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Latvia

The “Financial Crisis” – Support measures to the banking sector in Latvia

Depending on political decisions, financial market structure and its sensitivity to the global inter-bank market situation as well as limitations in budget resources different approaches can be found between EU member states in their approach to support measures in the banking sector. Latvia is amongst the countries which started with an ad hoc aid to an individual bank and soon after creating a support frame for banks in Latvia in the form of general state aid scheme.

I. Background information

A little background is necessary to better understand the Baltic financial market and Latvia's choice of support measures to tackle the financial crisis.

At 31 December 2008, there were 21 domestic banks in Latvia, seven branches of foreign banks, and seven representative offices of foreign banks. Although there are a relatively large number of banks in Latvia, there is significant concentration in the banking sector with more than two thirds of the total banking sector's assets, loans and deposits controlled by the top five banks in each respective area. The highest concentration is in the loans segment, where the share of the top five banks constitutes 74% of total banking sector loans.

As for other neighbouring Baltic countries:

- The Lithuanian banking sector is dominated by foreign banks. As of February 2009 the top 5 banks (all subsidiaries of Scandinavian banks) controlled 82.5% of the banking sector's total assets while also dominating the loans segment.
- In the Estonian market six companies licensed as credit institutions, nine branches of foreign credit institutions and over 200 cross-border banking service providers were operating at the end of the third quarter of 2008. The branches of foreign credit institutions hold more than 25% of the Estonian credit market. Again, the leading banks are subsidiaries of Scandinavian banks.

II. Ad hoc aid to JSC Parex banka¹

In 2008 JSC Parex banka (hereinafter – Parex) was the second largest bank in Latvia in terms of assets and third largest bank in the Latvian overall payment system, it is the largest Latvian bank without a strong foreign parent. Before the nationalisation of Parex through the acquisition of 84.83% of its shares by the Government of Latvia in November and December 2008²

the majority of its shares were held by two private individuals.

The failure of such a large market participant would have had a negative impact on the whole Latvian financial sector and the functioning of the Latvian payment system, therefore the Latvian Government acted by taking control of Parex accompanied with decisions on financial support measures as rescue state aid (with the rescue phase ending on 11 May 2009).

First step measure – Nationalisation of Parex

By means of an Investment agreement of 10 November 2008, 51% of Parex' shares, (amended on 3 December 2009 to 84.83%) shares owned by two major shareholders were transferred to the 100% State-owned Joint Stock Company “*Latvijas Hipotēku un zemes banka*” (Latvian Mortgage and Land Bank; hereinafter – LHZB) at a symbolic purchase price.

In February 2009 LHZB acquired an extra 200,000 shares (0.31% of capital) from a minority shareholder AB Svenska Handelsbanken also for a symbolic price thus holding 85.15% shares of Parex.

Pursuant to the purchase agreement of 25 February 2009 the shares owned by LHZB were transferred to the Latvian Privatization Agency (hereinafter – LPA). The decision to transfer was taken by the Government of Latvia having regard to International accounting standards according to which the exemption from the requirement to consolidate Parex's accounts into those of LHZB could be applied only for one year from the date of the acquisition of shares. As it became evident that the shares of the Parex owned by LHZB would not be sold during the one year

1 For details see the Commission decision of 24 November 2008 in case NN 68/2008 Public Support Measures to JSC Parex Banka, the Commission decision of 11 February 2009 in case NN 3/2009 and the Commission decision of 11 May 2009 in case N 189/2009 Modification of public support measures to JSC Parex Banka

2 As from February 2009 the State owns 85.15% of Parex shares

period and that consolidation of accounts would endanger the reputation and financial stability of the LHZB in such a fragile financial market environment all around in the world it was decided to transfer these shares.

Support measures initiated by the Latvian Government and approved by the Commission

From the first day it became clear that the nationalization of Parex should be accompanied with specially selected support measures composed of short-term liquidity support from the State Treasury, guarantees and recapitalization measures.

a. Short term liquidity support

The overall maximum amount that could be provided to Parex as short-term liquidity support was set at LVL 1.5 billion³. The first transfer of short-term liquidity support to Parex amounting to LVL 200 million was provided on 10 November 2008 to enable the Bank to settle deposit withdrawals. Further funds were provided in multiple injections to finance the continuous deposit outflow. Each amount was justified individually based on the regular liquidity forecasts provided by Parex to the State Treasury. Up to the end of 2008, the total amount of financing provided to Parex was LVL 674 million. In March 2009 a further injection of LVL 163 million was granted to finance Parex' first instalment to syndicated lenders in accordance with the terms of loan restructuring, therefore the total amount of the short-term liquidity support reached LVL 873 million.

b. Guarantee of Parex's syndicated loans

Initially the notification covered guarantee for new loans taken out

to refinance the syndicated loan maturing in February 2009. As on 14 November 2008 it became clear that the creditors of the syndicated loans were preparing to announce a default event (failure to fulfil contractual obligation), modifications in the original notification were pre-negotiated with the Commission and submitted on 20 November 2008. Modified guarantee measure contained also possibility to issue guarantees for Parex's existing syndicated loans maturing in February 2009 and June 2009.

In accordance with the terms of the loan restructuring agreed with the syndicated lenders, 30% of the total amount was repaid in March 2009 and the State has provided guarantees only for the residual amount, i.e. in respect of the amounts due beyond 2009 in accordance with the agreed repayment schedule.

c. Investment in capital

Initially, when overtaking control in Parex in November 2008, the State considered that there might be a need to grant subordinated loans (in Tier 2 capital) to Parex for up to LVL 200 million⁴.

Following the diligence exercise and the changed legal requirements, there was a need to inject capital also in Tier 1 capital into Parex to enable it to achieve the

minimum capital adequacy ratio (CAR). The level of Parex's recapitalisation by providing both Tier 1 and Tier 2 capital was accepted by the Commission⁵ at a level of 11 % (10% for the group) in the rescue period. According to the Financial and Capital Market Commission of Latvia this level corresponds to the minimum CAR required for Parex from the regulatory perspective. At the date of the respective Commission decision the total amount that would be needed to be injected to achieve this CAR was estimated at LVL 191.020 million. After this new capital injection the State owns 95.30% of Parex.

What comes next?

A restructuring plan has been submitted to the European Commission on 11 May 2009. After initial assessment of the plan, the European Commission has initiated a formal investigation procedure to be able to make in-depth assessment as to whether the restructuring plan is realistic and would lead to the long-term restoration of viability and whether the state aid foreseen in restructuring plan can be found compatible with the common market⁶. The same procedures have been initiated in respect of many other ad hoc support cases for banks in other Member States⁷.

3 In accordance with the Commission decision of 11 February 2009 in case NN 3/2009

4 Approved by the Commission decision of 24 November 2008, case reference NN 68/2008

5 Approved by the Commission decision of 11 May 2009, case reference N 189/2009

6 Decision has been taken on 29 July 2009, case reference C 26/2009 (ex-N 289/2009); not yet made public

7 See for example cases: decisions of 02.04.2008 and 27.05.2009 in case C 14 / 2008 – UK – Restructuring aid to Northern Rock; decision of 13.03.2009 in case C 9/2009 – Belgium – France – Luxembourg – Restructuring of Dexia; decision of 08.04.2009 in case C 11/2009 – Netherlands – Restructuring aid to Fortis Bank Nederland; decision of 06.05.2009 in case C15/2009 – Germany – Restructuring aid for Hypo Real Estate; decision of 11.05.2009 in case C 16/2009 – Germany – Restructuring aid for Bayern LB

III. General scheme – guarantees for banks in Latvia and bank takeovers⁸

Soon after having agreed to grant ad hoc aid to counter the difficulties faced by Parex, the Latvian authorities worked out general support measures for the Latvian banking sector.

a. Bank takeovers

The law on bank takeovers was adopted at the end of December 2008⁹ with the purpose to preserve the stability of the banking system of Latvia and to ensure smooth operation of the payment systems in the public interest.

Such a takeover, if necessary will be carried out in accordance with the Law on Bank takeover. A bank takeover can take place by alienating shares issued by the bank or by alienating a bank's assets, rights and obligations. The takeover provision is targeted at distressed banks only, which are not fulfilling or is at serious risk of not fulfilling the capital adequacy requirements.

Shareholders would receive fair compensation for their shares or the bank's assets rights and obligations on the basis of a special law. As regards the share price or the price for the bank's assets, rights and obligations, the same provisions as already described above would be used. The law for the takeover of banks does not have a limitation in time.

This law would be used in exceptional cases only if no other measures would lead to the intended aim of the preservation of the stability of the Latvian financial system.

As it is stated in the Commission's decision¹⁰, mere change of ownership, i.e. taking over of the bank by the State does not in itself entail state aid. Article 87(1) of the EC Treaty starts to become applicable only if the takeover of a bank is accompanied by other support measures. In such a case the Latvian authorities are obliged to seek approval for state aid and provide the Commission with a restructuring or liquidation plan of the bank concerned within 6 months of the date of grant of the first rescue aid.

b. Guarantees for banks

In addition, a special guarantee scheme¹¹ for banks was created with the same purpose – to maintain the stability of the national financial system.

This scheme targets solvent and adequately capitalized banks incorporated in Latvia (including the Latvian subsidiaries of foreign banks). Whether a bank is adequately capitalized shall be verified and confirmed by the Financial and Capital Market Commission and the Bank of Latvia.

A state guarantee under the scheme can be issued on new

short and medium term loans to refinance existing liabilities as well on existing loans. It is supposed that the State will guarantee existing loans only in exceptional cases, when a bank applies for a guarantee because its creditors can validly claim a major default event, which would lead to the bank's immediate bankruptcy without such state guarantee. The guarantee of existing loans would cover liabilities with a maximum maturity of 3 years, but the guarantee of the loans taken for refinancing of the existing loans would cover liabilities with a maturity between six months and three years.

This guarantee scheme was initially approved by the Commission up to end of June 2009 with a prolongation option till end of 2009 subject to separate approval by the Commission.

Although up to end May 2009¹² no guarantee has been issued under the scheme the scheme's importance remains valid and therefore it will be kept in force till the end of 2009 for the following reasons:

- The international financial crisis still affects the entire Latvian financial system and the economy as a whole, according to forecasts the Latvian economy will have a decrease of 18% in GDP in 2009.
- External and domestic developments damaged confidence in the banking sector, resulting in considerable outflows of both resident and non-resident deposits at the end of 2008 as well as the beginning of 2009.
- Latvian banks have a large exposure to syndicated loans. Even though these banks have successfully repaid more than LVL 159 million of syndicated loans

8 For details see the Commission decision of 22 December 2008 in case N 638/2008 Guarantee Scheme for Banks in Latvia and the Commission decision in case N 326/2009 Prolongation of Guarantee Scheme for Banks in Latvia

9 Adopted by the Parliament on 18 December 2008, entry into force on 31 December 2008

10 Decision of the Commission of 22 December 2008, case reference N 638/2008

11 Regulation of the Cabinet of Ministers "Procedure for issuing and supervision of guarantee for bank loans", adopted on 3 February 2009

12 Latvia issued guarantees covering Parex syndicated loans on the terms of the scheme; however, granting of the State guarantees for Parex were approved individually by the Commission, see footnote 1

- and none of the due loans has been refinanced, more than LVL 252 million of syndicated loans are due in 2009.
- In many of the loan agreements there is a clause that lenders can request repayment of the loan in full even before the loan is due if the rating of the bank falls below investment grade.
 - As such guarantee schemes exist in the majority of EU Member States, the termination of the guarantee scheme in Latvia could put additional stress on the Latvian financial markets. The mere fact that in case of necessity Latvia will systematically support important banks helps to reassure financial markets.
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