EUROPEAN COMMISSION

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Subject: **State aid NN 3/2009 – Latvia**
Modifications to the public support measures to JSC Parex Banka

Sir,

I. PROCEDURE

1. On 10 November 2008 Latvia notified to the Commission a package of measures in favour of JSC Parex Banka designed to support the stability of the financial system, which was approved on 24 November 2008[1]. On 26 January 2009, Latvia informed the Commission about several changes to the public support measures to JSC Parex Banka[2].

II. DESCRIPTION

1. The original measures

2. In response to the liquidity difficulties experienced by JSC Parex Banka (hereinafter, "Parex") due to the deterioration of the global economic situation and the mutual trust crisis in the finance sector, Latvia brought forward a package of measures designed to keep the bank afloat. Parex is considered to be a bank of systemic importance in Latvia and thus the designed measures aim at maintaining the stability of the financial system and remedying a serious disturbance to the economy of Latvia.

3. Parex was partly nationalised through acquisition of a 51% stake by Latvijas Hipotēku un zemes banka (Latvian Mortgage and Land Bank, hereinafter the state-owned bank or

[1] See Commission decision of 24 November 2008 in case NN68/2008 *Public support measures to JSC Parex Banka* - not yet published.

[2] In view of the fact that some modifications to the measures, such as modified interest rate and amount for the liquidity deposits, were put into effect by the Latvian authorities in the beginning of December 2008, *i.e.* before the Commission reached a decision on the case, the case has been registered with an NN-number.

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LHZB)[3] in November 2008. The notified public support measures for Parex were the following ones:

(a) The Latvian state undertook to invest up to 200 million LVL into the bank's Tier-2 capital, by granting to it subordinated term debt[4] with a maximum maturity of 5 years;

(b) The Latvian state undertook to guarantee the existing senior syndicated loans maturing within 6 months from the granting of the first measure to the bank in the amount of EUR 775 million since the respective creditors would otherwise have claimed a default of the bank. It also undertook to guarantee new loans taken out to refinance the syndicated loan that matures in February 2009 in the amount of EUR 275 million;

(c) On 11 November 2008 the State Treasury deposited LVL 200 million with Parex in order to ensure sufficient liquidity. As a result, the bank was provided with funds to acquire government debt securities, i.e. liquid collateral to use in operations with the central bank, which it did not have at the time.

2. The persistence of the bank's difficulties

4. On 7 December 2008 Moody's Investors Service further downgraded the bank financial strength rating (BFSR) of Parex from E+ to E and the bank's long-term deposit and senior debt ratings from Ba1 to B2 [5], five levels below investment grade. The rating actions followed the announcement of deposit withdrawal restrictions put in place earlier in the week by the cabinet of Ministers of the Republic of Latvia and the Financial and Capital Market Commission. Moody's decision to downgrade the BFSR to E took into consideration the bank's much weakened financial fundamentals and future franchise viability as a result of the significant outflows of deposits and other funding that would make it difficult for the bank to continue operating normally and competitively as a lending and deposit taking institution.

5. The E BFSR, the lowest on Moody's rating scale also reflects Parex weak liquidity position on standalone basis (i.e. excluding any expectations of external support). In Moody's opinion the government's intervention on 8 November 2008 revealed fundamental weaknesses in the bank's liquidity management as well as the need for capital support. The bank's credit risk concentrations remain high. The bank's real estate management sector exposure – which, in Moody's view, is likely to be hardest hit by the economic slowdown accounted for a high 18% of the total loan portfolio (or 175% of Tier 1 capital) at end June 2008.

3 LHBZ is a joint-stock company, 100% owned by the Latvian state. LHZB is an issuer of government debt securities. According to the information provided by the Latvian authorities, the State, being a 100% shareholder, approves all the strategic decisions of LHZB, including purchase/sale of shares in other companies.

4 Given that subordinated term debt is due after a specified time period, *i.e.* exit from the companies capital is automatic, it is a lower ranking capital instrument than preference shares or perpetual subordinated debt.

5 Moody's investors' service applies the following definitions of the abovementioned debt rating categories. Ba: obligations rated Ba are judged to have speculative elements and are subject to substantial credit risk. B: obligations rated B are considered speculative and are subject to high credit risk. Regarding numerical modifiers, Moody's adds 1, 2 and 3 to each generic rating classification. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category and the modifier 2 indicates a mid-range ranking. Source: Bloomberg.

6. The downgrade of Parex deposit and debt ratings to B2 reflects not only the downgrade of the BFSR, but particularly the partial deposit freeze, which Moody's views as constituting a selective default. In Moody's opinion, deposit withdrawal restrictions could badly damage the bank's franchise value over the near term.[6]

3. Description of the changes to the measures

7. Latvia has proposed the following changes to the provisions governing nationalisation of the bank and the public support measures.

Nationalisation of the bank

8. Pursuant to the investment agreement of 10 November 2008, as amended on 3 December 2008, the state-owned bank, instead of taking over a stake in Parex of 51%, acquired 84.83% of the shares, *i.e.* all of the bank's shares owned by the two major shareholders[7] were transferred to LHZB at a symbolic total purchase price of 2 LVL (around 3 EUR). Furthermore, the two major shareholders will no longer be entitled to purchase back their former shares in Parex from LHZB.

9. At this stage, it is not excluded that LHZB will fully nationalise Parex through acquisition of its remaining shares from the minority shareholders. In this regard, the Latvian authorities confirmed that the compensation that would be paid to these shareholders in such event would be set according to the Latvian Law on Bank Takeover that was notified to the Commission in the context of the guarantee scheme for banks in Latvia[8]. In particular, the maximum price paid to the shareholders for the shares would represent their respective market value, whereas the state aid, the funding by the Bank of Latvia and any value due to speculation on State support would be excluded.

Subordinated term debt[9]

10. Following the further downgrade of risk rating for long term senior debt of Parex by Moody's and the increased State's participation in Parex share capital, the Latvian authorities reconsidered the interest rate mechanism approved by the Commission on 24 November 2008 for the subordinated term debt (as well as for the guarantee and liquidity measures, see below).

11. The newly designed interest rate mechanism for the subordinated term debt essentially follows the European Central Bank's (hereunder "the ECB") recommendations for the pricing of recapitalisation instruments of 20 November 2008 (see point 3 and table 1 in Annex 1 of the ECB recommendations). It only deviates from them regarding the first element of the interest rate, *i.e.* the estimate of the funding cost of the Latvian State. In particular, given that Latvia is not a euro area Member State this fee element is differentiated depending on the currency the debt to Parex will be provided in, *i.e.* EUR or LVL. However, this fee element is always above the level recommended by the ECB with regard to the estimate of the government funding cost.

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6 Source: https://www.istockanalyst.com/article/viewiStockNews/articleid/2861133.

7 The two major shareholders are individuals (Viktors Krasovickis and Valērijs Kargins).

8 See Commission decision of 22 December 2008 in Case N638/2008 *Guarantee scheme for banks in Latvia* - not yet published.

9 The legal basis has changed with regard to the subordinated term debt: the commitment to provide such capital will not be based on an individual investment agreement between Parex and the state of Latvia anymore, but it will be granted upon Government decision should the bank need it.

12. In this regard, it has to be noted that Latvia is not a frequent issuer in the Eurobond market[10] and the liquidity in the secondary market for domestic securities is deemed not to be sufficient. Therefore, for the funding to be provided in EUR the Latvian authorities will use the sum of:

    (i) the credit spread over EUR mid-SWAP as priced at the time of the latest issue of Eurobonds for Latvia[11], which equals 1.2%, and

    (ii) the mid-SWAP rate for the EMU benchmark[12] 5-year bond on the day preceding the provision of the funding[13].

    For the funding to be provided in LVL the Latvian authorities will use the yield of domestic Treasury bills or bonds with the longest maturity[14].

13. In summary, the subordinated term debt interest rate will be determined at the date of funding depending on the total value of the following parameters and the currency:

    - The above mentioned estimate of the funding cost of the Latvian State;

    - a credit risk premium determined as the median value of 5 year CDS spreads on subordinated debt during the reference period for the A[15] rating category, based on a representative sample of euro area large banks, defined by the Eurosystem, which equals 0.735%;

    - an add-on fee of 2% *per annum*.

14. The resulting fee varies, depending on the funding cost of the government (the first element of the interest rate). As of January 2009, the total interest rate would have equalled 6.865% for subordinated debt to be provided in EUR and 10.435% for subordinated debt to be provided in LVL.

Guarantee arrangements to existing and new loans

15. The Latvian authorities also reconsidered the interest rate mechanism approved by the Commission on 24 November 2008 for the State guarantee. In particular the same fee as set in the general Latvian guarantee scheme[16] will apply to Parex as well. The fee will

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10 For instance, in January 2009 only two emissions of the Latvian bonds in EUR were outstanding and none of them had 5-year maturity.

11 *I.e.* issued and priced in the end of February 2008. The Latvian authorities submitted that the Latvian credit risk estimate resulting from the application of the ECB recommendation amounts to an average spread of 90 basis points or weighted average of 100 basis points, which is lower than the spread used by the Latvian authorities.

12 *I.e.* government bond with the lowest yield at the time considered.

13 As of January 2009 5Y EUR mid-SWAP rate for benchmark Eurobonds equalled 2.93%.

14 At present, it would correspond to the yield of one year Treasury bills. This is explained by unfavourable current market conditions in the Latvian government domestic securities market. In particular, new issuance of government Treasury bonds has diminished recently and lately was suspended. Investors were not willing to buy the medium and long-term government bonds due to unsustainable domestic financial market conditions at a rate level that would be acceptable to the Latvian Treasury. As of January 2009 the yield of the longest maturity Latvian government bonds/bills in LVL, i.e. 1Y Latvian Treasury bill, equalled 7.70%.

15 The respective CDS data is not available for Parex. Pursuant to the ECB recommendations on government guarantees on bank debt of 20 October 2008, the lowest rating category to be considered is A, as there is no sufficient data available for the rating category below this category.

16 The scheme was approved by the Commission on 22 December 2008, however the changed guarantee fee for Parex was not covered by the said decision (see Case N 638/2008 Guarantee scheme for banks in Latvia, 22.12.2008, not yet published).

equal *i)* a service fee of 0.1%, plus *ii)* the median value of 5 year CDS spreads of A-rated[17] euro area large banks over the reference period of 0.448% plus *iii)* an add-on fee of 0.5%. This leads to a final fee of 1.048%.

Short term liquidity measures

16. The Latvian authorities also reconsidered the interest rate mechanism approved by the Commission on 24 November 2008 for the short term liquidity measures in the form of deposits and the total maximum amount of deposits that the Latvian State may provide to Parex.

17. As regards the newly set interest rate, the modifications were already introduced in the beginning of December 2008. The new interest rate to be paid by Parex for the liquidity measures is based on the funding cost of the Latvian State plus a margin for the credit risk of the bank.

18. The estimate for the funding cost of the Latvian State for deposits in EUR consists of the abovementioned credit spread for Latvia of 1.2% and EURIBOR for the corresponding term of the deposit. For deposits in LVL it corresponds to the annual yield of the most recently issued domestic Treasury bills[18].

19. The credit risk margin[19] is based on the "Recommendations on government guarantees on bank debt" of the ECB of 20 October 2008. The latter will comprise two elements: a risk premium of 0.448% (5 year median CDS spread of A-rated[20] banks for the reference period) plus an add-on fee of 0.5%. Since December 2008, Latvia provided a number of additional term deposits for time periods ranging from 1 week to 11 months. The interest rate varied between 12.08% and 12.33% for deposits in LVL and between 4.56% and 5.87% for deposits in EUR depending on their term and the value of the floating element of the interest rate[21]. The margin for the credit risk for all the deposits granted was always higher than an overall flat fee of 0.5% recommended by the ECB for the pricing of the risk premium for the debt with maturities with less than or equal to 1 year.

20. As regards the overall maximum amount, Latvia has indicated that it would provide short term liquidity to Parex up to LVL 1.5 billion. On 1 January 2009 State funds in amount of LVL 674 million were already deposited in the bank. According to the Latvian authorities the cash flow started to stabilise in the beginning of 2009. However, Latvia estimates that almost the same amount may be necessary in the future. In particular, albeit the Latvian authorities have planned to guarantee certain existing syndicated loans of Parex, the maximum amount includes also the amount that would be necessary for the redemption of the existing syndicated loans (around LVL 193 million) in the worst case scenario. An emission of Notes is also outstanding and is due in 2011. In case the owners of these Notes (in the amount of EUR 130 million) would claim default event, the liquidity

[17] Ibid footnote 15.

[18] The yield used in the methodology is taken as at the time of the last emission of the Treasury bills in LVL.

[19] Given that the liquidity measures qualify as senior liabilities, the credit margin is associated to the one applicable to senior loans, rather than subordinated ones constituting capital instruments. The credit risk in senior and subordinated loans differs considerably, and so does remuneration.

[20] Ibid footnote 15.

[21] In addition, for the deposits granted prior to 8 January 2009, 5 year median CDS spread of A- rather than A rated banks has been used resulting in a reduction of the interest rate by 5 basis points.

measures would be used to cover the bank's liquidity needs.[22] The remaining amount is needed to cover other liquidity needs, mostly arising from the outflow of retail deposits.

21. The deposits made by the State in Parex are pledged with good quality loans, *i.e.* loans qualifying as standard loans and supervised loans,[23] of an amount exceeding the funds deposited by the State. In particular, on 1 January 2009 deposits of LVL 674 million were guaranteed with pledges of a total amount of LVL 866 million of which almost all loans are classified as standard loans (loans that are supervised constitute only 0.006% of total pledged loans).

Behavioural constraints imposed on Parex

22. Finally, Latvia intends to change the behavioural constraints imposed on Parex. The restated behavioural constraints will be in line with the ones imposed to other Latvian banks benefitting from the Latvian guarantee scheme.[24] In particular, the following constraints were imposed upon Parex during the period it benefits from State aid:

    - Advertising of the bank or its services will not be conducted with reference to the State support;
    - The bank will not pay dividends without the agreement of the Minister of Finance;
    - Gross annual remuneration to members of the Board, including mandatory State social insurance contributions, will not be fixed at more than LVL 150,000 per member of the Board;
    - Until repayment of the State aid measures, early repayment of subordinated loans due to private investors will not be made.

23. Consequently, the behavioural constraints imposed upon Parex remain essentially the same as in the decision of 24 November 2008, except for the following change: the Latvian authorities will no longer undertake to impose the balance sheet restriction set out in (25) (a) and (b) of the decision of 24 November 2008.[25]

III. POSITION OF LATVIA

24. In line with the decision of 24 November 2008, the Latvian authorities accept that the amended measures contain State aid elements. The Latvian authorities claim that the measures are compatible with the common market because they are necessary to remedy a serious disturbance in the Latvian economy pursuant to Article 87(3) (b) of the EC Treaty.

25. Latvia submits that, in view of the further downgrade of risk ratings for Parex and the very high level of the previously set interest rates, it was necessary for them to adjust the method that determines the fees paid by Parex for the use of State guarantee, liquidity

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22 As confirmed by the Latvian authorities, such an event is highly unlikely.

23 According to the regulations of the Latvian supervisory authority, Financial and Capital Market Commission, standard loans are paid back without any delay and the payments of supervised loans can be delayed by not more than 30 days.

24 See Commission decision of 22 December 2008 in case N 638/2008 Guarantee scheme for banks in Latvia, 22.12.2008, not yet published.

25 See Commission decision of 24 November 2008 in case NN68/2008 Public support measures to JSC Parex Banka - not yet published.

measures and subordinated term debt. Most importantly, the continuation of charging the previously set very high interest rates might have led to an erosion of the bank's capital. However, the revised interest rates for the State aid measures correspond to or are slightly higher than the level recommended by the ECB and, hence, will be in line with public support pricing conditions in the banking sectors in other countries. The Latvian authorities confirm their commitment to notify to the Commission a restructuring or a liquidation plan within 6 months from the granting of the first State aid measure.

26. With regard to the possibility to increase the amount of the liquidity measures to Parex, Latvia is of the view that this will enable Parex to manage the continuing outflow of retail deposits from the bank.

IV. ASSESSMENT

1. State aid character of the amended measures

27. As set out in Article 87(1) EC, any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.

28. Similarly to the assessment of the original measures granted to Parex (see decision of 24 November 2008), the Commission agrees with the position of Latvia that the amended measures for Parex constitute aid to it pursuant to Article 87 (1) EC.

29. With regard to takeover of the bank by the State, the Commission considers that a mere change of ownership does not in itself entail state aid. As regards possible aid to the two major shareholders, the Commission notes that the price paid for the acquired shares is purely symbolic, i.e. 2 LVL (around 3 EUR), and the Commission was not made aware of any obligations the existing shareholders might have had against the company or its creditors, of which they would have been relieved due to this transaction[26]. In addition, following the abovementioned amendment of the investment agreement, the two major shareholders are not any longer entitled to the special right to reacquire the shares. In such circumstances, the purchase of the shares from the existing major shareholders does not in itself contain aid to the current shareholders.

30. As regards the compensation to be paid to the minority shareholders in case of takeover by the State of the remaining shares held by the private investors, the Commission considers that the price to be paid would be a fair compensation for the shares to the extent that such compensation corresponds to market valuation of the bank's shares excluding any effects of State aid granted to the bank and funding provided by the Bank of Latvia and any speculation on State support. In such circumstances, the price would not include state aid elements to the minority shareholders of the bank.

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[26] On the contrary, pursuant to the amended investment agreement, a number of obligations remain to be imposed upon the two major shareholders (guarantees, pledging of property, penalties etc.), in order, inter alia, to cover the losses that were not duly reflected in the final reports of the bank on the closing date of the amended investment agreement, if any.

2. Compatibility of the amended measures

a) Application of Article 87(3)(b) EC

31. The Commission found the original measures to be compatible with the common market under Article 87(3)(b) EC of the EC Treaty. Given that the amended measures are practically identical to the original ones, and the situation on the financial markets has not improved, it is only necessary to assess whether this is still the case in view of the aforementioned amendments.

b) Assessment of the amendments to the measures

32. With regard to the revision of the interest rates for the State aid measures, the Commission notes that the previously set interest rates were very high leading to a total fee in the range between 15 and 25% for subordinated term debt, above 10% for State guarantee as in November 2008 and 20.27% for liquidity measure. These very high interest rates could have eroded the bank's capital and would have been counter effective to keeping the bank afloat until a long-term restructuring (or liquidation) plan is drawn up.

33. The Commission considers that the bank's increased difficulties, as demonstrated by the further downgrade of its risk ratings and the continuing outflow of deposits, confirm that Parex does not qualify as a fundamentally sound bank. Therefore, the Commission would, in principle, expect a higher remuneration to be charged to Parex, due to its risk profile.

34. However, in line with the guidance of the Commission, which was set out in point 15 of the recent Communication on "The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition" (hereinafter "Recapitalisation Communication")[27], the Commission considers that, in duly justified cases, it is appropriate to accept a lower remuneration in the short term for distressed banks, such as Parex, as long as this remuneration does not fall below that required for fundamentally sound banks benefitting from State support measures in Latvia and other Member States.

35. In particular, the Commission considers that charging a lower remuneration than would generally be necessary for banks of a similar risk profile may, exceptionally, be appropriate in order to keep the bank afloat, although only for the short term of the rescue phase. This level of remuneration is furthermore subject to the submission of the restructuring or liquidation plan. The Commission anticipates that the costs of public intervention in favour of Parex will, in the longer term, be reflected in the restructuring plan for the restoration of the bank's viability, which will need to take account of the competitive impact of the support given by making commensurate provision for compensatory measures. In this context, the Commission also recalls and notes positively the commitment of the Latvian authorities to present either a restructuring or a liquidation plan within 6 months from the granting of the first measure to the bank, *i.e.* by 11 May 2009.

36. The minimum acceptable benchmark remuneration depends on the State aid instrument chosen and its characteristics. In the Recapitalisation Communication, the Commission

[27] Commission Communication Recapitalisation of financial institutions in the current financial crisis: limitation of the aid to the minimum necessary and safeguards against undue distortions of competition. Adopted on 5 December 2008 (Official Journal C 10, 15.1.2009, p. 2-10).

endorsed the ECB's recommended method to determine the price of the recapitalisation instruments for fundamentally sound banks (see point 26 of the Recapitalisation Communication). In cases to date, the Commission also found that the ECB's recommended method to determine the price of guarantees was appropriate for the pricing of guarantees and applicable to pricing of the credit risk margin above funding costs for senior loans for fundamentally sound banks[28].

37. As regards the new interest rate for the subordinated term debt in EUR to Parex, the Commission notes that it exceeds the level recommended by the ECB to the extent that the Latvian authorities use the mid-SWAP rate for the EMU benchmark 5-year bond rather than yield. The former is always higher than the latter as it includes an additional credit risk. For instance, as in the second half of January 2009, the 5Y EUR benchmark mid-SWAP rate was 2.93% compared to the yield of 2.26% for the corresponding security.

38. As regards the new interest rate for the subordinated term debt in LVL to Parex, the Commission notes that Latvia uses as a benchmark the most recent funding costs, *i.e.* including current credit risk of Latvian bills emitted in LVL (rather than for the reference period suggested by the ECB). The Commission also acknowledges that there is no data available on yields for longer maturity domestic bonds at the moment and notes positively that this element in the interest rate method would be adjusted if such data became available. The other elements of the interest rate are the same as recommended by the ECB. On this basis, the Commission finds the method proposed by the Latvian authorities as appropriate.

39. Based on the above justification (see paragraphs 34-35), the Commission also considers the fee for state guarantees as described in paragraph 15 above to be appropriate for Parex.

40. As regards the new interest rate for the short-term liquidity measures to Parex, the Commission notes that the margin for the credit risk for the deposits already granted and the margin to be applied for future ones is higher than an overall flat fee of 0.5% recommended by the ECB for the pricing of the risk premium for the debt with maturities with less than or equal to 1 year.

41. On the basis of the above, the Commission finds that the interest rates charged by Latvia will remain above the floor pricing accepted in other cases for fundamentally sound banks and can thus be considered appropriate for this distressed bank, taking into account the commitment of the Latvian authorities to present either a restructuring or a liquidation plan for the bank within 6 months from the granting of the first measure to the bank, *i.e.* by 11 May 2009.

42. In addition, the Commission notes positively that in accordance with the Recapitalisation Communication certain restructuring measures were already implemented by changing the management and corporate governance of the bank[29].

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[28] E.g. Commission decision of 9 December 2008 in case N 557/2008 *Measures under the law on the stability of the financial markets and on strengthening the interbank market for credit institutions and insurance companies in Austria* (not yet published*),* paragraph 16 and, in particular, footnote 16 in conjunction with paragraph 36, and Commission decision of 30 October 2008 in case N 548/2008 *Mesures de refinancement en faveur des institutions financières,* not yet published.

[29] See point 44 of the Recapitalisation Communication.

43. With regard to the increased amount of the liquidity measures, the Commission notes that they address the imminent liquidity problems and thus serve the purpose of keeping the bank afloat until the long-term restructuring (or liquidation) plan is drawn up. The competition distortions are minimised by adequate safeguards. They, inter alia, aim to ensure that the State, despite the current market conditions, obtains an adequate minimum return on the investment, funding and/or credit risk assumed by it. This is achieved in this case through adequate annual interest rates. In addition, despite the increased overall amount of the liquidity measures, they are only made available to Parex to the extent it needs to satisfy imminent liquidity needs. This should prevent it from aggressive commercial expansion financed by State aid.

44. The amended behavioural constraints for Parex are in line with the revised guidance of the Commission set out in point 45 of the Recapitalisation Communication and with previous Commission decisions[30]. In light of the foregoing, the State aid measures in favour of Parex as amended by Latvia can be considered compatible with the Common market.

V. DECISION

45. The Commission regrets that Latvia put the aid in question into effect, in breach of Article 88(3) of the Treaty.

46. The Commission concludes that the notified amended measures are compatible with the Common market and has accordingly decided not to raise objections against them.

47. If this letter contains confidential information which should not be published, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to publication of the full text of this letter. Your request specifying the relevant information should be sent by registered letter or fax to:

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Yours faithfully,

For the Commission

Neelie Kroes
Member of the Commission

[30] E.g. Commission decision of 14 January 2009 in case N 9/2009 *Recapitalisation of the Anglo-Irish Bank by the Irish State*, not yet published, at paragraphs 24, 68 and 69.