise in the expenditure and hence also in the budget deficit was expected in the second half of the year. The increase in the current account deficit, typical for the second half of a year, as well as a rise in the budget deficit is a considerable macroeconomic risk. Therefore, the Government's commitment to reduce the budget deficit to 2.2% of GDP in 2004 should be regarded as a positive development.

The situation in the banking sector is stable. As a result of favourable economic conditions, the Latvian banking sector develops successfully, maintaining high profitability, liquidity and capital adequacy ratios. 22 banks and a branch of a foreign bank are registered in the Republic of Latvia. In nine banks, the share of foreign investment in banks' paid-up share capital exceeds 50%. At the end of June 2003, foreign investors, mostly residents of Estonia, Sweden and Germany, owned 52.2% in banks' paid-up share capital. Six banks are subsidiaries of foreign banks, and three of them are subsidiaries of banks originating in EU countries (Germany and Sweden).

## 2. CREDIT RISK CONCENTRATION ON THE DOMESTIC MARKET

**Loans granted to households posted the most rapid increase; nevertheless, loans granted to domestic enterprises dominate in banks' loan portfolio.**

Lending has been developing rapidly since 2000 in Latvia, facilitated by several factors: stabilisation of the economic situation, growing incomes, low enterprise and household indebtedness, an efficient system of registering ownership rights and encumbrances, low inflation rate and a drop in interest rates on the global financial markets. The strategic foreign investors, who have been operating on the Latvian financial market since the mid-1990s, have turned to penetrating new market segments and increasing market shares in recent years. As a result, competition among banks has intensified: interest rates on loans have decreased and the margins have narrowed, banks offer progressively more favourable terms and conditions for loans, and the scope of services has expanded. In the mid-1990s, banks granted loans mostly to large enterprises and wealthy individuals; beginning with 2001, they have been increasing their lending to small and medium-sized enterprises and households.

In 2003, loans granted to domestic enterprises and households continued to grow (see Chart 1). The growth rate of lending to the domestic corporate sector (public and private) and households (private persons and non-profit institutions servicing them) rose year-on-year. However, the growth rate of loans granted to non-bank financial institutions shrank due to the base effect. The types of loans accounting for a smaller share in banks' assets, as well as mortgage loans posted a more rapid rise (see Chart 2).

Although in recent years lending to households has been growing faster than in

*Chart 1*

**LOANS GRANTED TO DOMESTIC NON-BANK SECTOR**
(% of GDP)

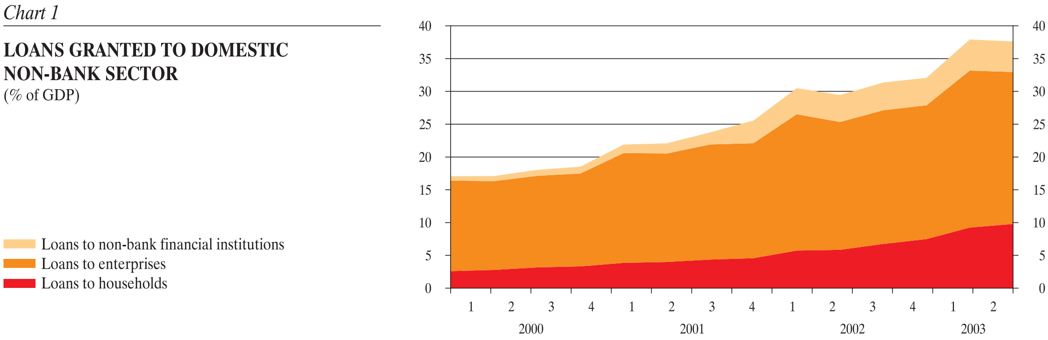
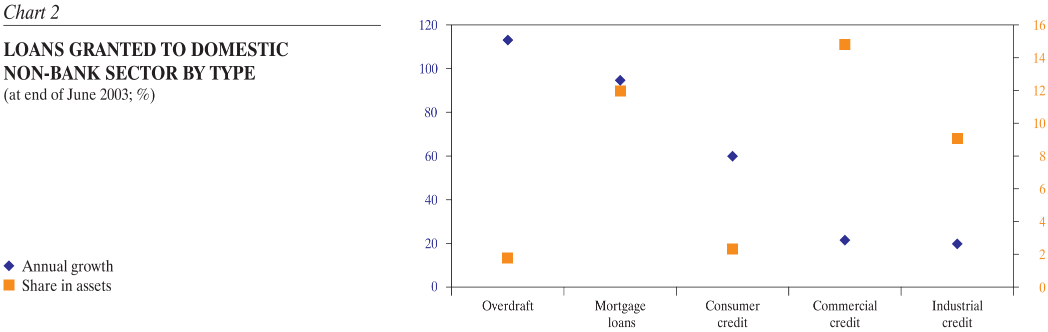



*Chart 2*

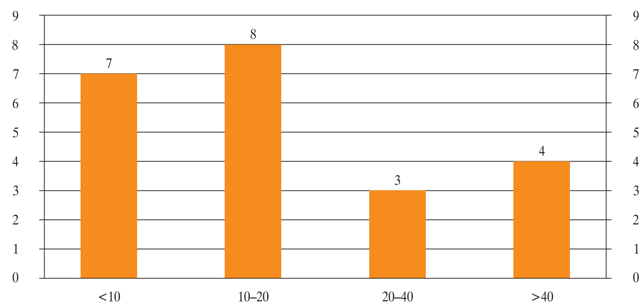
**LOANS GRANTED TO DOMESTIC NON-BANK SECTOR BY TYPE**
(at end of June 2003; %)




other market segments, loans granted to domestic enterprises continued to dominate in banks' loan portfolio. At the end of June 2003, they amounted to 23.2% {19.5%}[1] of GDP or 1 313.2 million lats, with the annual growth rate reaching 31.9% {26.1%} and the exposure to such loans being 27.0% {26.0%} of banks' assets. A high level of concentration was recorded in this market segment: the market share of just three banks was 60.7%. In seven banks, the exposure to domestic enterprises exceeded 20% of the banks' assets at the end of the first half of 2003 (see Chart 3), and the market share of these banks accounted for 48.7% of the banking sector's total assets. Under adverse conditions, the problems these banks might face would thus considerably affect the whole banking sector. However, improved risk management and diversification of the above banks' loan portfolios have reduced the credit risk. The exposure to enterprises of a particular branch does not exceed 30% of the total corporate loan portfolio. The trends in corporate financial indicators also suggest no increase in credit risk in this sector (see Section 8). In the future, credit risk might rise as a result of unfavourable trends in retail trade if trading premises continue to expand as rapidly as before and a part of supermarkets yields to competition, although the process of stabilisation and improvement in profitability indicators was observed in this sector over the last year.

*Chart 3*

**BREAKDOWN OF BANKS BY EXPOSURE TO DOMESTIC ENTERPRISES**
(at end of June 2003; %)

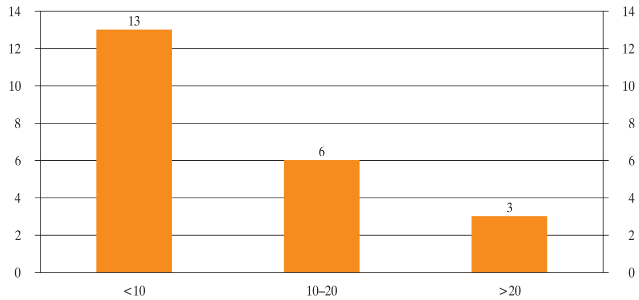



[1] {} – indicator of the corresponding period of the previous year.

With the housing market expanding, interest rates declining and household income and banking competition increasing, banks have changed their strategy over the last years, engaging in lending to households increasingly. The level of lending to domestic households, accounting for only 1% of GDP five years ago, still remains considerably lower than the amount of loans granted to domestic enterprises, whereas the growth rate of the former is much higher: at the end of June 2003, lending to domestic households totalled 555.0 million lats or 9.8% {5.8%} of GDP, with the annual growth rate reaching 86.0% {56.3%}. The rapid rise in lending to households was primarily determined by the development of mortgage lending. At the end of June, exposure to households accounted for 11.4% {7.8%} of banks' assets. Although the same banks dominated the markets for loans to enterprises and to households, the credit risk was more evenly distributed in the household segment. The market shares of the three leaders were almost the same, accounting for 56.7%. In one small and two medium-sized banks[1], the exposure to households exceeded 20% of the banks' assets (see Chart 4). Other banks have placed a comparatively small share of their assets in this market segment.

*Chart 4*

**BREAKDOWN OF BANKS BY EXPOSURE TO DOMESTIC HOUSEHOLDS**
(at end of June 2003; %)

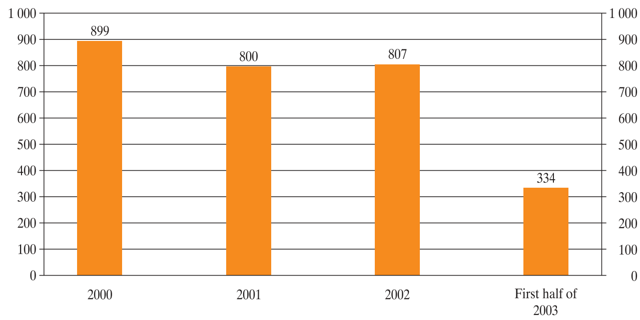



### *Box 1. Development of the Housing Market*

*The growing demand and the limited supply have been the factors underlying the rise in apartment prices in Latvia since the end of 2001. The rapidly increasing demand has been affected by several factors, the development of mortgage lending since 2000 being the most essential one due to a considerable drop in interest rates and more favourable mortgage loan terms and conditions offered by banks and leasing companies. At the end of 2001, the concern regarding a potential depreciation of the US dollar caused a substantial decrease in interest rates on transactions performed in this currency. Therefore part of the population converted their US dollar savings into deposits in lats with higher interest rates, or invested them in real estate. As both the apartment prices and their rent increased rapidly, purchasers more often bought the less expensive one- and two-room standard apartment block flats for their own*

*Chart 5*

**NUMBER OF NEWLY BUILT APARTMENTS**




[1] Banks are dividend into three groups on the basis of the value of their assets: large banks (with their assets exceeding 400 million lats), medium-sized banks (with assets within the range of 80 million lats to 400 million lats) and small banks (with their assets below 80 million lats).

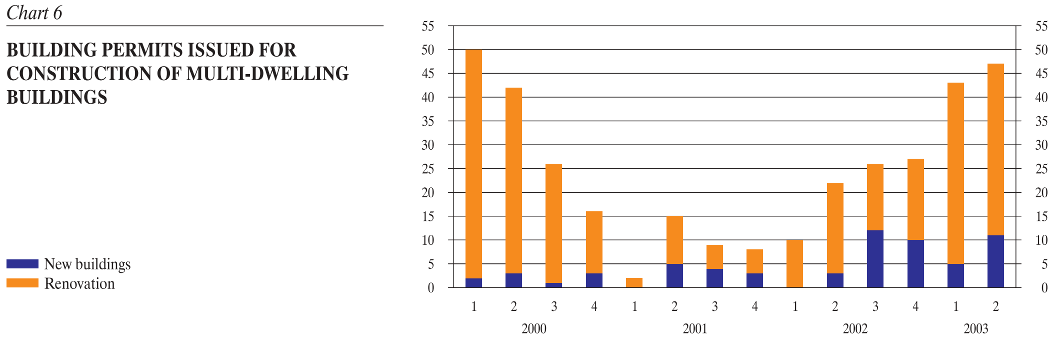
*needs or for renting to others. Also, the old apartment blocks, which had hardly been renovated during the last 13 years, were the cause of the price rise (see Chart 5): for the most part, such private houses and residential buildings were built where the price levels were by far higher than those in the old residential buildings and hence the majority of the population could not afford them. Thus, with a restricted supply and the demand for apartments increasing, their prices rose as well.*

*Since spring 2003, the situation on the apartment market has remained stable, and, according to the information provided by real estate companies, apartment prices have no longer increased and have even shrank slightly. Such a development was caused by a decline in the demand for standard apartment block flats, for the price per one square meter of dwelling space in the latter sometimes reached the renovation cost per square meter of an older apartment. Therefore, part of purchasers with a higher income opted to buy apartments in newly built or privately owned buildings, selling their old flats. Mass media also expressed concern that on the secondary apartment market prices would soon plummet; therefore, some potential purchasers probably held back. The situation was similar to that in Estonia in spring 2002. In line with the experience of our neighbouring country, a substantial drop in apartment prices on the secondary apartment market in Latvia should not be expected. Apartments in the newly built houses are comparatively spacious, and although prices per square metre in the old and new houses do not differ all that much, most purchasers still cannot afford an apartment in a newly built house.*

*The fact that since 2002 the number of building permits issued for the construction of new apartment houses and the renovation of those unfinished in the Soviet period has increased also indicate structural changes in the housing market (see Chart 6). The number of apartments built in 2003 might exceed 1 000 (807 in 2002). In 2004, construction is expected to increase in scale even further.*

*Chart 6*

**BUILDING PERMITS ISSUED FOR CONSTRUCTION OF MULTI-DWELLING BUILDINGS**



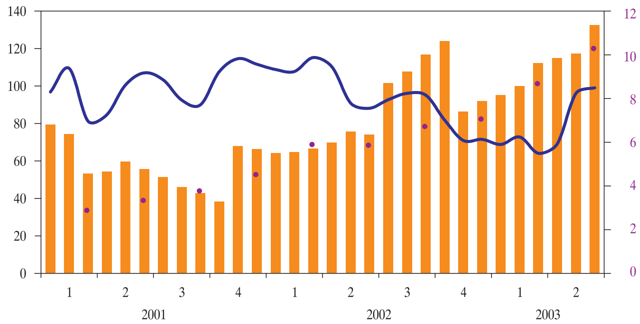

*Thus, on the one hand, prices of standard apartment block flats will be positively affected by the development of mortgage lending and, on the other hand, the price rise will be curbed by an increase in the supply due to changes in the market structure. In view of the above, stabilisation of prices for standard apartment block flats is expected in the near future, but in 2004, with the supply of new apartments increasing considerably, they will slightly decrease (a more pronounced price drop is expected for apartments in older houses). In the future, the rise in apartment prices will be more moderate, in line with increases in household income.*

*The risk associated with fluctuations in apartment prices is limited by the fact that Latvian banks carefully assess a borrower's cash flows as the primary source of loan repayment is based on his/her regular income. Moreover, to apply a reduced (50%) capital requirement to a loan granted to a household, the amount of the loan may not exceed 70% of the market value of the real estate collateral. Otherwise, 100% risk weighting applies to such type of loans. In view of the fact that, for the time being, exposure to housing loans exceed 20% in two banks only, and the market share of the* *above banks is comparatively small, as well as that the household debt level is fairly low and at the initial stage of market development loans are granted to households with a higher level of income, it can be concluded that the potential fluctuations in apartment prices will not cause serious problems to the banking sector.*

With lending to households growing rapidly, banks' mortgage loan portfolio has expanded considerably over the last years. Mortgage lending started to evolve fairly recently. Five years ago mortgage loans accounted for less than 1% of GDP. It was only at the end of 2001 that, with interest rates decreasing, a rapid growth in mortgage lending began. The drop in interest rates resulted not only from the overall decrease in global interest rates, but also from competition. Thus, at the end of June 2003, the annual growth rate of mortgage loans granted to domestic enterprises and households was 99.0% {88.0%} and totalled 595.8 million lats or 10.5% {5.9%} of GDP (see Chart 7), including a rise of 1.3 times in housing loans to households, amounting to 339.2 million lats or 6.0% {2.9%} of GDP. In May 2003, the growth rate of mortgage loans accelerated rapidly, partly due to a reclassification of loans in the amount of 59.9 million lats. The mortgage loan growth rate surged to a higher level, the complementary effect of the reclassification of loans notwithstanding.

*Chart 7*

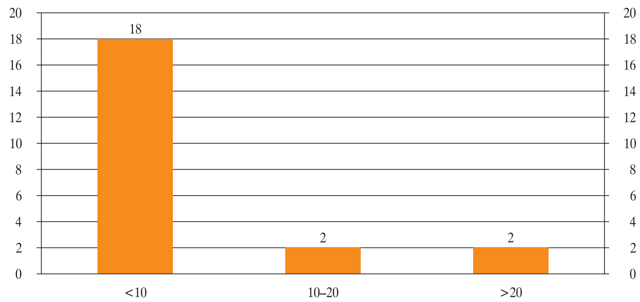
**DOMESTIC MORTGAGE LOANS**
(%)




At the end of June 2003, housing loans accounted for only 7.0% {3.8%} of banks' assets. Nevertheless, some banks' exposure to housing loans was substantial. In two banks, the exposure to housing loans exceeded 20% (see Chart 8); assets of these banks accounted for only 4.6% of the total assets of the banking sector. Concentration in this market was high: the market share of the three market leaders amounted to 55.2%. To date, the exposure of the lending leaders to housing loans has been relatively small, but with an upward trend. As a result, the risk associated with potential real estate price fluctuations will increase.

*Chart 8*

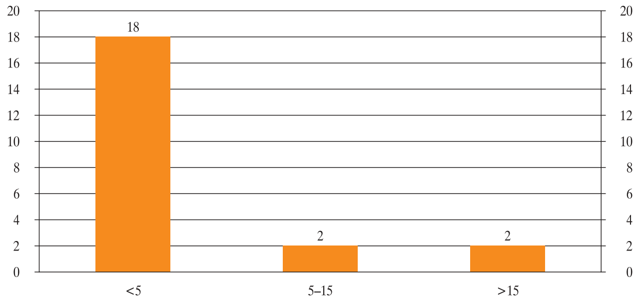
**BREAKDOWN OF BANKS BY EXPOSURE TO HOUSING LOANS**
(at end of June 2003; %)




By the very end of 2001, the amount of loans granted to domestic non-bank financial institutions was insignificant, but since then it has grown rapidly, mostly owing to a rise in the funding of leasing companies owned by banks. At the end of June 2003, loans granted to domestic non-bank financial institutions reached 265.0 million lats or 4.7% {4.1%} of GDP (an annual increase of 26.3%). Several large and medium-sized banks were engaged in lending to domestic non-bank financial institutions, and some of the banks owned shares in these financial companies as well. Thus, at the end of June 2003, a very high level of concentration was observed in this market segment: the market share of three banks accounted for 91.8% of the banks' assets. Although loans granted to non-bank financial institutions expanded at a rapid rate, their share in banks' assets still was relatively small (5.4% {5.5%}; see Chart 9). Since leasing companies were the ones who received most of the loans and whose significance in the financial sector of Latvia continued to grow, the performance of leasing companies has been analysed in Section 9 of this Report.

*Chart 9*

**BREAKDOWN OF BANKS BY EXPOSURE TO DOMESTIC NON-BANK FINANCIAL INSTITUTIONS**
(at end of June 2003; %)




Risks associated with lending to enterprises are limited by improvement in the quality of banking risk management, loan portfolio diversification by branch and improvement in the financial indicators of the corporate sector. Retail trade is a sector liable to risk, since the segment of shopping centres is saturated and retail companies have a high level of debt (see Section 8); nevertheless, declining indebtedness is reported in this sector as well. The risk related to lending to households is not high for the time being; however, it is picking up gradually, with several banks increasingly expanding in this market segment and the household debt-to-disposable income ratio growing.

## 3. THE OVERALL INTEREST RATE MARGIN

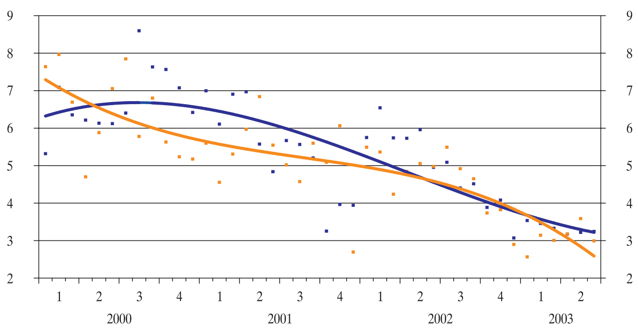
**The expanding competition facilitated narrowing of the overall interest rate margin.**

The overall interest rate margin on new businesses (as the lending rate minus the deposit rate) tended to shrink. Between January 2000 and June 2003, the overall margin on transactions both in lats and the OECD currencies narrowed (by 2.1 percentage points, to 3.2% and by 4.6 percentage points, to 3.0%, respectively; see Chart 10), approaching the overall margin in mature economies. A reduction in the overall margin, a drop in interest rates on the money market and lower yield on Government securities did not affect the profitability of the banking sec-

*Chart 10*

**OVERALL MARGIN**

Transactions in lats
Transactions in the OECD currencies



tor adversely, since the value of transactions increased considerably. Given the potential of the credit market, market growth can be expected in the coming years as well; nevertheless, improving the cost efficiency will be more essential for maintaining high profitability for banks in the future.

The overall margins were almost the same for transactions in lats and the OECD currencies, because the factors affecting them were similar. The stabilisation of the macroeconomic environment, the development of the financial market and banking sector, as well as the increasing competition on the domestic market underlay an almost equivalent reduction in the interest rate margins. A slightly narrower overall interest rate margin for transactions in foreign currencies than the corresponding one in lats was observed due to the possibility for banks to borrow cheaper foreign currency funds from their parent companies or other financial institutions in the form of credit lines. As a result, cheaper loans could be granted, ensuring a larger market share. A decline in interest rates on new loans granted to domestic non-banks and deposits attracted from them in the OECD currencies was more rapid than those on the respective transactions in lats, for the Federal Reserve System and the European Central Bank (ECB) reduced the base rates. Interest rates on transactions in the OECD currencies also were lower than those on the respective transactions in lats.

The downward trend of the overall margin was determined by narrower margins both in the domestic enterprise and the household sectors (see Charts 11 and 12). This decline was affected by the comparatively stable and only slightly lower interest rates on deposits and a more prominent drop in those on loans. The overall margin mostly depended on transaction interest rates in the enterprise sector, the level of transactions with enterprises being higher than that with households (between January 2000 and June 2003, new loans to resident enterprises accounted for 82.8% of such loans in total, while the share of deposits reached 73.1% of total deposits). In the enterprise and households sector, the interest rate margin of long-term transactions had a similar downward trend. A more pronounced drop was observed in 2000; in 2001 it stabilised, and then, beginning with 2002, shrank again. The interest rate margin of long-term loans and deposits depended on the

*Chart 11*

**INTEREST RATE MARGIN FOR TRANSACTIONS IN LATS WITH ENTERPRISES**

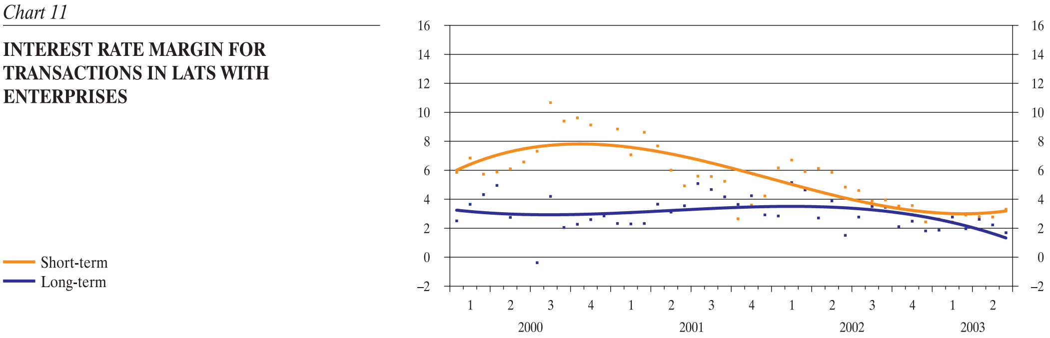
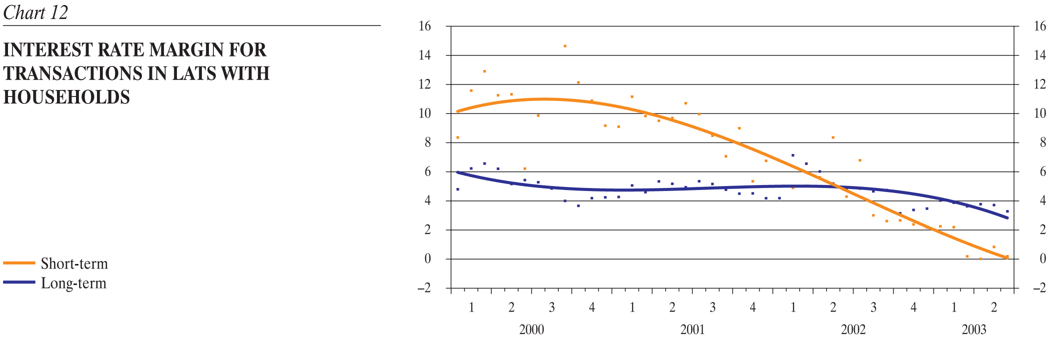



*Chart 12*

**INTEREST RATE MARGIN FOR TRANSACTIONS IN LATS WITH HOUSEHOLDS**



banking sector's liquidity or the funds price on the lats money market (RIGIBOR[1]), since it narrowed at those periods when the banking sector's liquidity improved and the RIGIBOR declined respectively. However, it remained stable when the banking sector's liquidity was comparatively low, for example in 2001. The interest rate margin of short-term transactions between banks and households shrank more rapidly than that of respective transactions in the enterprise sector. This was caused by the relatively stable and only slightly declining interest rates on deposits, contrasting with those on loans decreasing at a much more rapid rate. Risks associated with lending to households diminished, but a drop in interest rates on household deposits was hindered by banks willing to strengthen their market share and by the real interest rates, which, due to inflation, were lower than the nominal ones. A tendency to grant customers (also households) short-term loans (with maturity of a few days and up to one month) against a collateral (securities collateral) of a higher quality, with an interest rate similar to that on the money market loans, was more pronounced. Such transactions had a considerable impact on the overall margin due to the ample turnover, as the share of new loans granted to residents in lats with maturity of 1 month in the short-term loan profile grew from 42.9% in 2000 to 66.1% in the first half of 2003. Nevertheless, the exposure to these loans was not high (in June 2003, loans granted to residents in lats with maturity of up to 6 months accounted for 3.3% in the short-term loan profile). Therefore, the overall margin was mostly affected by a reduction in interest rates on loans, with that in interest rates on short-term deposits having a less pronounced effect.

The lower overall margin and the volatility of interest rates both indicated stiffer competition among banks. The fierce competition for increasing market share facilitated diminishing differences in interest rate margins. In recent years, structural changes continued in the banking sector, affecting the overall margin. Along the five to seven universal banks providing a wide range of services (using price policy, diversity of the services offered and increasingly professional customer service for rising market share), the small banks who had specialised in niche banking, also entered the lending market more actively, thus increasing competition on the domestic market. In order to improve their competitiveness, banks expanded the scope of services offered and developed services via the Internet. Banks faced competition in debt securities market also from mutual investment and pension funds investing in government debt securities.

***Box 2. Interest Rate Policy of Banks with Different Ownership Structures***

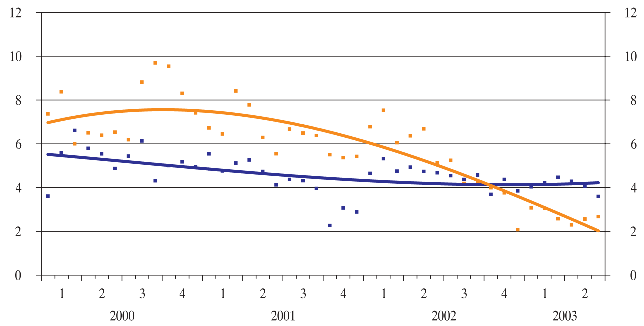
*In terms of bank's capital owner, business strategy and size, the Latvian banking sector is heterogeneous. A more accurate insight in banks' competitiveness can be obtained, examining the overall margin in different groups of banks. To identify differences in interest rate policies chosen by banks depending on the ownership structure, banks were divided into two groups: a group of banks with domestic capital dominating, and banks with the predominance of foreign capital[2]. The overall margin of transactions in lats executed in banks mostly belonging to non-residents narrowed gradually from 4.9 percentage points in June 2000 to 3.6 percentage points in June 2003 (see Chart 13), whereas the same in banks mostly owned by residents was initially*

[1] *Riga Interbank Offered Rate* – money market interest rate index calculated by the Bank of Latvia.

[2] Depending on the ownership of the paid-up capital, banks with the predominance of foreign capital are divided into two groups subject to the following criteria:
1) the share of foreign investment in the bank's paid-up share capital at the end of 2002 (>95%);
2) the share of loans granted to residents by the bank in the banking sector's total loans (>2.0%).
Four subsidiaries of foreign banks and a branch of a foreign bank were included in the group with the predominance of foreign capital. Other banks comprised the group with domestic capital dominating. The group's monthly interest rate is calculated as the weighted average indicator of banks' interest rate.

*Chart 13*

**OVERALL MARGIN FOR LATS TRANSACTIONS**



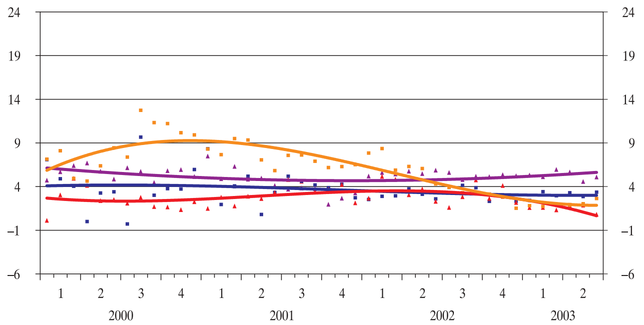
Banks with the predominance of domestic capital
Banks with the predominance of foreign capital

*higher (6.5 percentage points in June 2000) and more volatile; it posted a more marked decline in 2002, stabilising at a fairly low level (2.7 percentage points in June 2003).*

*In banks mostly owned by residents, a decrease in the overall margin resulted from a sharp drop in interest rates on short-term loans (particularly so in the household sector; see Charts 14 and 15). The interest rate margin of long-term transactions in the household sector recorded insignificant downward changes, and that in the enterprise sector remained continuously stable. Although interest rates on short-term lending shrank substantially, the amount of loans was not large. Therefore the interest rate margin on long-term transactions gave a better insight into the competition conditions and the differences between banks depending on the ownership structure. It was the interest rate margin that recorded a lower level in banks with the predominance of foreign capital (see Charts 14 and 15). In the latter, interest rates paid for attracting deposits were slightly lower than the respective interest rates in banks with domestic capital dominating. Moreover, cheaper loans from parent companies were available to the banks mostly belonging to non-residents; hence, the latter could afford to grant cheaper loans as well. Nevertheless, recently the difference between the prices for which the funds had been attracted and the long-term interest rates on loans in banks with the predominance of domestic capital and foreign capital was minor. Thus it can be concluded that competitiveness in banks with the predominance of domestic capital has increased, reaching the level of the banks mostly belonging to foreigners.*

*Chart 14*

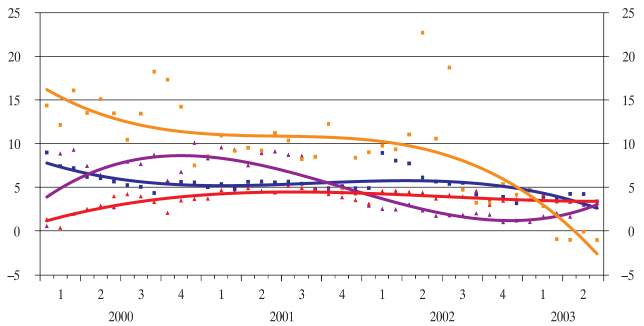
**INTEREST RATE MARGIN FOR TRANSACTIONS IN LATS WITH ENTERPRISES**



Banks with the predominance of domestic capital (short-term transactions)
Banks with the predominance of domestic capital (long-term transactions)
Banks with the predominance of foreign capital (short-term transactions)
Banks with the predominance of foreign capital (long-term transactions)

*Chart 15*

**INTEREST RATE MARGIN FOR TRANSACTIONS IN LATS WITH HOUSEHOLDS**



Banks with the predominance of domestic capital (short-term transactions)
Banks with the predominance of domestic capital (long-term transactions)
Banks with the predominance of foreign capital (short-term transactions)
Banks with the predominance of foreign capital (long-term transactions)

## 4. BUSINESS WITH NON-RESIDENTS

**The dependence of the Latvian national economy on non-resident savings and investors' risk assessment has increased.**

Business with non-residents both in funding and investment is a characteristic feature of the Latvian banking sector. At the end of June 2003, claims on non-residents accounted for 39.2% {41.8%} of the assets, and the share of liabilities to non-residents was 52.8% {52.3%} of liabilities (see Charts 16 and 17). With a rapid increase in loans granted to domestic enterprises and households, the share of non-residents in the assets of the banking sector has been gradually declining since 2000, whereas the impact of non-residents on financing banks increases. Several factors determine it: banks increasingly use loans from their parent companies for lending to the private sector, and deposits attracted from non-residents grow year by year.

*Chart 16*

**TOTAL ASSET PROFILE**
(in millions of lats; %)

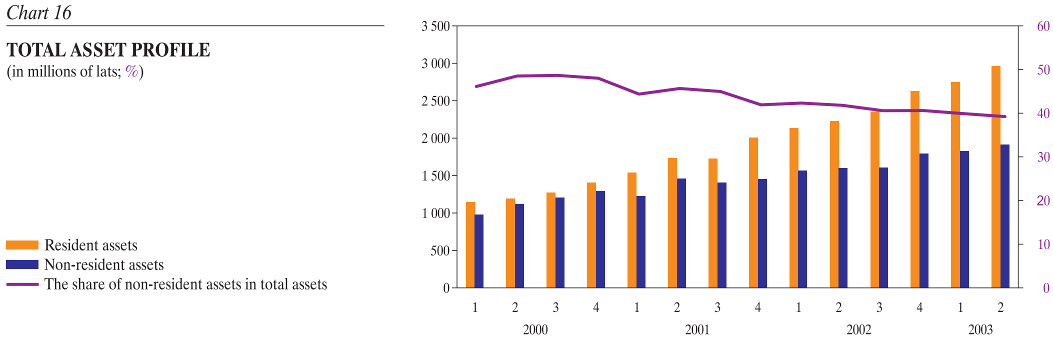
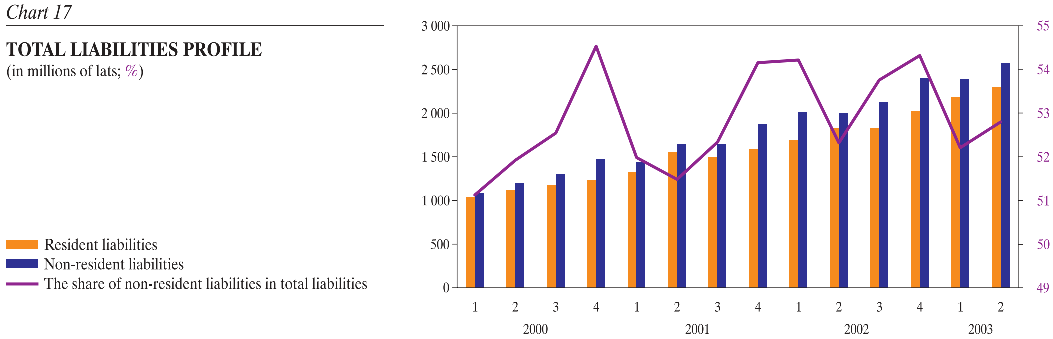



*Chart 17*

**TOTAL LIABILITIES PROFILE**
(in millions of lats; %)




At the end of June 2003, claims on non-resident banks totalled 980.7 million lats {777.2 million lats} or 20.1% of assets. Major debtors of Latvian banks were credit institutions of the US and EU countries, where Latvian banks had their accounts (268.2 million lats {254.7 million lats} and 504.0 million lats {429.2 million lats}, respectively). The majority of claims on non-resident credit institutions were recorded by the so-called niche banks, which mostly service foreign currency accounts of non-resident clients. Claims on non-resident credit institutions by three banks accounted for 47.2% of total claims in this segment, and in six banks the exposure exceeded 50% of their assets. Since the US and EU countries are rated as low-risk countries, and banks are to ensure adequate liquidity, a high share of claims on banks in these countries should be considered a positive factor. The level of claims on the CIS countries remained fairly low, picking up as from April 2003 and reaching 104.5 million lats {28.5 million lats} at the end of June. It is attributed to the fact that the resolution adopted by the Bank of Russia on March 31, 2003 to delete Latvia from the list of countries and territories with whom foreign exchange operations are under particular control, took effect in April. Hence cooperation between Latvian and Russian companies became simpler.

At the end of June 2003, loans granted to non-resident non-bank sector totalled 256.8 million lats {268.6 million lats} or 5.3% of the assets of the banking sector. Slightly less than half of these loans were granted to the US residents; approximately one fifth of them were issued to residents of the EU and CIS countries. This market segment was characterised by a high concentration level: three banks granted 59.3% of total loans to non-resident non-banks. The risk associated with loans granted to the non-resident non-bank sector was insignificant, since the exposure was comparatively small: in three small banks only, loans granted to non-residents exceeded 20% of their assets. Moreover, in comparison with the end of June 2002, the outstanding amount of these loans decreased.

At the end of June 2003, liabilities to non-resident banks totalled 547.2 million lats {414.7 million lats} or 11.2% of the banking sector's liabilities. Majority of funds were attracted from EU countries (398.4 million lats {288.5 million lats}), for several Latvian banks are subsidiaries of credit institutions of EU countries, and a branch of an EU country bank operated in Latvia. Liabilities to banks from other countries were fairly low. Liabilities of three banks accounted for 58.6% of total liabilities in this segment. Loans from non-resident credit institutions were a significant source of funding in several banks, the latter mostly being subsidiaries of credit institutions of EU countries or receiving funding from investment banks abroad for implementing a particular project. The rapid growth of the Latvian national economy, the prospective membership in the EU as of May 1, 2004, and the potential of credit market growth underlay the interest of foreign investors in this market. Foreign capital inflows in the Latvian banking sector are expected to continue. In view of the fact that only one third of liabilities to foreign credit institutions are long-term, and these funds are mostly invested in domestic long-term loans, it can be concluded that the liquidity risk related to these liabilities has increased. However, since most of the short-term funds come from parent companies, the risk is limited.

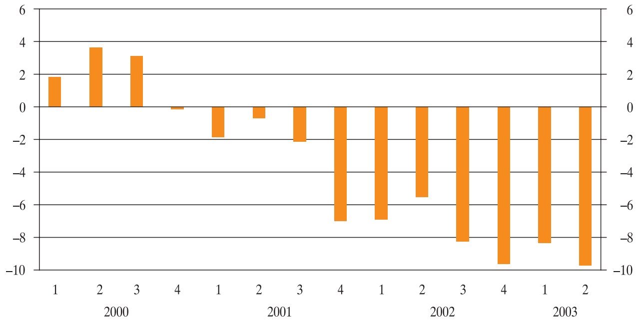
At the end of June 2003, deposits received from the non-resident non-banks reached 1 744.9 million lats {1 325.3 million lats} or 35.8% of the banking sector's liabilities. Non-resident non-bank deposits in three banks accounted for 59.0% of total non-resident deposits. In ten banks, the share of non-resident non-bank deposits exceeded 50% of liabilities of these banks. The majority of banks had adequate liquidity in the form of claims on credit institutions of the OECD countries or a portfolio of liquid securities; hence their liquidity ratios were very high (see Section 7). The liquidity risk related to non-resident deposits in one small and one medium-sized bank was somewhat higher, as they had used a part of their non-resident deposits for lending to domestic customers. Nevertheless, the liquidity ratios of the above banks were much higher than in the banking sector overall; however, a gradual decline was observed, with the banks increasing their loans granted on the domestic market.

In recent years, the dependence of the Latvian economy on foreign savings and investors' assessment of risk has increased, and it is also evident in the banking sector. At the end of June 2003, banks' net foreign assets[1] decreased to –473.6 million lats {–211.0 million lats} (see Chart 18). It is attributed to the fact that several banks increasingly invested funds from their parent companies or loans granted by foreign investment banks (European Bank for Reconstruction and Development (ERAB), Nordic Investment Bank (NIB)) on the domestic market, along some banks investing part of their non-resident non-bank deposits there as well. Thus, in the first half of 2003, the liquidity risk related to non-residents slightly increased. However, the credit risk associated with non-residents decreased, with loans granted to non-resident non-banks shrinking.

[1] Difference between foreign assets and liabilities (excluding equity).

*Chart 18*

**BANKS' NET FOREIGN ASSETS**
(% of assets)




## 5. BANK PROFITABILITY

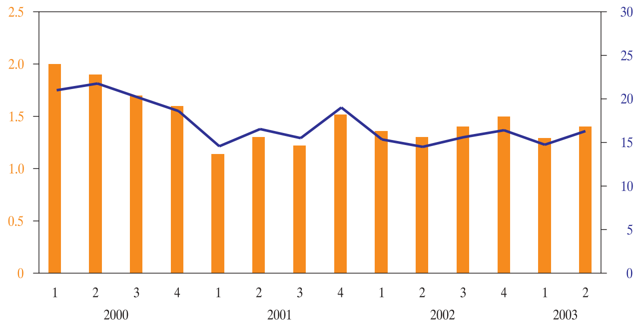
**Banks maintained high profitability indicators.**

In recent years, bank profitability has been high. Like in 2002, in the first half of 2003 all banks earned profit totalling 32.9 million lats after taxes, which was an increase of 40.3% year-on-year. Return on equity (ROE) reached 16.3% {14.5%}, return on assets (ROA) was 1.4% {1.3%} (see Chart 19).

*Chart 19*

**PROFITABILITY INDICATORS**
(%)

ROA
ROE

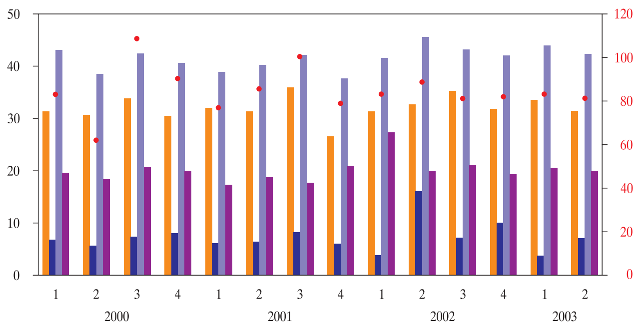



In comparison with the corresponding period of 2002, banks' total income from interest grew by 3.1%. The drop in interest rates on loans had not affected bank profitability, as it was offset by a rapid growth in banks' lending to non-banks. As a result, interest income from loans granted to non-banks rose by 5.6%, whereas that from claims on credit institutions and the central banks shrank by 4.6% due to lower interbank interest rates. Interest expense decreased in almost all interest expense groups (6.8% in total; interest expense for securities was an exception, increasing more than twice as a result of a rise in the amount of debt securities issued, but accounting for only 3.0% in total interest expense). Consequently, net interest income grew by 11.2%, amounting to 31.4% {32.7%} of total income (see Chart 20).

*Chart 20*

**INCOME AND COST PROFILE**
(%)

Net interest income to total income
Net income from currency trading and its revaluation to total income
Operating costs and intangible asset amortisation to total income
Net commission and fee income to total income
Cost-to-income ratio



The global securities market being stable, it had a positive impact on income from securities, and rose by 7.6% (this income recorded a drop in 2002). Net income from commissions and fees grew by 13.9%, accounting for 19.9% {19.9%} of total income.

Income from foreign currency trading doubled, obviously resulting from exchange rate volatility of major currencies, as well as a high trading turnover. In the first half of 2003, the share of net income from foreign currency trading and income from currency revaluation shrank to 7.7% {9.9%} in total income, as that from foreign currency revaluation declined.

With the banking sector expanding, operating costs increased considerably (by 12.0%, including a rise of 11.1% and 13.9% in personnel wages and salaries and in other operating costs, respectively), whereas expenditure for Board of Governors and Executive Board wages and salaries decreased (by 9.8%). The pickup in operating costs was related to an increase in the number of employees and branches, as well as to opening several new customer service centres. The share of operating costs and amortisation of intangible assets in total income remained almost unchanged (43.1%) {43.2%}.

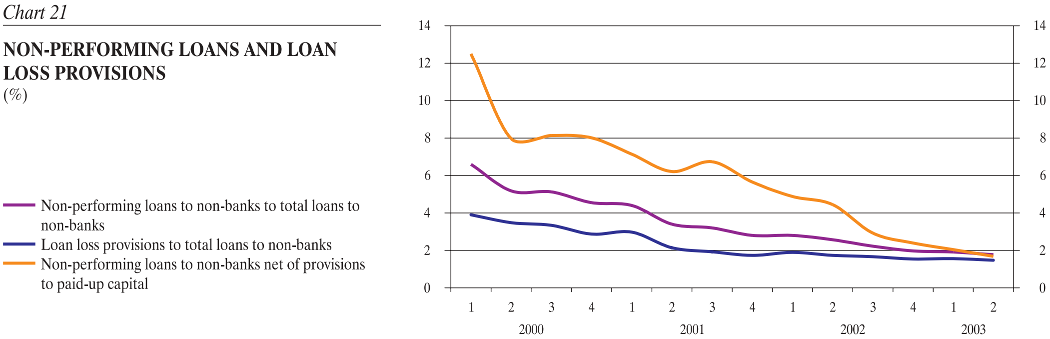
Banks' income grew more markedly than expenditure (by 11.6% and 6.8%, respectively). Thus the cost-to-income ratio continued to decrease in the first half of 2003, reaching 82.1% {85.8%} but still being higher than in the banks of EU countries where the ratio is below 70%. Nevertheless, with banks' cost efficiency increasing, further improvement is expected.

**Asset quality continued to improve.**

Despite the rapidly growing lending, the quality of banks' assets improved: non-performing non-bank loans, net of loan loss provisions, contracted to 1.7% {4.4%} in banks' equity (see Chart 21). The ratio of loan loss provisions to total loans also continued to shrink, at the end of June 2003 accounting for 1.8% {2.6%} and 1.5% {1.7%}, respectively.

*Chart 21*

**NON-PERFORMING LOANS AND LOAN LOSS PROVISIONS**
(%)




Thus, despite the growing competition and the falling spreads, banks maintained high profitability indicators, and their asset quality continued to improve.

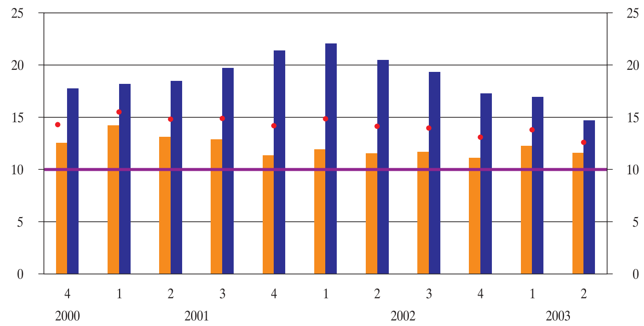
## 6. BANK CAPITAL ADEQUACY

The level of bank capitalisation ensures adequate buffer against potential losses.

Since June 2002, the regulatory capital adequacy ratio (CAR) declined, with the credit risk capital requirement growing more rapidly than equity. Nevertheless, the CAR still exceeded the minimum limit (10%), accounting for 12.6% {14.1%} at the end of June (see Chart 22).

*Chart 22*

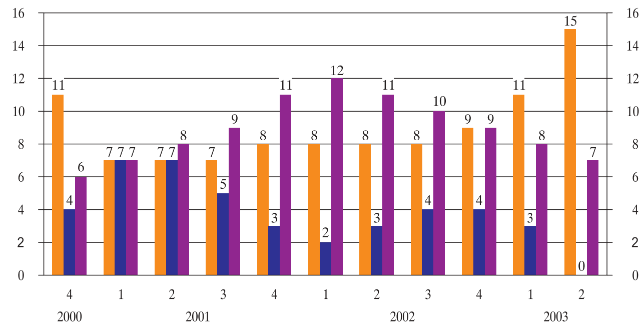
**CAPITAL ADEQUACY RATIO**
(%)




Differences in CARs across banks diminished: banks with a CAR of 16%–20% reduced it considerably, thus joining the banks with a CAR below 15% (see Chart 23). It was attributed to the fact that several medium-sized and small banks, which had had a very high CAR, expanded lending, increasingly becoming more exposed to domestic enterprises and households, whereas the CAR of large banks remained at the level of June 2002 (11.6%). Thus, the CARs of large banks and other banks levelled out gradually.

*Chart 23*

**BREAKDOWN OF BANKS BY CAPITAL ADEQUACY RATIO**
(%)




The bank capitalisation level remained high, allowing for potential losses if any.

***Box 3. Deposit Guarantee Fund***

*Deposits of natural persons with Latvian credit institutions have been guaranteed since 1998 when the Law "On Natural Person Deposit Guarantees" became effective. Since 2003, funds accumulated in the Deposit Guarantee Fund have served as a guarantee for deposits of natural persons and legal entities in the amount provided for by the Law. In 2003, the guaranteed cover both for natural persons and legal entities was stipulated in the amount of 3 000 lats. Within the next five years, the maximum level of a guaranteed cover will gradually increase to 13 000 lats per person in each bank and credit union, equaling the minimum amount of a guaranteed compensation stipulated by the EU.*

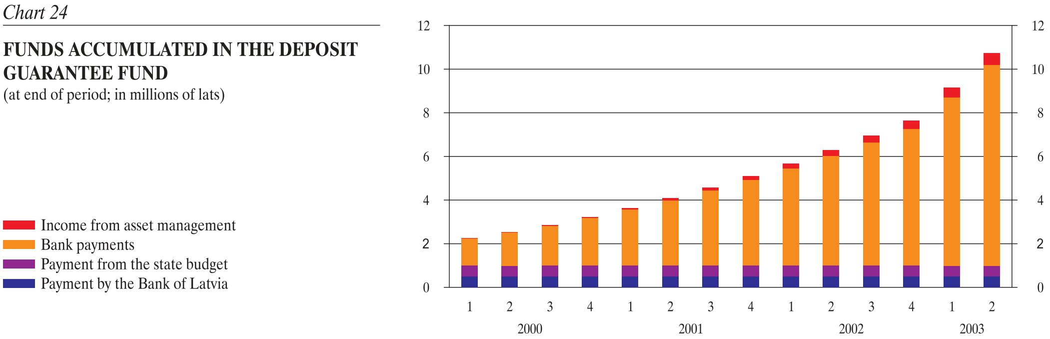
*Any bank, branch of a foreign bank or credit union shall make quarterly payments in the Deposit Guarantee Fund in the amount of 0.05% of an average amount outstanding of the guaranteed deposits (of natural persons and legal entities) with the deposit holder in the previous quarter. The FCMC shall ensure the accumulation of funds with the Deposit Guarantee Fund and their management. By the end of June 2003, 10.7 million lats had been accumulated in the Deposit Guarantee Fund (see Chart 24).*

*Payments under a guarantee are also supervised by the FCMC. Where the Fund's*

[1] Information provided by the FCMC.

*Chart 24*

**FUNDS ACCUMULATED IN THE DEPOSIT GUARANTEE FUND**
(at end of period; in millions of lats)




*resources are insufficient to pay the guaranteed compensation to depositors, it shall be paid from the general government budget pursuant to the Law.*

## 7. BANK LIQUIDITY

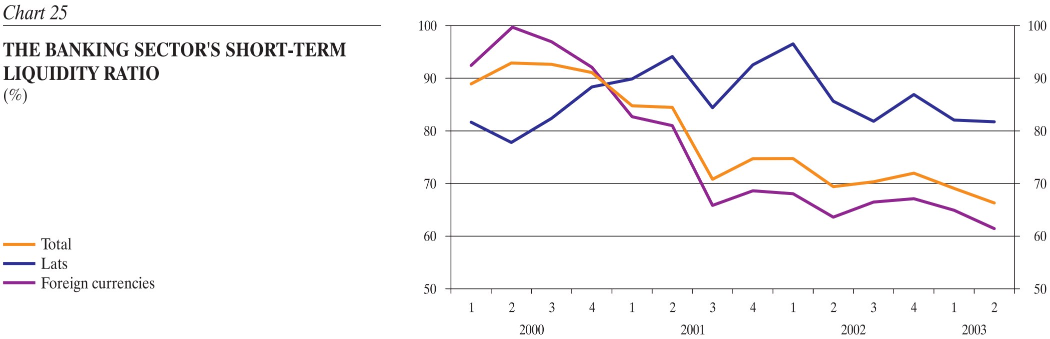
**All groups of banks maintained high liquidity.**

High liquidity was characteristic of the Latvian banking sector, considerably exceeding the minimum level (30%) stipulated by the FCMC. In the second quarter of 2003, it reached 57.9%.

To assess bank liquidity by currency and group of banks, a short-term liquidity ratio was calculated. Since 2000 it had been declining and was 66.3% {69.4%} at the end of June 2003 (see Chart 25). Nevertheless, the liquidity ratio of the banking sector remained high. The decline resulted from changes in the asset structure. The share of liquid assets in total assets shrank to 34.7% {36.1%} (see Chart 26), mostly due to a rapid pickup in loans granted to non-banks. As regards the short-term liquidity ratio by currency, a decline was reported for foreign currencies as a result of liquid assets in foreign currencies increasing at a slower rate than liabilities (liabilities to parent companies and non-resident non-bank deposits), whereas the liquidity of the lats has been more volatile since 2000, declining slightly only in 2003.

*Chart 25*

**THE BANKING SECTOR'S SHORT-TERM LIQUIDITY RATIO**
(%)



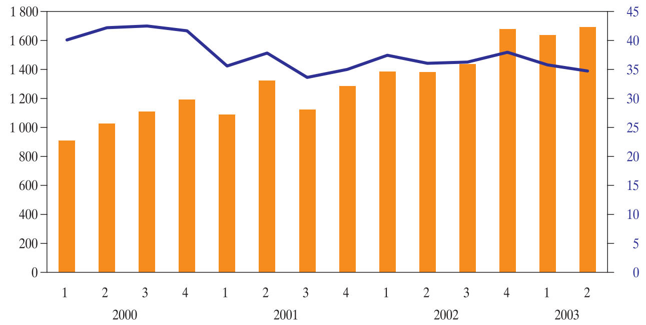

With loans expanding, the non-bank loan-to-deposit ratio rose to 73.9% {68.6%} at the end of June 2003 (see Chart 27). For resident transactions, this ratio was 140.4% {116.6%}, whereas loans to non-residents accounted for only 14.7% {20.3%} of total deposits attracted from non-residents. Such a trend has existed

[1] The amount of assets with the term of repayment or sale not exceeding 30 days may not be less than 30% of total liabilities with maturity of 30 days.
[2] Short-term liquidity ratio = liquid assets/demand liabilities (to banks and non-banks) x 100.
[3] Liquid assets = vault cash + claims on central banks and other credit institutions + central government fixed income debt securities.

*Chart 26*

**LIQUID ASSETS AND THEIR SHARE IN TOTAL ASSETS**
(in millions of lats; %)

Liquid assets
The share of liquid assets in total assets

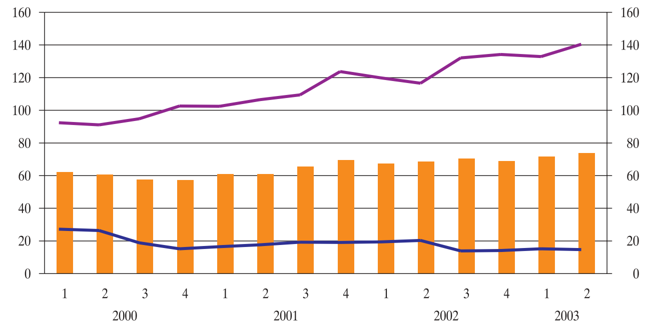


since 2000. It is related to the fact that two large and four medium-sized banks financed part of the loans granted to domestic non-banks from the funds of their parent companies and Western investment banks (EBRD, NIB), whereas one medium-sized and one small bank financed part of the loans granted to domestic non-banks from non-resident non-bank deposits. Moreover, the development of lending was facilitated also by the growing banks' capital.

*Chart 27*

**RESIDENT AND NON-RESIDENT LOAN-TO-DEPOSIT RATIOS**
(%)

Non-bank loan-to-deposit ratio
Resident non-bank loan-to-deposit ratio
Non-resident non-bank loan-to-deposit ratio



A more detailed analysis of the banking sector's liquidity demonstrates that all groups of banks maintained high liquidity ratios.

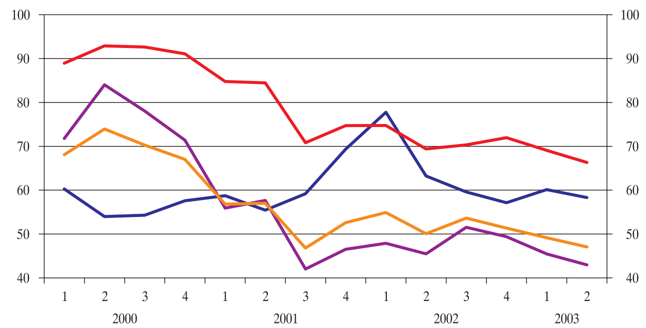
Assessing the liquidity risk of large banks, the highly diverse structure of their balance sheets and business strategy should be taken into account. There are banks that attract funds mostly from resident non-banks and foreign parent companies, lending them to domestic customers. The liquidity risk of these banks is higher in comparison with other large banks that attract non-resident non-bank short-term funds in foreign currencies, investing them mostly in credit institutions of the OECD countries and fixed income debt securities. The liquidity ratio of all large banks was high enough to fulfil the liquidity requirements stipulated by the FCMC.

Since 2000, the overall short-term liquidity ratio of large banks has decreased and was 47.1% {50.1%} at the end of June 2003 (see Chart 28). It was related to a rise in non-bank lending. As of 2001, the liquidity risk was higher in foreign curren-

*Chart 28*

**SHORT-TERM LIQUIDITY RATIOS OF THE BANKING SECTOR AND LARGE BANKS BY CURRENCY**
(%)

Banking sector
Large banks
Lats
Foreign currencies



cies, since loans from parent companies were increasingly invested in long-term lending. The impact of liquidity ratio fluctuations of the lats on the overall liquidity ratio was limited, as foreign currencies dominated not only on the balance sheets of banks engaged in attracting non-resident deposits, but also those operating on the domestic market had a substantial share of foreign currencies on their balance sheets.

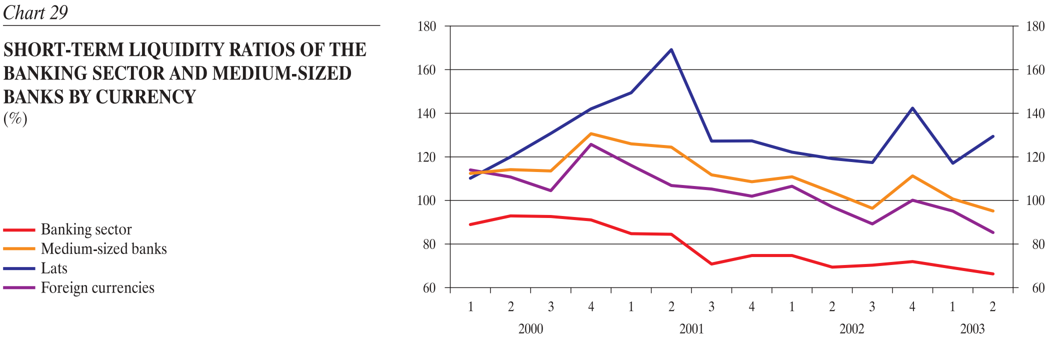
At the end of June 2003, the non-bank loan-to-deposit ratio of large banks grew to 78.4% {72.5%}. An increase in this ratio was observed also in previous periods as the large banks dominated on the Latvian credit market.

For purposes of analysis, liquidity ratios of medium-sized banks could be divided into two groups. The so-called universal banks are largely involved in lending to domestic non-banks; others (the so-called niche banks) attract short-term deposits of non-resident non-banks and place them in short-term claims abroad (mostly in the credit institutions of the OECD countries).

The overall short-term liquidity ratio of medium-sized banks slightly declined since 2000, but still retained a very high level, reaching 95.2% {103.8%} at the end of June 2003 (see Chart 29). It resulted from a pickup in loans granted to non-banks by universal medium-sized banks. This ratio was slightly lower in foreign currencies, as it was affected by non-resident demand deposits with medium-sized niche banks, as well as foreign currency loans to some universal banks by parent companies, increasingly invested in domestic long-term lending. The lats liquidity fluctuations had a limited impact on the overall liquidity, as foreign currencies dominated on the balance sheets of banks with a large share of non-resident deposits; universal banks also had a significant share of foreign currencies on their balance sheets. The impact of foreign currency liquidity ratio on the overall liquidity ratio continued to increase, as the share of foreign currencies of these banks in the non-bank demand deposits grew in comparison with 2000, and so did the amount of funding from foreign banks (parent companies and foreign investment banks).

*Chart 29*

**SHORT-TERM LIQUIDITY RATIOS OF THE BANKING SECTOR AND MEDIUM-SIZED BANKS BY CURRENCY**
(%)




At the end of June 2003, the non-bank loan-to-deposit ratio of medium-sized banks grew to 70.5% {60.0%}. In previous periods, this ratio was volatile, mostly affected by changes in non-resident deposits outstanding with medium-sized banks; only since 2003, an upward trend could be observed, resulting from a rise in the loans of medium-sized banks.

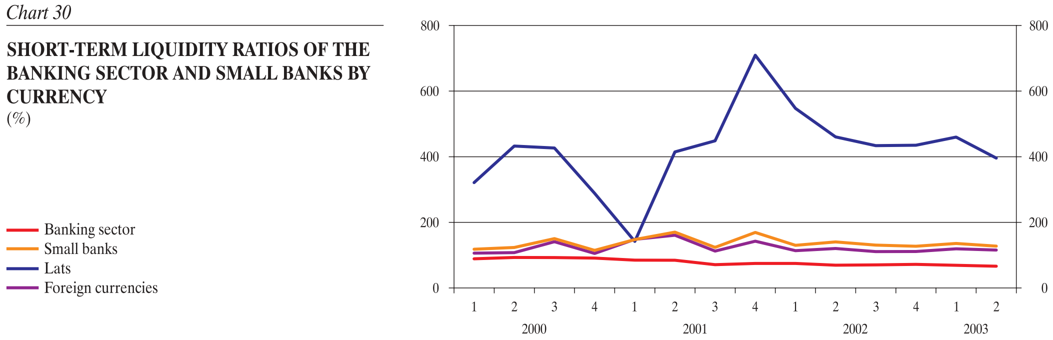
The performance of small banks did not have an essential effect on the overall banking sector, as their market share accounted for only 6.2%. Moreover, the majority of these credit institutions service very few residents.

The small banks can be split into three groups: the first group comprises banks operating on the domestic market; the so-called niche banks, placing non-resident short-term funds in the credit institutions of the OECD countries, make up the second group; and the third group consists of banks of a mixed type, investing non-resident funds both in the credit institutions of the OECD countries and lending to residents.

In view of the fact that the small banks have narrow specialisation and their resources are scarce, they place their funds in liquid assets. Hence, there is almost no liquidity risk, since the liquid assets of almost all small banks fully cover their demand deposits. At the end of June 2003, the overall short-term liquidity ratio of small banks was 127.4% {140.2%} (see Chart 30).

*Chart 30*

**SHORT-TERM LIQUIDITY RATIOS OF THE BANKING SECTOR AND SMALL BANKS BY CURRENCY**
(%)




In view of the particularly high liquidity ratios and the high capitalisation level of these banks, it can be concluded that the liquidity risk is limited and has not increased in comparison with the previous periods.

Hence, despite the slight increase in liquidity risk in recent years it was limited. All groups of banks maintained high liquidity.

## 8. FINANCIAL VULNERABILITY

**Financial indicators of the corporate sector improved.**

With the economic situation stabilising after the Russian financial crisis, Latvian companies' assets recovered a higher growth rate. Although the external environment was volatile, export industries also facilitated the economic growth considerably, contributing to an increase in assets and profit. The trade sector growth underlay the increase in the assets of the enterprise sector for the most part; so did the robust expansion of the manufacturing and transport, storage and communication sectors.

Following a rapid acceleration in 2000, the growth in assets slightly declined in the subsequent two years, still maintaining a high level. With the asset growth rate continuing to increase in most sectors, its decline was determined by a drop in the trade sector growth and fluctuations in the assets of the shipping sub-sector. In the first half of 2003, the pickup in assets stabilised, mostly due to the growth rate of the major sectors of the economy becoming more moderate.

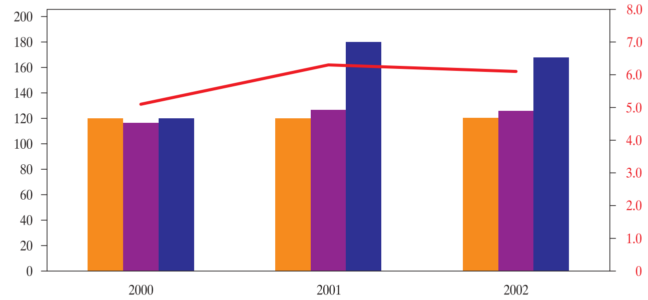
With the cost of sales and administrative costs growing slower than the revenue, increased business efficiency underlay a surge in profits and corporate profitability. However, a rise in competition on the domestic market resulted in acceleration in the distribution costs. In 2002, a decline in return on assets was attributed to the complicated situation in transit and shipping businesses, with the remaining sectors of the economy maintaining an upward trend. Still, in the first half of 2003, total profit recorded a considerable pickup, giving rise to optimism with respect to annual results.

Growing retained earnings of the enterprise sector in the last two years facilitated a rise in equity; therefore the debt-to-equity ratio remained stable (see Chart 31). Loans from financial institutions partially replaced other sources of funding. Borrowing from banks and leasing companies considerably exceeded the growth in enterprises' equity.

*Chart 31*

**FINANCIAL INDICATORS OF ENTERPRISES**[1]
(%)

Return on assets
Debt-to-equity ratio
Liquidity
Interest coverage ratio

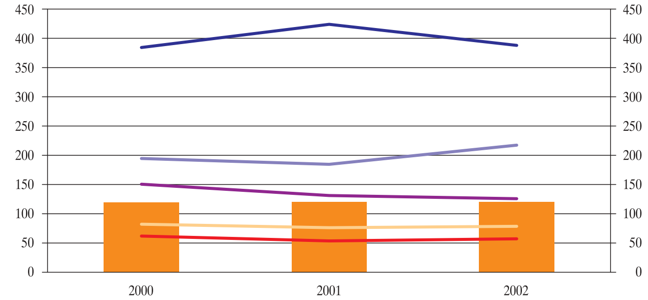



The debt-to-equity ratio and its development in various sectors of the national economy was extremely diverse (see Chart 32). In the first half of 2003, the growth in retained earnings and hence also in equity, observed already in 2002, continued both in trade and manufacturing, whereas the debt-to-equity ratio continued to shrink. A slight increase in the average debt-to-equity ratio was mostly determined by growing borrowing for financing investments in transport, storage and communication, a sector of low indebtedness.

*Chart 32*

**CORPORATE SECTOR'S DEBT-TO-EQUITY RATIO BY MAJOR SECTOR OF ECONOMY**
(%)

Corporate sector in total
Wholesale and retail trade
Manufacturing
Transport, storage and communication
Construction
Real estate, renting and business activities




The growing investment in enterprises was increasingly financed by long-term loans, and lending by Latvian banks also played an important role in this process. At the end of 2002, loans from banks accounted for almost 40% of enterprises' long-term liabilities. In 1999–2002, short-term liabilities decreased by 8.2 percentage points in enterprises' liabilities, falling to 60.2% at the end of 2002. However, this indicator differs by sector considerably, given the specific features of their financing structure.

Enterprises' interest expense recorded a slower growth than their liabilities, although the share of bank loans in their liabilities increased. It was also facilitated by the downward trend of interest rates. Moreover, in 2000–2002, the enterprise sector's profit grew, providing adequate cash flows to cover interest payments. The average interest coverage ratio of the Latvian enterprises was very volatile (120.0% in 2000; in 2001, due to a rapid growth in profit, it reached 180.0%; in 2002, with interest payments growing faster than profit, it shrank to 167.6%).

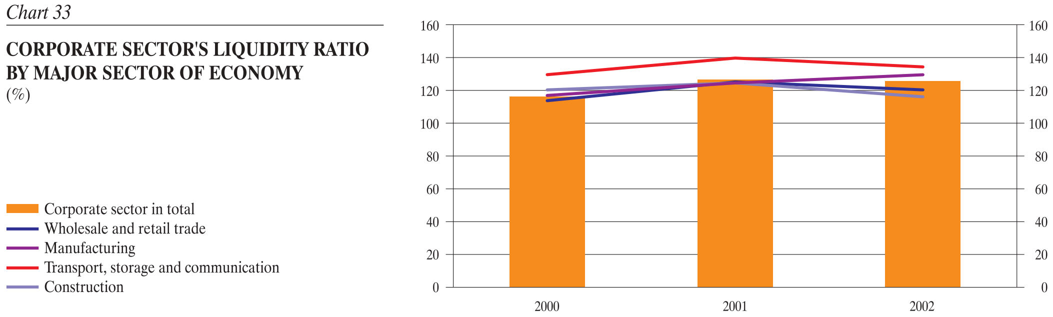
Since 2000, the average liquidity of Latvian enterprises (current assets to short-term liabilities ratio) has been satisfactory and is following an upward trend (see

[1] Return on assets is the ratio of profit to assets; debt-to-equity ratio: debt to equity; liquidity: current assets to short-term liabilities; interest coverage ratio: profit to interest expense.

Chart 33). In 2001, the liquidity ratio grew from 116.3% to 126.6% as a result of a rise in the liquidity of trade where approximately 40% of the corporate sector's current assets have been concentrated. The liquidity of other major sectors of the economy also improved.

*Chart 33*

**CORPORATE SECTOR'S LIQUIDITY RATIO BY MAJOR SECTOR OF ECONOMY**
(%)




In 2001, with the corporate sector's profit increasing rapidly, the sector's financial vulnerability decreased considerably. The profit growth resulted in a drop in the demand for short-term funds for financing enterprises' day-to-day operations.

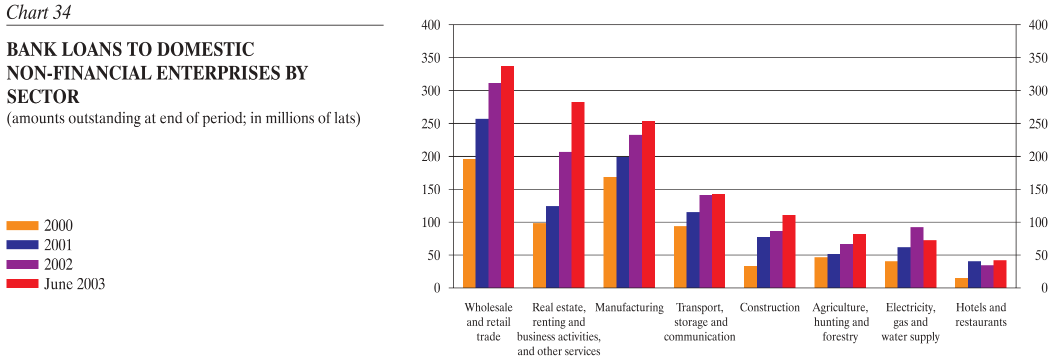
Although the average liquidity in 2002 declined slightly (by 1.0 percentage point), in the first half of 2003 it improved in most sectors of the national economy.

In recent years, with the enterprises' profit and debt servicing capability growing, borrowing from banks has increased; at the end of 2002, bank loans accounted for almost a quarter of the enterprise liabilities.

At the end of 2002, the trade sector recorded the highest share of loans in the Latvian banks' loan portfolio (see Chart 34). The following sectors dominated in the banks' corporate loan portfolio: trade (26.5%), manufacturing (19.9%), real estate, renting and business activities, as well as other community, social and personal service activities (16.9%, including a 10.5% share of real estate, renting and business activities).

*Chart 34*

**BANK LOANS TO DOMESTIC NON-FINANCIAL ENTERPRISES BY SECTOR**
(amounts outstanding at end of period; in millions of lats)




Over the last years, the highest growth rates in lending were reported for real estate, renting and business activities, as well as trade. As a result of a rapid rise in the services sector borrowing, in the first half of 2003 the growth in loans to the services sector accelerated, posting a higher increase than those granted to the trade sector.

Higher borrowing was predetermined by the size of the above sectors and their role in the economy; moreover, they also received more substantial funding from banks than the economy on average. The average indicator was lower due to the wholesale and retail trade. Banking loans accounted for only 18.2% of the liabilities of this sector.

Growth in wholesale and retail trade, one of the most dynamic sectors of the economy, was financed by borrowed funds; nevertheless, a substantial amount of own funds was also invested. The Latvian banking sector granted most funds to the trade sector, where high indebtedness is a sector-specific feature resulting from an extensive use of trade credit. In 2002, with the sector's assets increasing only by 3.2%, its growth was mostly financed by own funds, twice exceeding the increase in debt. Thus in 2002, the debt-to-equity ratio of the trade sector decreased by 35.9 percentage points, interrupting the former upward trend. In the first half of 2003, a more rapid growth in equity continued as well.

An increase in profit and a decline in the asset growth rate in the first half of 2003 underlay the expectations of the sector's risk reduction, with the trade sector reaching a certain level of saturation. The sector's profitability remained low since 2000, due to intensifying competition and the restructuring of the sector. Therefore, the trade sector, with its robust growth and high indebtedness, including banking loans, remained rather vulnerable.

Interest coverage ratio for trade companies was among the lowest in the national economy. In 2000, with the sector's profit declining and interest payments gradually increasing, it fell as low as 35%. As profit grew in the last two years, the interest coverage ratio increased, exceeding 60%. Positive trends were observed in the first half of 2003 when interest payments shrank along higher profit. Nevertheless, the low interest coverage ratio and the high short-term debt suggested that the sector is interest rate sensitive.

A large share of current assets in total assets is a sector-specific feature as well, enabling to maintain high liquidity ratios. The wholesale and retail trade liquidity exceeded 100%, affecting the average ratio of the economy considerably. Following a substantial increase in the sector's liquidity ratio in 2001, it shrank by 4.8 percentage points (to 120.3%) in 2002 due to a declining growth rate of current assets.

Manufacturing was the second major borrower from Latvian banks: its debt-to-equity ratio was higher than the national economy average; however, in contrast to the average indicator, this ratio tended to decrease. Manufacturing, rating the second largest sector in terms of revenue and the third one in terms of assets, has recorded a particularly accelerated growth since 2001 (see Charts 35 and 36). During this period, the revenue and the assets of the sector have increased by 28.7% and 22.2%, respectively, accounting for almost one fourth of the growth in the assets of the national economy. In 2000, this sector was still mostly dependent on short-term funding, but a marked increase in profit in recent years resulted in the debt-to-equity ratio of only 125.8% at the end of 2002 (150.6% at the end of 2000). The sector's profit posted the highest pickup, growing more than four times in 2001 (in comparison with the low base) and almost twice in 2002. With interest

*Chart 35*

**TURNOVER BY SECTOR**
(in millions of lats)

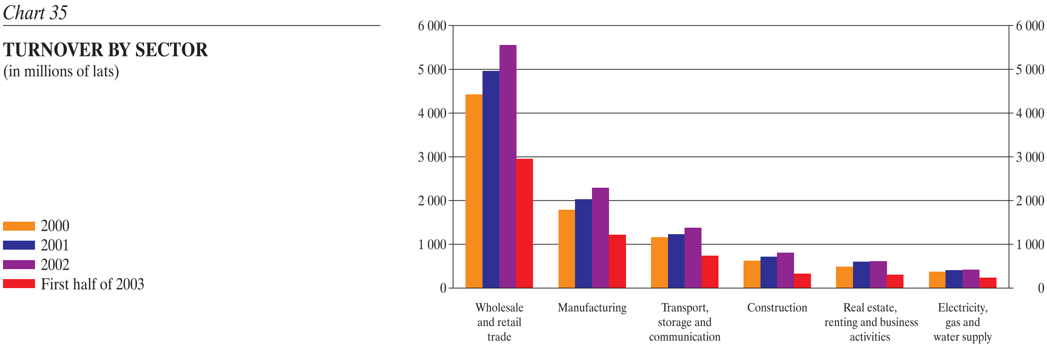
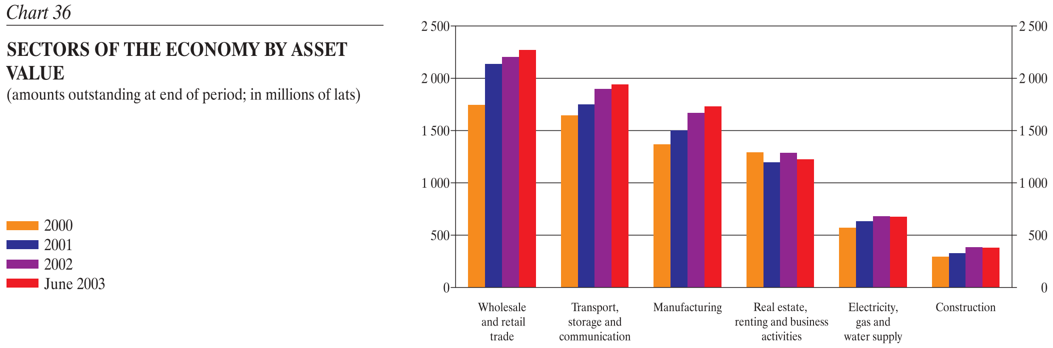


*Chart 36*

**SECTORS OF THE ECONOMY BY ASSET VALUE**
(amounts outstanding at end of period; in millions of lats)




payments increasing at a moderate rate, interest coverage ratio continued to improve. Higher cash flows had a positive effect on the liquidity ratio of manufacturing as well. With continuous rapid growth in assets (current assets) and the slow increase in short-term debt, the sector's liquidity ratio reached almost 142%.

The development of most sub-sectors in manufacturing has been fairly steady, with the profit growing and the fragility indicators improving over the last two years. In 2001 and 2002, retained earnings of almost all sub-sectors increased. Several developing and financially robust sectors gained strength. For example, the profit of manufacture of other transport equipment was almost three times higher in 2002, reaching the level of manufacture of food products and beverages, one of the largest branches, whereas the latter recorded the second highest level of profit, following that of the manufacture of wood and of products of wood and cork, except furniture. In the manufacture of food products and beverages, with one of the lowest profitability and interest payment coverage indicators, the increase in profit caused a sharp rise in the interest payment coverage (to 76.9%). Although the amount of the sub-sector's liabilities posted rapid growth in 2002 (with its debt-to-equity ratio of 140.4% being among the lowest in manufacturing), its liquidity remained high and current assets exceeded short-term liabilities by 26.5%.

Although bank loans accounted for more than a quarter of enterprise liabilities of the transport, storage and communication sector, the funding structure of that sector was very conservative and its debt amounted to only slightly more than half of its equity. This was the most profitable sector of the economy: in 2002, its profit amounted to 38.1% of total profit of the national economy. Interest coverage ratio also rated among the highest. Although the sector's profit slightly declined after an upward trend for three years, in the first half of 2003 it still reached a high in recent years. It was largely due to the growth in post and communication, its most robust sub-sector (27.2% in turnover, 28.6% in assets, accounting for 67.6% of the sector's profit in 2002).

Real estate, renting and business activities is a diverse sector; its sub-sectors are influenced by essentially different economic environment developments. In recent years, its overall indicators were affected by the development of the real estate trading and commercial services, as well as the changing financial situation in the joint-stock company *Latvijas Kuģniecība*. This sector also financed its operation mostly from its own funds. At the end of 2002, the debt-to-equity ratio was 78.6%. Within the sector, the ratio was lower in shipping, whereas in real estate, with almost 90% of the sector's bank loans concentrated there, they exceeded equity by 15.7%. In 2002, the sector's debt-to-equity ratio improved, with investment of own capital in fixed assets accelerating rapidly. Replacing a considerable amount of short-term borrowed funds with own resources increased the sector's liquidity ratio to 122.6% (103.9% in 2001). Nevertheless, the sector's profit dropped sharply, the interest coverage ratio (37.4%) being the lowest in comparison with other major sectors of the economy. In the first half of 2003, short-term liabilities of the real estate, renting and business activities shrank drastically, and the sector's balance sheet indicated a marked improvement in its liquidity. The semi-annual profit reached a high in recent years, facilitating better interest coverage year-on-year.

As a result of the growth of the national economy overall and the real estate market in particular, construction was one of the most rapidly developing sectors in recent years. At the end of 2002, the share of loans granted to it amounted to 7.4% of banks' loan portfolio, reaching 8.4% at the end of June 2003. A low level of equity and a high share of debt are characteristic of the sector. The high debt-to-equity ratio (over 217% in 2002) resulted from substantial advance payments by customers and other debt owed to customers financing the sector's current assets. Given the creditors' profile of the sector, its interest payments were comparatively small, and the interest coverage ratio was one of the highest in the national economy. Current assets of the construction sector exceeded its short-term liabilities substantially; nevertheless, in 2002, its liquidity dropped 8.4 percentage points (to 116.1%).

Thus, with a continuous rapid growth in the national economy, in 2002 and the first half of 2003, improvement in the key financial fragility indicators was observed in the major sectors of the economy. In the first half of 2003, the average debt-to-equity ratio increased by 2.2 percentage points, whereas the ratios of the most vulnerable sectors improved. With the average share of long-term loans and the liquidity ratio increasing, short-term risks decreased. The semi-annual profit of the corporate sector reached a high in the last five years, resulting in a sharp rise in the interest coverage.

**Household debt still accounted for a fairly small share of their income.**

As noted in Section 2, in recent years lending to domestic households increased considerably from a very low level, with the development of mortgage lending and a reduction in interest rates mostly underlying the increase. Household debt to banks was mostly comprised of housing loans and consumer credit, accounting for 61.1% and 19.0%, respectively, of total loans granted to households at the end of June 2003. Households' interest payments to banks grew considerably slower than the debt: in the first half of 2003, they reached 20.5 million lats, increasing by 32.5% year-on-year.

According to the data on lending to households, released by the three major leasing companies, at the end of June 2003, the above loans reached 75.3 million lats[1], recording an increase of 44.2% year-on-year. Unfortunately, information on households' interest payments to leasing companies is not available, but, judging by the level of debt, they are considerably smaller than those paid to banks.

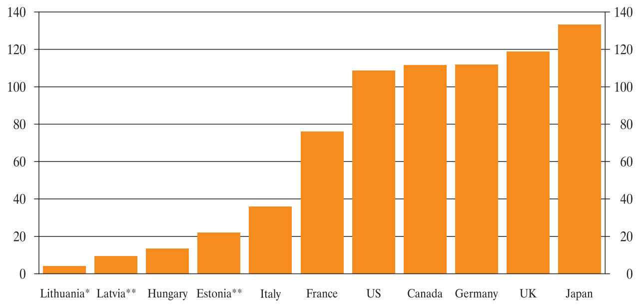
Data on the disposable income of households[2] are compiled with a considerable delay and are currently available only for the year 2001. In Latvia, the level of household debt to banks and leasing companies was really low in comparison with the developed countries and other transition economies in 2001: it accounted for only 9.4% of the disposable income of households (see Chart 37). In 2001, the share of interest payments to banks amounted only to 0.8% of the disposable

[1] Data provided by the Latvian Leasing Association. The lease portfolio profile by the lessee's sector of the economy: other sectors, including households.
[2] The sum total in cash and in kind (after taxes and other compulsory deductions) that is owned by households and can be used for consumption, other needs and for saving, i.e., wages and salaries, other income from work, social allowances, "net income" (after deducting the costs for production purposes), income from domestic craft or farming, etc. (gifts, alimony received, income from goods sold, etc.).

income of households. Since 2001, the household debt has risen considerably, exceeding the growth rate of disposable income. At the end of 2002, it could have reached 15% of the disposable income of households.

*Chart 37*

**HOUSEHOLD DEBT-TO-INCOME RATIO IN 2001**
(%)




* Household debt to banks
** Household debt to banks and leasing companies

As regards the ratio of the household debt to the gross wage and salary fund, both the debt to banks and leasing companies, as well as interest payments to banks have been increasing since June 2002, and the upward trend has become more pronounced. The share of debt and interest payments grew by 13.2 percentage points (to 36.6%) and 0.9 percentage points (to 3.1%; see Chart 38), respectively. These indicators should be treated with certain caution, given the fact that the gross wage and salary fund reflects only part of household income.

*Chart 38*

**HOUSEHOLD DEBT AND INTEREST PAYMENTS TO THE GROSS WAGE AND SALARY FUND RATIO**
(%)


Interest payments to banks
Liabilities to banks
Liabilities to leasing companies

In recent years, household debt has increased, and its currency profile has changed. Since the second half of 2001, interest rates on long-term lending to households have been considerably lower for loans in the OECD currencies (in June 2003, the spread between interest rates on loans granted in lats and the OECD currencies was 2.9 percentage points). Since the end of 2001, loans in the OECD currencies have grown at an increasingly rapid rate; hence the share of loans granted in foreign currencies has expanded. At the end of June 2003, it reached 56.3% {48.2%} of total household debt to banks. This trend was largely determined by housing loans, since, as mentioned above, at the end of 2001 the development of mortgage lending started to develop, and transactions in US dollars have dominated on the real estate market in Latvia to date. Such a trend has to be treated as a rise in currency risk for those households whose income is in lats but the loan has been granted in a foreign currency. In the event the US dollar or the euro appreciate considerably against the lats (housing loans are normally taken in lats, US dollars or euros), the borrower's debt servicing costs will also increase, and that in turn may affect the quality of the loan portfolio. With interest rates on loans granted in US dollars or euros increasing (it will happen along the recovery of the economy in the US and the euro area countries), the borrowers' debt servicing costs will also increase. It could particularly affect households with lower income where interest payments account for a larger share in their expenditure.

As regards lending to households, there is still a considerable gap between Latvia and other countries, and the share of interest payments both in the disposable income of households and in the gross wage and salary fund is comparatively small. Unlike the developed countries where majority of households have liabilities against credit institutions, only a small percentage of households have borrowed in Latvia. According to the data provided by the limited liability company *Baltijas Datu nams* (the study *The Banking and Finance System*, conducted in 2003), consumer credit is used by only one fourth of the respondents, whereas less than one fifth of all respondents have borrowed for the purpose of real estate purchase or renovation. These are households with higher income and the young families who usually are not able to start independent life without taking a loan.

In general, it can be concluded that the share of loan portfolio to households in banks' assets is comparatively small, and so is the share of debt in households' income; therefore the risk associated with such loans does not impair the stability of the banking sector. However, an increase in foreign exchange and interest rate risks with respect to households is observed, as the share of loans granted in foreign currency is growing.

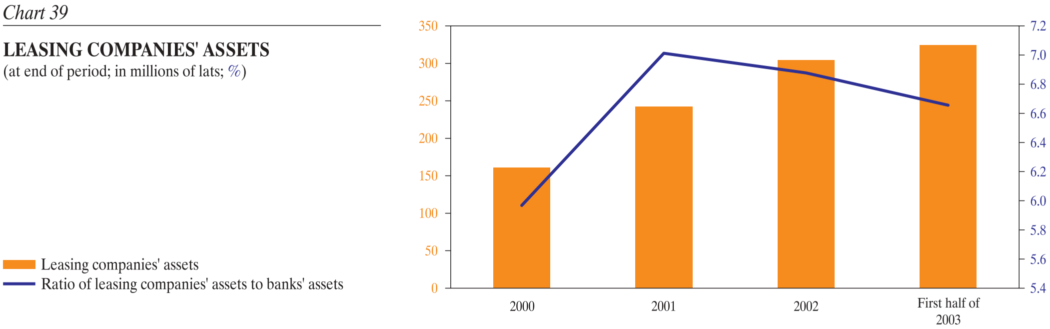
## 9. LEASING COMPANIES

**The growth rate of the lease and loan portfolio gradually declines.**

The non-bank leasing sector is one of the most rapidly growing segments on the Latvian financial market since the mid-1990s. At the end of June 2003, leasing companies' assets reached 324.2 million lats or 6.7% of banks' assets (see Chart 39). The considerable growth of leasing companies has been facilitated by the rapid development of the economy, rise in household income, drop in interest rates, improvement of leasing services, as well as an increase in the popularity of leasing, with the public's prejudices regarding "life on credit" losing their effect and the desire to swiftly increase one's level of well-being growing.

*Chart 39*

**LEASING COMPANIES' ASSETS**
(at end of period; in millions of lats; %)




A high level of concentration and close links with the banking sector are characteristic features of the leasing sector. The three major leasing companies are subsidiaries of banks: the limited liability company *Hanza Līzings* is a subsidiary of the joint-stock company *Hansabanka*, the limited liability company *Unilīzings* is a subsidiary of the joint-stock company *Latvijas Unibanka*, and the limited liability company *Nordea Finance Latvia* is the subsidiary of *Nordea Bank Finland Plc*. The market share of the above companies in leasing exceeds 90%.

At the end of June 2003, the lease and loan portfolio of the three major leasing companies amounted to 301.4 million lats, with financial lease (68.1% {70.6%}), operating lease (9.8% {4.8%}) and factoring (11.2% {14.1%}) having dominant positions. Operating lease has become increasingly popular with companies, while households still prefer financial lease.

Lease of vehicles, manufacturing equipment and real estate dominated in the lease portfolio profile of leasing companies (approximately 90% of the lease portfolio; see Chart 40). The lease portfolio is fairly diversified both by type of assets and by sector. The most essential ones are transportation, storage and communication sector (21%), industry (20%) and trade (17%), as well as agriculture, hunting and forestry sectors (8%). Lease transactions of households account for approximately 28% of the overall lease portfolio (see Chart 41). The above leasing services are mostly used for purchasing real estate, cars and household appliances.

*Chart 40*

**LEASE PORTFOLIO OF LEASING COMPANIES BY TYPE OF ASSETS**
(at end of June 2003)

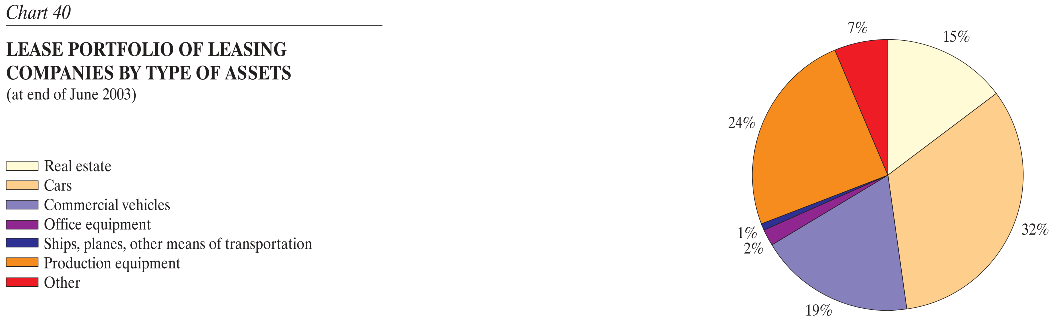
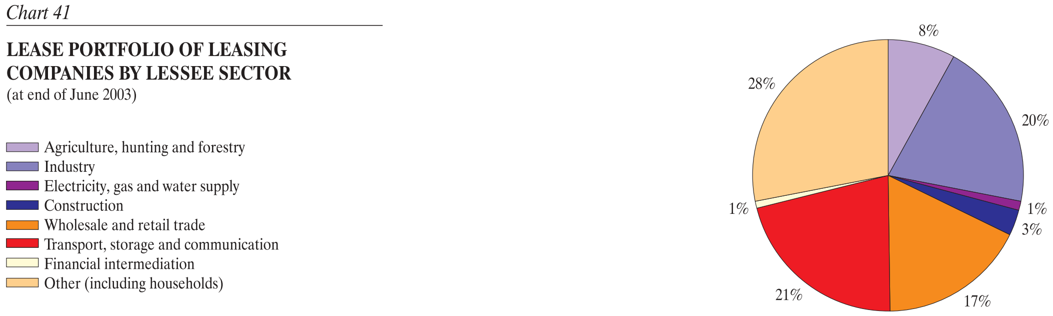



*Chart 41*

**LEASE PORTFOLIO OF LEASING COMPANIES BY LESSEE SECTOR**
(at end of June 2003)




The growth rate of the lease and factoring portfolio is gradually declining. In 2001, the lease and factoring portfolio of the three major leasing companies expanded by 52.2% year-on-year. In 2002, its growth rate shrank to 30.4%, and at the end of June 2003, it increased by 22.2% year-on-year. The high base of the lease portfolio in previous years, expansion of banks' lending, as well as the saturation of the leasing market are the main factors behind the decline.

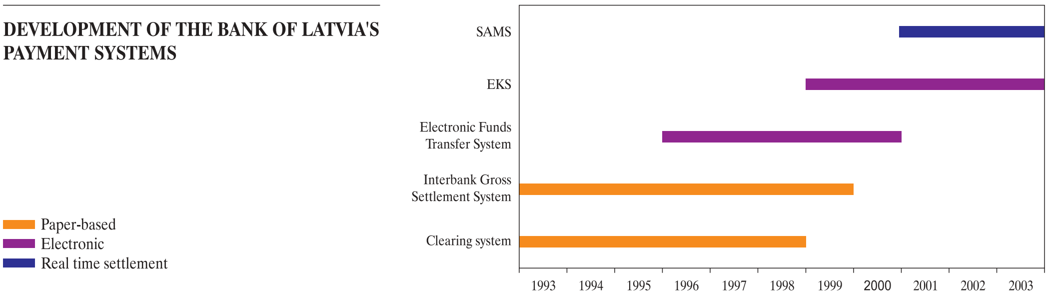
## 10. PAYMENT SYSTEMS

**The payment system is an essential part of the financial infrastructure; its effective operation facilitates the economic processes in the country, ensuring timely completion of payments.**

Latvia's payment system evolved and developed along the development of its banking sector. Since the restoration of operation in 1991, the Bank of Latvia has ensured the infrastructure for interbank settlements, thus facilitating the development of the payment and financial system. Initially, paper-based payment documents were handled by the Bank of Latvia's interbank payment systems (see Chart 42); in 1995, the first interbank electronic funds transfer system of the Bank of Latvia was developed where the data transmission infrastructure and message forms of the S.W.I.F.T. were used for domestic payments. It was a semi-automated system initially processing several tens of transactions per day.

*Chart 42*

**DEVELOPMENT OF THE BANK OF LATVIA'S PAYMENT SYSTEMS**



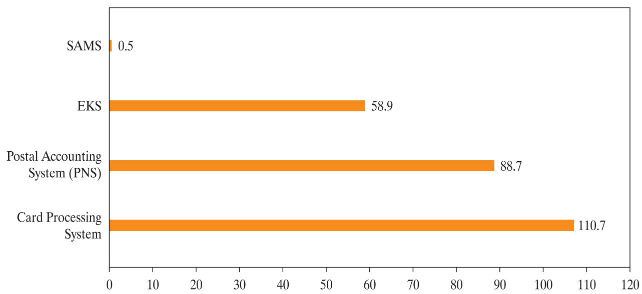

In November 1998, the Bank of Latvia introduced the electronic clearing (net settlement) system (EKS), which is the ACH (automated clearing house) system, replacing the previous paper-based clearing system. Along the introduction of the EKS, an interbank communication network was developed as well, used for secure exchange with payment files. The EKS established a safe and efficient environment for handling customers' retail payments: currently in Latvia funds of the banks' customer payments normally are available on the beneficiary's account already on the next day of their initiation. This is a very good indicator in comparison with other European countries.

In 1998, the Bank of Latvia commenced one of the most important projects in the development of the interbank payment systems: development of the real-time payment system project which was accomplished by introduction of the Bank of Latvia's interbank automated payment system (SAMS) in September 2000. The real time gross settlement principle used in the SAMS prevents the possibility of credit risk. The SAMS is the Bank of Latvia's investment in the development of the financial infrastructure with the purpose of reducing the operational and financial risks in large-value settlements. The SAMS ensures mutual settlements of large-value interbank payments and those of the Bank of Latvia's monetary policy operations, as well as settles final positions of other payment systems. In this system, banks may perform their customers' mutual payments as well; however, due to the system's costs, only customers' large-value or urgent payments are processed in the SAMS for the most part.

Currently the SAMS and the EKS are the core of Latvia's payment systems, handling 97.1% of the cash flow processed in all payment systems in the first half of 2003. Their smooth operation is a precondition for facilitating the stability of the financial sector (see Charts 43 and 44).

*Chart 43*

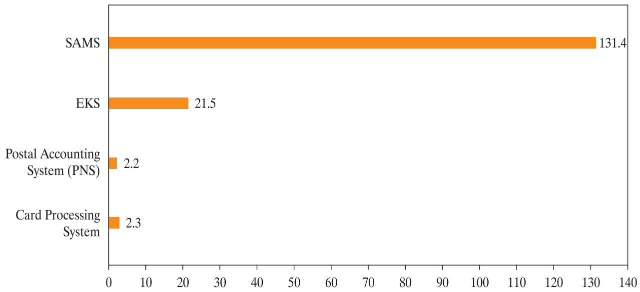
**VOLUME OF TRANSACTIONS IN THE FIRST HALF OF 2003, DAILY AVERAGES**
(in thousands)




At the end of 2001, amendments were also made to Article 9 of the Law "On the Bank of Latvia" stipulating the following: "The Bank of Latvia shall promote smooth operation of the payment systems in the Republic of Latvia. The Bank of Latvia is entitled to approve regulatory requirements and regulations to ensure efficient and sound functioning of the clearing and payment systems." The Bank of Latvia's

*Chart 44*

**VALUE OF TRANSACTIONS IN THE FIRST HALF OF 2003, DAILY AVERAGES**
(in millions of lats)




payment system policy stipulates that the Bank of Latvia oversees the systemically important interbank payment systems for settlements in the national currency, operating in the Republic of Latvia, thus considerably reducing the systemic risk throughout the payment system.

Currently only SAMS can be regarded as a systemically important payment system in Latvia. The daily average value of transactions handled by SAMS is 131.8 million lats (see Charts 45 and 46).

*Chart 45*

**VOLUME OF TRANSACTIONS HANDLED BY THE BANK OF LATVIA'S GROSS SETTLEMENT SYSTEMS**
(in thousands)

Interbank Gross Settlement System
Electronic Funds Transfer System
SAMS

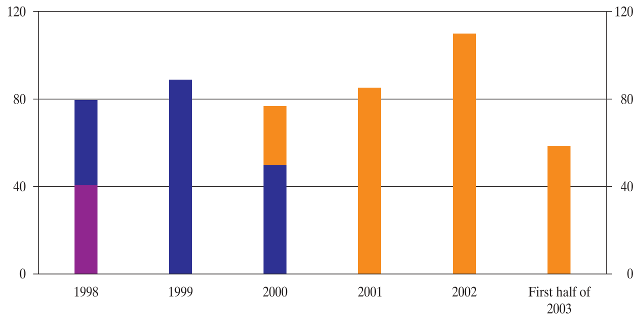
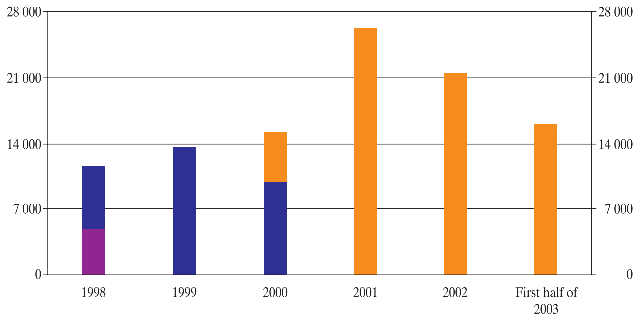



*Chart 46*

**VALUE OF TRANSACTIONS HANDLED BY THE BANK OF LATVIA'S GROSS SETTLEMENT SYSTEMS**
(in millions of lats)

Interbank Gross Settlement System
Electronic Funds Transfer System
SAMS




To make sure that the system's operation complies with internationally accepted criteria and that the risks within it are adequately limited, in 2003, the Bank of Latvia conducted a compliance assessment of the SAMS within the oversight framework. It was based on the "Core Principles for Systemically Important Payment Systems" (hereinafter, the Core Principles) published by the Committee on Payment and Settlement Systems[1] of the Bank for International Settlements, stipulating criteria for a systemically important payment system to be internationally acknowledged as adequately safe and efficient. According to the Bank of Latvia's assessment, the SAMS meets the requirements of the Core Principles in general. The assessment also analyses a reduction of particular risks in the SAMS and

[1] A group of payment systems experts from the central banks in G-10 countries, established in 1980 to encourage the development of payment systems.

provides comments and recommendations for further improvement of the system's operation and the measures of risk reduction.

**Credit and Liquidity Risk**
The real time settlement principle in the SAMS operation ensures immediate settlement and finality of payments made, thus preventing the impact of credit risk on the system. To reduce liquidity risk, an opportunity for continuous liquidity management is offered to the SAMS participants, monitoring the balance and payment flow on their settlement accounts in real time. The SAMS maintains a queue management providing for the detection of the unsettled payments and changing of their priority, if necessary, as well as enabling an automatic gridlock solution mechanism. Since a comparatively high liquidity is necessary for effecting settlements in gross settlement systems, the Bank of Latvia also offers banks an opportunity to use fully collateralised intraday credit free of charge in the form of settlement account overdraft, in order to ensure smooth operation of the SAMS and to promote settlement efficiency.

Credit and liquidity risk management fully meets the requirements prescribed in the Core Principles; however, the system's regulation should provide a more detailed description of the system's operation in emergency in order to ensure participants' complete understanding of the risk management possibilities in the event the system operates in emergency regime.

**Settlement Agent Risk**
Settlements in the SAMS are effected through bank settlement accounts with the Bank of Latvia, thus considerably reducing risks within the system, preventing the liquidity risk and credit risk with respect to settlement assets of the system's participants.

**Operational Risk**
In the SAMS, S.W.I.F.T. data transmission infrastructure is used for data exchange, ensuring data transmission security. The system's continued functioning is ensured by the hardware solution chosen by the Bank of Latvia: two parallel servers are in place; in the event the operation of one server is disrupted, the other backs up the system's operations.

**Legal Risk**
The operation of the SAMS is regulated by the Laws "On the Bank of Latvia", "On Credit Institutions" and "The Civil Law". At present, when credit institutions registered in the Republic of Latvia are the sole participants in the SAMS and hence the system's operation as well as all its participants are subject to Latvian law, the legal framework of the SAMS ensures compliance with the European Community legislation with regard to payments and settlements.

The SAMS operation complies with the Core Principles. However, in view of the time when Latvia will become an EU country, and credit institutions, whose operation is regulated by the law of any EU country, will also be entitled to apply for the participation in the SAMS, the existing legal framework will not ensure settlement finality and payment irrevocability in the event of a participant's insolvency, and the system is not safeguarded against the potential conflict of laws.

An assessment conducted by international experts in August 2001 within the framework of FSAP expressed a similar view. It was stated that Latvia's payment system is efficient and the systemically important payment systems comply with the Core Principles in general; it was acknowledged that improvements in the legal framework are necessary in order to fully ensure settlement finality and payment irrevocability in the event of a system participant's insolvency. In line with the above assessments and to fully ensure the implementation of the requirements of Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems, a draft Law "On Settlement Finality in Payment and Financial Instrument Settlement Systems" has been developed (adopted on December 11, 2003). Implementation of this Law would ensure higher stability on the financial market and promote safe and efficient operation of Latvia's and cross-border payment and securities settlement systems.

The EKS, the other Bank of Latvia's interbank payment system, is the largest operating electronic clearing (net settlement) system in Latvia, ensuring customers' credit transfers among Latvian banks. Almost half of all bank customers' credit transfers in lats are processed in the EKS (47.5% in 2002). In 2003, like in previous years, the Bank of Latvia performed the EKS oversight, monitoring the system's operation and analysing statistics and development trends (see Charts 47 and 48).

*Chart 47*

**VOLUME OF TRANSACTIONS HANDLED BY THE EKS**
(in thousands)

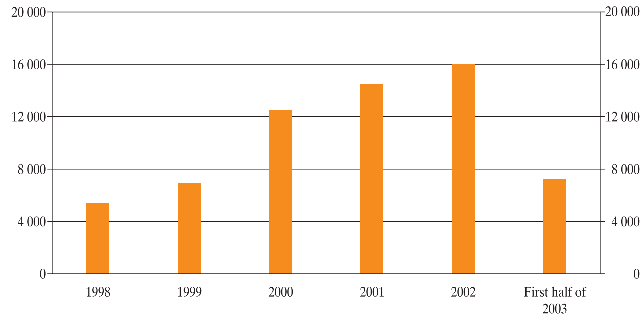
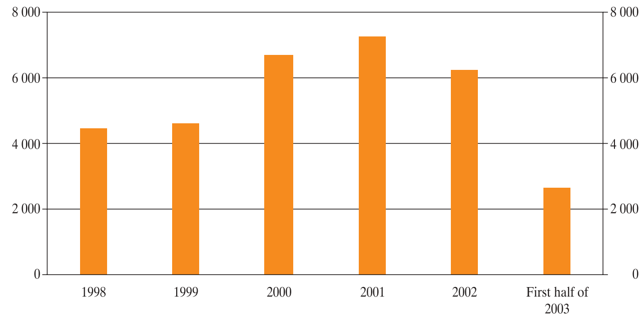



*Chart 48*

**VALUE OF TRANSACTIONS HANDLED BY THE EKS**
(in millions of lats)




The Bank of Latvia developed the EKS in close cooperation with banks, and its functions fully met the participants' requirements: there is one clearing cycle in the EKS, where clearing is performed at 11.00 a.m. and payments submitted by customers on the previous day are processed in the system for the most part. However, with the volume of customers' payments increasing in the banking sector and, accordingly, in the EKS and in order to support banks' competition driven willingness to ensure better service to their customers, including an opportunity to execute payments on the same day they are submitted, the Bank of Latvia has started to develop a project of a new version of the EKS. It is expected that the extended operation time till 3.00 p.m. and two clearing cycles will increase settlement speed and efficiency, giving a positive impulse to the development of the national economy.

In order to assess whether banks as participants of the Bank of Latvia's interbank payment systems create additional risks to the operation of the payment system, the Bank of Latvia, in cooperation with the FCMC, conducts audits in the banks. In addition to the Bank of Latvia's interbank payment system, several other retail payment systems operate in Latvia: the Postal Accounting System of the non-profit organisation state joint-stock company *Latvijas Pasts*, the Card Processing System of the limited liability company *Banku servisa centrs*, and the joint-stock company *Nacionālais maksājumu centrs*, and one of its key functions is servicing of the document flow of direct debit transfers. In comparison with the EKS, these systems process relatively small cash flows (see Chart 44), and they are intended for settlements of specific payment instruments; therefore, their impact on their participants' financial stability is insignificant. In 2003, the Bank of Latvia performed oversight of these systems by compiling statistical data on the payments processed in the systems and by monitoring their development trends.

Payment instruments are an important part of the payment system (infrastructure). Promoting smooth operation of the payment system, the Bank of Latvia performs oversight of the development of the payment instruments used in this country. An article of the Law "On Credit Institutions", stipulating that only credit institutions are allowed to issue and service cashless payment instruments, is effective in Latvia since 2002. The compiled data indicate that modern and secure payment instruments issued by banks are rapidly developing in Latvia (see Charts 49 and 50). The effective legislation ensures the regulatory framework required for secure development of payment instruments. In addition to the provisions of the Law "On Credit Institutions", the Bank of Latvia's "Regulation for Credit Transfers" provides for the obligations and duties of the parties involved in credit transfers, promoting safe and efficient payment environment for domestic as well as cross-border credit transfers. The Bank of Latvia's "Recommendations for Transactions Effected by Means of Electronic Payment Instruments" set forth principles to be complied with by banks when issuing and servicing electronic payment instruments, including liability of a bank and a customer in the event of losing a payment instrument or acting fraudulently with respect to it.

*Chart 49*

**VOLUME OF PAYMENT INSTRUMENTS**
(in thousands)

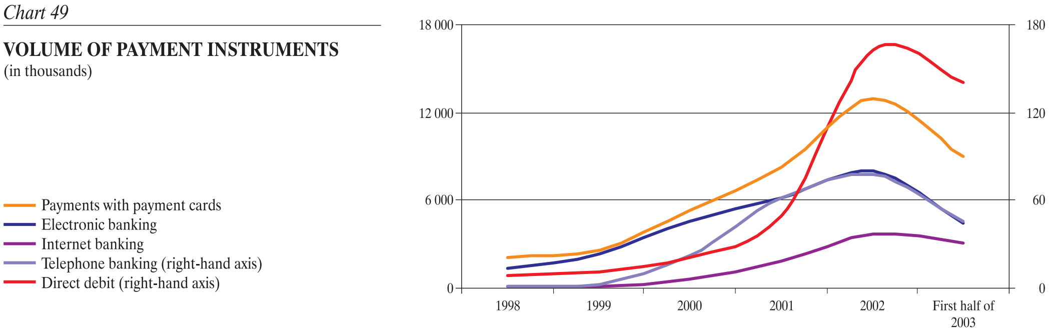
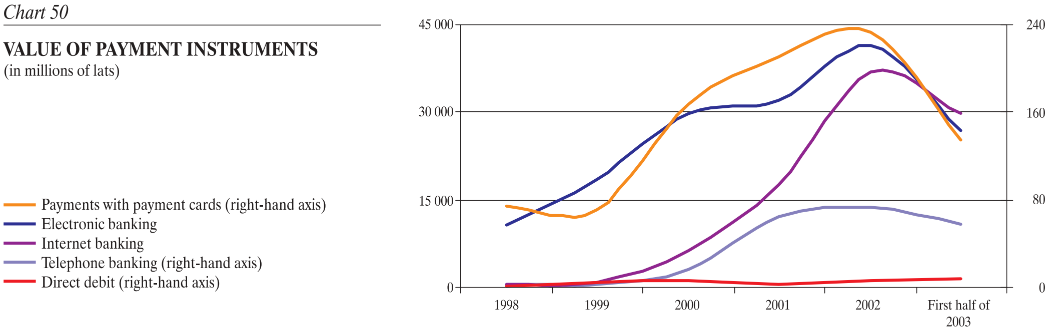



*Chart 50*

**VALUE OF PAYMENT INSTRUMENTS**
(in millions of lats)




On November 14, 2002, the Bank of Latvia approved the "Regulation for Issuance and Maintenance of Electronic Money" (in effect as of January 1, 2003), regulating the issuance, servicing and usage of electronic money in the Republic of Latvia. The objective of the regulation is to develop safe environment for issuing electronic money prior to its introduction in Latvia's payment system. When commencing the issuance of electronic money, the prospective issuers will have to take into account certain security and risk reduction requirements, and they will not cause any additional risks to the payment system.

In 2002, the ECB, in cooperation with the national central banks, conducted an assessment of the payment and securities settlement systems and the corresponding oversight functions of the EU candidate countries. It was concluded that, upon Latvia's accession to the EU, Latvia's payment infrastructure will not cause additional risks to the EU payment system; nevertheless, the ECB expressed several proposals regarding the improvement of the payment systems operation in Latvia, indicating, *inter alia*, that it would be necessary to achieve a higher level of standardisation by introducing the IBAN (International Bank Account Number) standard in Latvia.

Account numbers currently in use in Latvia differ both in length and structure, increasing the possibility of error when the originator indicates the beneficiary's account number. Hence the risk of the payment being returned, delayed or even credited to another beneficiary (i.e. as a result of error when specifying the account number) also increases. In 2002, the Bank of Latvia, in cooperation with banks, developed a concept for the implementation of the IBAN, the bank account number standard, which is used internationally as a bank detail that reliably identifies the customer account with a financial institution. Pursuant to the concept, the "Regulation for the Use of the IBAN" was approved in May 2003, setting forth the IBAN structure and the requirements regarding the procedure for assigning, validating and using the IBAN in Latvia. A transition period was determined (from January 1, 2004 to January 1, 2005), when institutions would have to start using the IBAN, replacing the current customer account numbers. Upon Latvia's accession to the EU, the Regulation (EC) No 2560/2001 of the European Parliament and of the Council of 19 December 2001 "On Cross-Border Payments in Euro" provides for the duty of banks to issue the IBANs to their customers upon their request, should it be necessary for cross-border transactions in euros; however, beginning with January 1, 2005, the IBAN will be the sole identifier of the account both for the domestic and cross-border payments.

## CONCLUSIONS

In recent years, the macroeconomic stability and economic growth ensured favourable conditions for the development of the banking sector. An increase in the domestic as well as foreign demand facilitated considerable growth, despite the low economic activity of the major trade partners. The slow growth in the national economies of EU countries implied one of the most significant external risks for the Latvian national economy, which could have weakened the foreign demand; nevertheless, the development in recent years indicated that the somewhat slower progress in the EU countries did not greatly affect Latvia's exports and the economic growth.

Over the last years, Latvia's budget deficit gradually declined, and at the end of 2002 fiscal policy was more expansive due to the election of the 8th Saeima. In the first half of 2003, the strict fiscal policy resulted in a lower domestic demand; nevertheless, a rapid rise in the expenditure and hence also in the budget deficit was expected at the end of the year. Both the growing current account deficit typical for the second half of a year as well as an increase in the budget deficit could increase the macroeconomic risks. Therefore the Government's commitment to reduce the budget deficit to 2.2% of GDP in 2004 is considered as a positive measure in regard to diminishing risks.

An upswing in banks' lending has been observed since 2000 as a result of several factors: buoyant macroeconomic environment, growing household income, low level of enterprise and household debt, improving the efficiency of the system for registration of ownership rights and the appropriate legal framework, low inflation rate and a drop in interest rates on the global financial markets. The strategic foreign investors, who entered the Latvian financial market in the mid-1990s, have penetrated new market segments and engaged in the loan market redistribution in recent years. As a result, competition among banks has intensified: interest rates on loans have decreased and the overall margin has narrowed; banks began to offer progressively favourable terms and conditions for loans, and the scope of services has expanded. In the mid-1990s, banks granted loans mostly to large enterprises and well-off households; beginning with 2001, they have been increasingly lending to small and medium-sized enterprises and households. Given the low level of the financial intermediation, banking services continue to develop without hazard to the financial stability.

Although lending to households outpaced the growth in lending to other market segments in recent years, loans to domestic enterprises continued to dominate in the banks' loan portfolio. In the first half of 2003, credit risk associated with domestic enterprises did not increase, as a brisk growth of the economy was observed. Although a high level of concentration was reported in this market segment and loans to enterprises dominated in banks' assets, banks' loan portfolios were highly diversified, limiting the credit risk. Moreover, banks' capitalisation was adequate, allowing for potential losses, if any. Retail trade incurred one of the highest levels of credit risk, since it is the major borrower among all other sectors. Borrowed funds comprised a large share in the liabilities of retail trade enterprises; however, according to analysis, with the financial results of retail trade enterprises improving, the risk in this sector has decreased recently.

With the housing market expanding rapidly, interest rates declining and household income and competition within the banking sector growing, banks have increasingly engaged in lending to households over the last few years. Nevertheless, the exposure to households is still relatively small, and so is the indebtedness of households. For the time being, credit risk related to households is not high; however, with several banks' activity in this segment and the household debt growing, an increase in the risk is observed.

Housing loans account for a substantial share in loans granted to households. As of the end of 2001, a rise in apartment prices in Latvia was largely caused by the development of mortgage lending; however, beginning with spring 2003, the situation on the apartment market has remained stable and, according to the information provided by real estate companies, apartment prices no longer increased and even shrank slightly. According to real estate companies, prices for typical apartments will remain stable or decrease slightly. On the one hand, the price rise for typical apartments will be curbed by an increase in the supply of newly built apartments and, on the other hand, by further development of the mortgage lending. The risk associated with fluctuations in apartment prices is limited by the fact that Latvian banks carefully assess a borrower's income, which is considered the most important factor for assessing loan repayment. Moreover, to apply a reduced (50%) capital requirement to loans granted to households, the amount of the loan may not exceed 70% of the market value of the pledged real estate. Otherwise, a 100% risk weighting applies to such type of loans. In view of the fact that for the time being exposure to housing loans is substantial in three banks only, and the market share of the above banks is comparatively small, it can be concluded that the potential fluctuations in apartment prices will not cause serious problems to the banking sector in general.

With the competition intensifying, the interest rate margin shrank, particularly in the household sector. Still, banks' profitability remained high, as banks were able to attract funds in financial markets on more favourable terms, thus allowing for lower interest rates on deposits; that in its turn made it possible to reduce interest rates on loans.

The liquidity risk associated with non-residents slightly increased in the first half of 2003. It resulted from a rise in banks' foreign liabilities (mostly demand liabilities to foreign parent companies and non-resident non-bank deposits), with banks investing part of non-resident funds on the domestic market. However, the credit risk associated with non-residents decreased, with loans granted to non-resident non-banks shrinking.

The CAR still exceeded the minimum limit of 10% (12.6% at the end of June 2003). It shrank slightly, with the credit risk capital requirement growing more rapidly than equity. Overall, the capital adequacy ratio was typically lower than that of other banks, for the large banks were more active in lending. Banks' capital adequacy ratios are levelling out gradually.

With the long-term lending developing, liquidity risk has slightly increased, remaining limited though. Liquidity ratios are adequately high for all banks, particularly for the banks servicing non-residents.

In general, the situation in the banking sector remained stable. Under favourable economic conditions, Latvia's banking sector will develop successfully, maintaining high profitability, liquidity and capital adequacy indicators.

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