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Order of the Cabinet of Ministers No. 841

In Riga on November 1, 2006 (Prot. No. 55 § 27)

About the concept "On the development of the state joint-stock company "Latvijas Hipotēku un zemes banka" for 2007-2013"

1. To support the concept "On the development of the state joint-stock company "Latvijas Hipotēku un zemes banka" 2007-2013" of the 1st variant of the solution included in the summary.

2. Determine the Ministry of Finance as the responsible institution for the implementation of the concept.

3. Determine that the state joint-stock company "Latvijas Hipotēku un zemes banka" (hereinafter - Hipotēku banka) as a development bank complements the services provided by commercial banks in the following sectors:

3.1. creation and development of small and medium-sized enterprises, technology development, innovation lending;

3.2. crediting of state support measures for agriculture and rural development;

3.3. financing of environmental protection projects;

3.4. providing financial support in the form of pilot projects to special socially sensitive population groups (e.g. disabled, unemployed, young families, national minorities), replacing grants with lending (including financing of employment, business start-up and other social support measures);

3.5. financing of public-private partnership projects;

3.6. venture capital loans or investments for business development;

3.7. guaranteeing financial loans for small and medium enterprises;

3.8. guaranteeing and insuring export transactions;

3.9. provision of quality financial services to Latvian citizens in populated areas where such commercial banking services are not available (in cooperation with the state joint-stock company "Latvijas Pasts").

4. To the Ministry of Transport, in cooperation with the Ministry of Finance and other participating institutions, prepare and By October 1, 2007, to submit proposals to the Cabinet of Ministers in accordance with the established procedure:

4.1. on providing the citizens of Latvia with quality financial services throughout the territory of Latvia, using the possibilities of the state joint-stock company "Latvijas Pasts" and the Mortgage Bank;

4.2. *(deleted by MK order No. 529 of 22.08.2007).*

(Amended by MK order No. 529 of 22.08.2007)

5. The Ministry of Economy, in cooperation with the Ministry of Finance and other participating institutions, will establish a working group that would evaluate the possibilities and submit an informative report to the Ministry of Finance by September 1, 2007 on the merger of the limited liability company "Latvijas Garantiju agency" and Hipotēku banka, export credit financing, guaranteeing and insurance, as well as proposals for lending state support measures for housing development.

(in the version of MK 22.08.2007 order No. 529)

6. To the Ministry of Regional Development and Local Government Affairs, in cooperation with the Ministry of Finance and the Union of Local Governments of Latvia, to prepare and submit to the Ministry of Finance by September 1, 2007, proposals for the financing of development measures for specially supported areas, the financial attraction of municipal infrastructure projects and the financing of public-private partnership projects, using the services of the Mortgage Bank.

(in the version of MK 22.08.2007 order No. 529)

7. The Ministry of Finance, in cooperation with the Ministry of Regional Development and Local Government Affairs, the Ministry of Economy, the Ministry of Transport, the Ministry of the Environment and the Ministry of Agriculture, will establish a working group that:

7.1. develop a detailed timetable for the transformation of the Mortgage Bank into a development bank;

7.2. coordinate the transformation process referred to in subsection 7.1, ensuring connection with the relevant ministries whose competence is in the areas referred to in paragraph 3 of this order;

7.3. starting from 2007, until the transformation process is completed (every year no later than June 1 and December 1), report to the Cabinet of Ministers on the progress of the transformation process of the Mortgage Bank;

7.4. develop and submit to the Cabinet of Ministers by April 1, 2008 a concept for the future development of the Mortgage Bank, taking into account the materials developed in accordance with paragraphs 4, 5 and 6 of this order, and providing for the limited liability company "Environmental Investment fund" and the addition of the state joint-stock company "Rural Development Fund" to Hipotēku banka, as well as the transfer of the functions of the limited liability company "Latvijas Garantiju aentīra" to Hipotēku banka.

(Amended by Order of the MK 22.08.2007 No. 529; Order No. 807 of the MK 17.12.2007)

Prime Minister A. Kalvitis

Minister of Finance O. Spurdziņš

Summary of the concept "On the development of the state joint-stock company "Latvijas Hipotēku un zemes banka" for 2007-2013"

The purpose of the concept "On the development of the state joint-stock company "Latvijas Hipotēku un zemes banka" for 2007-2013" is to provide proposals for the transformation of the state-owned joint-stock company "Latvijas Hipotēku un zemes banka" (hereinafter - Hipotēku banka) into a full-spectrum development bank, which would introduce and would administer special state support programs in the financial field, as well as supplement and develop existing financial support instruments, ensuring that they are directed to the implementation of government priorities according to available resources.

Latvian Mortgage Bank as a state commercial bank was established by the Latvian government on March 19, 1993 with the Minister Cabinet Order No. 140.

According to the concept accepted by the Cabinet of Ministers on June 22, 1999, "On the development of the state joint-stock company "Latvijas Hipotēku un zemes banka" for 1999-2005", the planned variant of the development of the Mortgage Bank is the transformation of the Mortgage Bank into a development bank.

According to the statutes, the main purpose of the activity of the Mortgage Bank is to support the economic development of Latvia in accordance with the types of its commercial activity and to obtain the necessary profit for development from its activity.

The mortgage bank, in cooperation with the responsible sectoral ministries, has developed and implements government-approved target programs and projects, as well as performs other functions delegated to it:

1) Implement the Agricultural Development Project, providing support to Latvian farmers for the development of farms, as well as the development of the agrarian and forest industry. Within the framework of the project, 5,078 loans were granted for a total amount of 4.56 million lats.

2) Implement the Rural Development Project, providing support to Latvian rural entrepreneurs, including business starters. Within the framework of the project, 1005 loans were granted for the total amount of 9.1 million lats.

3) Provides support to Latvian small and medium-sized entrepreneurs. Within the program, 211 promotions were awarded risk loans for the total amount of 19 million lats.

4) Implements the 1st stage of the Housing Development Credit Program (MAKP), providing state support to low-income residents for housing construction and renovation, as well as financing them. As part of the program, 6,747 housing loans for the total amount of 35.3 million lats and 164 apartment building loans for the total amount of 2.4 million lats were granted.

5) Issue and administer guarantees in accordance with the 2nd stage of the updated Housing Development Credit Program. Within the framework of the program, 17 guarantees were issued for the total amount of 172 thousand lats.

6) Finances projects increasing energy efficiency.

7) Finances environmental protection projects and carries out their monitoring in accordance with the environmental protection pilot project "Housing rehabilitation initiative for energy saving". Within the framework of the project, 4 loans were granted for the total amount of 1.1 million lats.

8) Provides loans for long-term investments in agricultural production buildings, structures and infrastructure in accordance with the Agricultural Long-Term Investment Lending Program (LIIPP). Within the framework of the program, 406 loans were granted for the total amount of 16.5 million lats.

9) Provides loans for the purchase of land required for agricultural production in accordance with the Agricultural Land Purchase Lending Program (LIZIKP). Within the framework of the program, 470 loans were granted for a total amount of 7.9 million lats.

10) Provides loans, consultations, guarantees and grants for the purchase of new fixed assets to small and medium-sized rural commercial companies in accordance with the Non-Agricultural Business Development Program (NUAP). Within the program, 222 loans for the total amount of 4.1 million lats and 244 grants for the total amount of 1.8 million lats were granted.

11) Provides state support to small and medium-sized commercial companies by financing (in the form of loans) commercial company development projects. During the implementation of the first and second stages of the program, 2,087 loans were granted for the total amount of 84 million lats.

12) Implements the European Regional Development Fund co-financed project "Lending for business start-ups system development". Within the framework of the project, 29 loans were granted for the total amount of 4.25 million lats.

13) Implements the European Social Fund co-financed project "Training, consulting and financial support for starting commercial activities and self-employment".

14) In accordance with the Law "On Privatization Certificates", accounts of privatization certificates are opened in the Mortgage Bank, in which the certificates belonging to the owners of the certificates and the operations performed with them are recorded.

15) In accordance with the Law "On Privatization Certificates", the Mortgage Bank monitors that each person who has certificates for the time they lived in Latvia and certificates for a politically repressed person has only one privatization certificate account, and also controls the amount of issued, circulating and canceled certificates.

16) In accordance with the Law "On Privatization of Land in Rural Areas", the Mortgage Bank carries out privatization-related activities settlement and credit operations, as well as conclude land purchase agreements with land owners for land purchase.

17) In accordance with the Law "On Completion of Land Reform in Rural Areas" and the Law "On Completion of Land Reform in Cities" property rights to land are confirmed in the land register in the name of the state in the person of the Mortgage Bank. The mortgage bank is also selling this land.

18) In accordance with the law "On the privatization of state and local government residential houses", the Mortgage Bank performs with the state and settlement operations related to the privatization of municipal residential houses.

19) In accordance with the Law "On State and Local Government Property Privatization Funds" and in accordance with the Law on the State Budget for the current year, the Mortgage Bank can use the funds of the State Property Privatization Fund for the creation of long-term credit resources, the development of mortgage lending and targeted lending.

The Mortgage Bank consistently increases and plans to increase the proportion of functions that correspond to its main purpose and qualified as the implementation of the functions of a development bank.

The proportion of the functions of the Development Bank in the operation of the Mortgage Bank, as of June 30, 2006, is approximately 65% of all transactions of the Mortgage Bank. Regarding lending, which is the main activity of the Mortgage Bank, development loans account for 51.7% of the total loan portfolio, but at the end of 2006 it will reach 64.1%.

Hipotēku banka has consistently fulfilled the tasks defined in the concept "On the development of the state joint-stock company "Latvijas Hipotēku un zemes banka" for 1999-2005" accepted by the Cabinet of Ministers on June 22, 1999, by introducing and implementing target programs supplementing the services of commercial banks, as well as by actively engaging in agricultural and rural development, housing development, support and development of small and medium-sized commercial companies and their implementation. Therefore, Hipotēku banka fulfills the functions of both a development bank and a universal bank, because according to the statutes, the main purpose of the activity of Hipotēku banka is to support the economic development of Latvia in accordance with the types of its commercial activities and to obtain from its activity the necessary profit for its development.

In order to use the accumulated experience and potential of the Mortgage Bank in implementing the functions of a development bank, it must be transformed into a development bank, gradually transforming the functions of a universal bank into the functions of a development bank.

Development banks operate in many countries as a mechanism for the implementation of financial support. The task of development banks is to perform complementary functions to the financial market. Therefore, development banks also operate in countries with developed economies and commercial banking sectors (for example, Canada, Sweden, the Czech Republic, Finland, France, Germany and Spain).

It is important to note that in each country, the functions and tasks of the development bank are determined according to the country's interests and specific historical situation. Therefore, it is necessary to define the areas in which it would be useful for the Mortgage Bank to operate as a development bank from the point of view of national economy and national development.

In Latvia, there are a number of economic and social problems, for the solution of which the society's needs for quality financial services are not satisfied by the traditional mechanisms of the free market, and where it would be useful to use the Mortgage Bank as a development bank to provide support. The mortgage bank could be used in the following areas:

- 1) Creation and development of small and medium-sized enterprises, technological development, crediting of innovations.
- 2) Lending of state support measures for agriculture and rural development.
- 3) Financing of environmental protection projects.
- 4) Implementation and lending of state support measures for housing development.
- 5) Providing financial support in the form of pilot projects to special socially sensitive population groups (for example, the disabled, the unemployed, young families, national minorities), replacing grants with lending (including financing of employment, business start-up and other social support measures).
- 6) Guaranteeing financial loans.

7) Risk capital loans or investments in business development.

8) Financing, guaranteeing or insurance of export transactions.

So far in our country 6. and the management of the financial instruments referred to in point 7 is carried out by the Latvian Guarantee Agency. When transforming the Mortgage bank into a development bank, it is useful to integrate the Mortgage bank and the Latvian Guarantee Agency, using the experience of both institutions. On the other hand, it is possible to use the Mortgage Bank for financing, guaranteeing and insurance functions of export transactions.

In order to evaluate the integration possibilities of the Latvian Guarantee Agency and the Mortgage Bank, the implementation of the functions of financing, guaranteeing and insurance of export transactions in the Mortgage Bank (provision of state support according to the "one-stop" principle), as well as the creation and maintenance of the risk management system of the financial resources diverted to the needs of financial support, it is necessary to create a working group from representatives of the Ministry of Economy, the Ministry of Finance, the Latvian Guarantee Agency and the Mortgage Bank.

9) Financing of public-private partnership projects.

In order to prepare proposals for the financing of development measures for specially supported areas, the financial attraction of municipal infrastructure projects, the lending of state support measures for housing development and the financing of public-private partnership projects, using the potential of the Mortgage Bank, it is necessary to create a working group from the Ministry of Regional Development and Municipal Affairs, Latvia For representatives of the Union of Local Governments, the Ministry of Finance and the Mortgage Bank.

10) Implementation and co-financing of programs and projects of international financial institutions (eg CEB, EBRD, NIB, KfW).

11) Development of the Northern European regional financial center in Latvia.

As one of the possible development scenarios, the possibility of using the Mortgage Bank in the creation of a regional financial, transit and related logistics service center should be considered.

Taking into account the geopolitical location of Latvia and its capital, it is possible for Latvia to become a globally important financial, transit and logistics service center that would serve the flow of passengers and goods between the West and the East, including the countries of Southeast Asia. Therefore, the Ministry of Finance and the Ministry of Transport together with the Mortgage Bank should prepare appropriate proposals for the implementation of this goal. It is important to note that the Swedish government has already established a working group whose task is to develop proposals to make Stockholm, not Riga, the financial center of Northern Europe.

12) Provision of qualitative financial services to Latvian residents in all populated areas.

There are still many settlements in Latvia where residents cannot receive quality financial services, because banks, taking into account the principles of free market operation, have closed their branches or settlement groups and do not consider it economically beneficial to open new ones. In order to provide residents with the opportunity to make payments, receive cash, as well as microcredits as close as possible to their place of residence, they can use the departments of the state joint-stock company "Latvijas Pasts" (hereinafter - Latvijas Pasts) and the Postal Payment Services Service. However, the more efficient operation of the payment services service requires significant investments, training of employees, as well as opportunities that meet banking standards, for example, in the field of lending.

This problem can be solved by integrating the payment function blocks of the Postal Payment Service Service and the Mortgage Bank. In order not to distort competition in the banking sector, the provision of financial services needed by the citizens through the Mortgage Bank and Postal Payment Services Service can be limited, providing it only in those populated areas where there are no other bank branches or settlement groups.

In order to develop in detail a proposal for the integration of a separate Postal Bank or Postal Payment Services Service and the Mortgage Bank's settlement block, it is necessary to create a working group from representatives of the Mortgage Bank, Latvian Post, the Ministry of Transport and the Ministry of Finance.

The concept also envisages the creation of a working group from representatives of the Ministry of Finance, the Ministry of Regional Development and Municipal Affairs, the Ministry of Economy, the Ministry of Transport, the Ministry of the Environment and the Ministry of Agriculture to develop a detailed timetable for the transformation of the Mortgage Bank into a development bank, to coordinate the transformation process, ensuring a connection with the ministries, whose competence includes the relevant areas, and also, starting from 2007, until the completion of the transformation process (each year no later than June 1 and December 1), would report to the Cabinet of Ministers on the progress of the bank transformation process.

In the concept, two options have been developed for solving the mentioned problems and for determining the direction of the future development of the Mortgage Bank.

Option 1. Gradual transformation of the Mortgage Bank into a development bank

Necessary measures

- 1) The mortgage bank is planning to reduce the operation of the universal bank and increase the proportion of development programs, as also introduces new state-backed financial services products in line with government priorities.
- 2) The settlement block, which includes, for example, settlements, internet banking, payment cards and deposits, is located in the area of sharp competition and qualifies as universal bank services, is integrated with the payment services service of Latvijas Pastas. The created system allows providing financial services to citizens who do not have access to them, because it is economically unprofitable for private commercial banks to create branches or settlement groups in parishes and small towns with a small population.
- 3) During the transition period, separate accounting records are provided for development (state-supported) programs and for the implementation of financial services resulting from them.
- 4) To ensure that the Mortgage Bank operates as a development bank, a special law or the Minister is required cabinet regulations on development bank.

Advantages

- 1) Customers are provided with the opportunity to receive state-supported target program products and related products services according to the "one stop" principle.
- 2) The development bank has the necessary personnel and material base for its operation, as it is created on the basis of an existing bank.
- 3) The existing network of branches is preserved. It is possible by integrating it with Latvijas Pastas payment services to reach practically any resident of Latvia by providing the necessary financial services.
- 4) Professional risk management of the use of financial resources entrusted by the state is ensured. The Mortgage Bank has already established and operates a professional risk management system that meets the requirements of international standards, and the Financial and Capital Market Supervisory Commission, an international audit and an internationally recognized rating agency continue to provide comprehensive and professional supervision in accordance with internationally recognized banking supervision standards.
- 5) The status of a mortgage bank allows to attract financial resources for financing development programs.
- 6) The status of the mortgage bank and the resources at its disposal ensure stability during the transition period.
- 7) Continuous operation of the Mortgage Bank and transition to a full-scale development bank is ensured.
- 8) The bank maintains its credit rating, which is necessary when cooperating with commercial banks and attracting resources. This is especially important when implementing the Basel II norms for bank risk management.
- 9) The mortgage bank has the ability to implement large-scale programs in a short time.
- 10) The mortgage bank develops new services and programs simultaneously with the transformation.

Flaws

- 1) A complex transition process that will require a large commitment of personnel during the transition period.
- 2) During the transition period, the attitude of investors will be more cautious, and this will make it difficult to attract resources.
- 3) Transfer of customers to other banks is possible.
- 4) The mortgage bank remains the property of the state, and further capital increase is the responsibility of the state as the owner.

Option 2. The division of the mortgage bank into two legally independent banks - a development bank and a commercial bank

Necessary measures

- 1) The components of the development bank are gradually separated from the Mortgage Bank, and the state continues to implement the relevant functions through a new credit institution (development bank) or a special financial institution. The holder of state-owned capital shares in the development bank (special financial institution) is the Ministry of Finance. Leftovers

Capital shares of the mortgage bank are privatized.

- 2) The mortgage bank is gradually increasing the implementation volumes of development programs and related financial services.
- 3) Separate implementation and accounting of development programs is ensured.
- 4) In order to provide the Mortgage Bank with stable financial resources, negotiations are organized with the bank's creditors and the necessary conditions are discussed so that the creditors do not withdraw the borrowed financial resources. If necessary, loan agreements are switched.
- 5) Assets, employees and operational infrastructure as well as information systems are distributed in the mortgage bank. The mortgage bank is developing an internally separated structure to perform the functions of a development bank, so that it can be separated into a separate independent legal entity.
- 6) In order to reach the population of Latvia and offer them the products and financial services envisaged within the framework of the national target programs, new branches are created to ensure regional representation, as the existing network of branches remains with Hipotýku banka.
- 7) The state provides a guarantee for the loans of the Mortgage Bank (or attracts resources and lends them to the Mortgage Bank) for the implementation of target programs.
- 8) In order to ensure the operation of the development bank (special financial institution), it is necessary to adopt a new special law or regulations of the Cabinet of Ministers.

Advantages

- 1) The potential of the Mortgage Bank as a universal bank is partially preserved, and when it is sold, it is partially "earned" previous investments.
- 2) The Mortgage Bank brand is preserved.
- 3) A separate institution (with appropriate employees, infrastructure, material.) is separated from the Mortgage Bank base), which ensures the implementation of the functions of the development bank.
- 4) Continuous operation of the development bank is ensured.
- 5) It is possible to implement extensive programs in a short time.
- 6) Comprehensive and professional risk monitoring is provided in accordance with internationally recognized standards.
- 7) The state can obtain income from the sale of the Mortgage Bank as a universal bank to invest in development in a bank (special financial institution).
- 8) The status of a mortgage bank requires internationally recognized supervision, which remains comprehensive and professional monitoring according to internationally recognized standards.

Flaws

- 1) The development bank (special financial institution) starts its work practically from "zero" (for example, it loses recognition, market share).
- 2) It is necessary to create a new material base.
- 3) A complex transformation process that requires a high level of personnel commitment.
- 4) An internationally recognized credit rating is not maintained and will be difficult to obtain.
- 5) The transformation of the bank requires relatively large investments of the bank itself and state resources.
- 6) A long transition is associated with great uncertainty, which may threaten the loss of customers and employees.
- 7) Splitting Mortgage Bank into two banks will result in two small banks with reduced competitiveness.
- 8) During the transition period, a reserved attitude of foreign investors towards the newly established development bank is expected (special financial institutions), which will make it difficult to attract the resources necessary for the implementation of target programs;
- 9) Negotiations with the services of the European Commission regarding the structural fund managed by the bank are expected

programs, and there is a risk of having to repay the part of the European Union's co-financing for these programs.

The Council of Europe Regulation of June 21, 1999 no. 1260/1999 "On general provisions on structural funds". Article 30.4 of the Regulation stipulates that within five years after project approval, no significant changes in the implemented activities are allowed, nor is a change of ownership rights allowed. In violation of the provisions of Article 30.4 of the said regulation, the Member State shall repay the funds of the European Union's structural funds to the European Commission in accordance with Article 39 of the regulation. This means that the issue of the privatization of the Mortgage Bank must be initially coordinated with the European Commission, otherwise Latvia will have to repay the funds of the European Union's structural funds intended for the implementation of the aforementioned structural funds' programs. This is a total of 12 million lats (the total amount of programs is 28.4 million lats).

For the stable operation of the development bank, a special law or regulations of the Cabinet of Ministers on the development bank are required, which define the limits of the state's responsibility regarding the programs implemented by the bank and the principle of risk sharing between the state and the development bank.

The law or regulations must define the scope of activities of the development bank, as well as the responsibility for the implementation of the programs entrusted to it, loans, guarantees, management of grant schemes, venture capital financing, participation in the capital of commercial companies, export credits and export insurance.

Regarding the supervision of the development bank, it must obey the Financial and Capital Market Supervisory Commission of Latvia, therefore, the law on the development bank should determine only those norms that will be different in the supervision of the development bank from the supervision of commercial banks.

In order for Hipotēku banka as a development bank to be able to supplement the services provided by commercial banks in the above-mentioned sectors, it would be necessary to create expert working groups, which would include representatives from various ministries (for example, the Ministry of Finance, the Ministry of Economy, the Ministry of Transport, the Ministry of the Environment, the Ministry of Regional Development and Local Government Affairs) and institutions with competence in the relevant field. A more detailed analysis or possible integration of cooperation between the Mortgage Bank and various other support instruments and institutions could be carried out in these working groups.

The draft order of the Cabinet of Ministers envisages supporting **the 1st variant of the development of the Mortgage Bank**.

The implementation of option 1 does not require additional state budget funds.

Minister of Finance O. Spurdziņš