EUROPEAN COMMISSION

Brussels, 24.11.2008
C(2008) 7554

Subject: **State aid NN 68/2008 – Latvia**
Public support measures to JSC Parex Banka

Sir,

1 PROCEDURE

(1) The Latvian authorities notified public support measures to the Commission on 10 November 2008. The Commission requested further information on 9, 10 and 12 November. Information was provided by the Latvian authorities by e-mails of 10 November, 12 November and 13 November 2008. A conference call was held on 13 November 2008. The Latvian authorities confirmed the commitments and information provided by a letter of 14 November 2008. The Latvian authorities submitted additional information and clarifications on 20 and 21 November 2008.

2 DESCRIPTION OF THE MEASURES

The Beneficiary and the events triggering the measures

(2) JSC Parex Banka (hereinafter "Parex") is a financial institution based in Riga, Latvia. It is a universal bank offering the full range of banking products directly and through specialised subsidiaries. Parex is the second largest bank in Latvia in terms of assets. Its assets constituted 13.8% of the total assets of the Latvian banking sector. With its 646,000 customer accounts and 448,000 payment cards Parex is the third largest bank

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in the Latvian overall payment system[1]. It is also the third largest bank in customer credit transfers performed in Latvia and in the number of card payments.

(3) Parex' shares are not listed on any stock exchange and, hence, the market price of the shares is not observable. The two major shareholders[2] of Parex possess a controlling interest (85%) in the bank, the other shares are hold by minority shareholders.

(4) As regards Parex' presence in the markets, it has a 23% market share in the turnover of the Latvian foreign exchange market and a 13.6% share in deposits of Latvian residents (11.4% of all corporate deposits and 14.3% of private customer deposits). In lending, Parex has a market share of 7.7% in the corporate lending market and an 8.6% market share in the private lending market. Moreover, Parex holds 26.2% of all non-residential deposits placed in Latvia and is a leading bank in this segment of the market. Besides being active in its home market, Parex has also subsidiaries in Azerbaijan, Belarus, Estonia, Germany, Lithuania, Russia, Sweden, Switzerland and Ukraine.

(5) While Parex is the largest non-resident service provider bank in Latvia, it has strengthened its domestic franchise dramatically in the last few years. According to a public source, the bank is seeing an increase in its impaired lending presently due to the sharp economic slowdown in Latvia and the Baltics as a whole. Although the non-resident business has been generating stable fees and commission income, cost of funds appears to be increasing as well as impairment charges and non-interest expenses[3].

(6) According to the Latvian authorities Parex came into liquidity difficulties due to the deterioration of the global economic situation and the mutual trust crisis in the finance sector, significantly reducing the bank's ability to use its liquid asset portfolios for the management of its liquidity. The Latvian authorities considered it highly likely that the trust crisis could also spread to retail investors, comprising the major part of Parex liabilities (see Table 1 below), in particular to non-resident investors. These investors have a significant amount of deposits in the bank (approximately 1 billion LVL). Overall, the Latvian authorities consider that the current financial difficulties of Parex derive from the credibility gap caused by the global finance crisis, both on the part of institutional, as well as the retail investors.

(7) The current financial situation of Parex is characterized by increasing liquidity problems and, as a consequence, a deterioration of a number of its prudential indicators. In particular, the liquidity indicator has fallen significantly since September 2008[4] and by beginning of November has reached almost the minimum level required

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1 As regards the interbank market, Parex ranks as number four within the Latvian interbank automated payment system in terms of the number of transactions performed. Within the interbank euro payment system, Parex is the second largest bank in Latvia in terms of transactions.

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

3 Source: http://news.nasdaq.com/aspxcontent/newsstory.aspx?&cpath=20081112%5CACQDJON200811121151DOWJONESDJONLINE000632.htm.

4 From 44.16% as of 31.08.2008 to 31.35% on 04.11.2008. This indicator should be no less than 30% of total current liabilities of the bank as laid down in the provisions of Section 37 (2) of the Credit Institution Law and Clause 3.2 of the Financial and Capital Market Commission's (FCMC) Regulations No 166 On the Compliance with Liquidity Requirements of 23.12.2005.
In the Latvian banking sector the average liquidity ratio at the end of September 2008 was 49.1 %.

under Latvian legislation. Excessive outflows of Parex' deposits have also been observed in the recent weeks[5]. The bank's capital adequacy ratio has decreased as well, touching upon the regulatory minimum required of 8%[6]. A decrease in the capital adequacy ratio has been linked to a negative change in the financial instruments revaluation reserve affected by the global financial system crisis. Furthermore, Parex' financial instruments' portfolio liquidity declined throughout the ongoing crisis.

(8) In spite of the abovementioned difficulties, Latvia maintains that the quality of Parex' assets, equity pool and efficiency indices are satisfactory.

(9) In the near future, Parex has the obligation to pay back two syndicated loans[7] of a total of EUR 775 million. These loans are of 1 and 2 years and mature in February and June 2009 respectively (see table 2 below). Given the limited options for raising finance in the financial markets in the context of the ongoing financial turmoil, the Latvian authorities initially had substantial doubts as to Parex' ability to pay back, extend or replace these loans by new ones.

(10) Therefore, the Latvian authorities concluded that at the time[8] there were sufficient grounds to assume that the bank's liquidity indicator could dip below 30%. Consequently, following an extraordinary meeting of the Latvian government on 8 November 2008 on this matter, the Latvian authorities decided to partly nationalise the bank and to undertake to provide public support measures in favour of Parex.

(11) Parex' balance sheet as of 31 October 2008 and the abovementioned syndicated loans are presented in the tables below:

Table 1: **Parex' balance sheet as of 31 October 2008, in thousands of LVL**

ASSETS	31.10.2008	LIABILITIES	31.10.2008
Cash, deposits at the Bank of Latvia (BL)	126 627	Liabilities to banks, incl.: - liabilities to BL - syndicated loans due in 2009	887 319 166 000 545 000
Claims on credit institutions	309 612	Deposits	1 742 872
Loans	1 918 632	Other liabilities, incl.: - subordinated liabilities	259 676 52 765
Securities	591 023	Capital and reserves, incl.:	212 967
Fixed assets	21 056	- profit of 2008	10 474
Other assets	135 884	- securities revaluation reserve	-32 276
TOTAL	**3 102 834**	TOTAL	**3 102 834**

5 Resident and non-resident deposit withdrawals between 1 October and 7 November amounted to 12% of total customer deposits (source: http://news.nasdaq.com/aspxcontent/newsstory.aspx?&cpath=20081112%5CACQDJON200811121151DOWJONESDJONLINE000632.htm).

6 The average own equity in the Latvian banking sector was 12.3 % (minimum requirement is 8 %). At the end of 2007, for the Parex' parent company based in Latvia, capital adequacy ratio was 10.7% and the group's , i.e. including all its subsidiaries operating also in non-banking financial services sectors, capital adequacy ratio was 9.6%.

7 The syndicated loans are senior as regards the order of claims.

8 I.e. prior to government's decision to undertake to grant the measures in consideration.

Table 2: **Syndicated loans due in 2009**

Initial mandated lead arrangers	Total amount	Credit rate	Date of issue	Maturity date
Commerzbank AG HSBC Bank plc *Intesa SanPaolo S* *Lloyds TSB Bank* *Mizuho Corp Bank* *Raiffeisen Zentralbank*	EUR 500 million	EURIBOR+ 0.45%	29.06.2007	29.06.2009
Raiffeisen Zentralbank *HSBC Bank plc* *Mizuho Corp Bank* *Sumitomo Mitsui Bank*	EUR 275 million	EURIBOR+ 0.55%	21.02.2008	21.02.2009
Total:	EUR 775 million *(LVL 545 million)*			

(12) Following the granting of the measures (see below) on 12 November 2008, Fitch Ratings downgraded Parex' debt rating to BB, two levels below investment grade, from BB+ and the individual rating to F from C/D[9]. In addition, the rating was placed on rating watch negative, meaning it could be lowered again within the next year. The Fitch cut followed a downgrade for Parex by Moody's to Ba1, one level below investment grade. The downgrade also followed a cut in Latvia's credit rating to BBB-, the lowest investor grade, by Fitch. While the State committed to provide liquidity support and guarantees to the bank[10], the resident and non-resident deposit outflow has not stopped and Fitch continues to closely monitor the situation[11].

(13) Furthermore, 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). This would have meant that these loans would have become due immediately rather than upon their maturity in 2009. After negotiations, the Latvian authorities agreed with the abovementioned creditors that the loans will continue until their regular maturity provided that the state of Latvia issues a guarantee for these loans.

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9 Fitch Ratings assigns individual ratings only to banks. These ratings, which are internationally comparable, attempt to assess how a bank would be viewed if it were entirely independent and could not rely on external support. These ratings are designed to assess a bank's exposure to, appetite for, and management of risk, and thus represent Fitch Ratings' view on the likelihood that it would run into significant difficulties such that it would require support.
C denotes: an adequate bank, which, however, possesses one or more troublesome aspects. There may be some concerns regarding its profitability and balance sheet integrity, franchise, management, operating environment or prospects.
D denotes: a bank, which has weaknesses of internal and/or external origin. There are concerns regarding its profitability and balance sheet integrity, franchise, management, operating environment or prospects. Banks in emerging markets are necessarily faced with a greater number of potential deficiencies of external origin.
F denotes: a bank that has either defaulted or, in Fitch's opinion, would have defaulted if it had not received external support. Examples of such support include state or local government support, (deposit) insurance funds; acquisition by some other corporate entity or an injection of new funds from its shareholders or equivalent.

10 This commitment was also rendered public. The commitment derives from the agreement and is subject to a number of conditions (see point (14)).

11 See footnote 3.

The Measures

Partial nationalisation of the bank

(14) To implement the partial nationalisation of Parex an investment agreement was signed on 10 November 2008 by two major shareholders in the bank, Parex, the State of Latvia represented by the Ministry of Finance and the 100% State-owned joint stock company "Latvijas Hipotēku un zemes banka" (Latvian Mortgage and Land Bank, hereinafter the state-owned bank or LHZB)[12]. In accordance with the agreement, Parex will become a subsidiary of LHZB. The agreement should enter into force and the purchase of the shares should be executed upon the fulfilment of a number of conditions. One of the conditions is the approval of the European Commission of the State aid provided under the agreement at least for 6 calendar months[13].

(15) Pursuant to the agreement:

(a) 51% of the bank's shares owned by the two largest shareholders are transferred to LHZB at a symbolic total purchase price of 2 LVL (3 EUR);

(b) the remaining 34% of the bank's shares owned by the two major shareholders are to be pledged for the benefit of LHZB so that it can exercise the voting rights of the abovementioned shares. Therefore, the Latvian state will de facto control 85% of the shares in Parex;

(c) if needed and required by the state-owned bank within 2 years, the Latvian state undertakes to invest up to 200 million LVL into the bank's subordinated capital, by granting to it subordinated loans with a maximum maturity of 5 years;

(d) the Latvian state undertakes to guarantee the abovementioned existing senior syndicated loans in the amount of EUR 775 million since the respective creditors would otherwise claim a default of the bank, as well as to guarantee new loans taken out to refinance the syndicated loan that matures in February 2009 in the amount of EUR 275 million;

(e) to curb the risks associated with granting of the State guarantee to Parex, a number of obligations are imposed upon the two major shareholders (guarantees, pledging of property[14], penalties etc.), as well as restrictions regarding the possible changes in Parex' corporate governance and shareholders;

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[12] 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.

[13] The standstill clause does not however cover the liquidity measure (see below) that was not contained in the agreement.

[14] To meet their obligations, the two major shareholders have resolved to put up the rest of their bank's shares and private properties as collateral, as well as each will hold at least LVL 14 million in savings at the bank. Both shareholders will continue as the bank's board members. As the bank's board members, they will have an obligation to comply with and carry out all the resolutions of the bank's new shareholders' meetings as well as the decisions and instructions of the bank's council.

(f) Parex' two major shareholders undertake to cover any losses that are not duly reflected in the financial reports of the bank at the closing dare of the agreement upon request of LHZB or the State;

(g) as from the date of the signing of the agreement, LHZB may seek an outside investor and sell 51% interest in Parex at market price without any limitation. The strategic investor would have to be approved by the Latvian government. In such event Parex' two major shareholders would be obliged to sell Parex' shares in their possession (34%) to the buyer specified by the Latvian state.

(h) Parex' two major shareholders are entitled to repurchase shares back from LHZB at the same purchase price, *i.e.* symbolic total purchase price of 2 LVL (3 EUR) increased by the sum equal to 1% of the whole amount of funds granted under the agreement to the bank provided that:

- at least 12 months have passed since the date of the signing of the agreement;
- Parex has repaid all the subordinated loans provided to it by the Latvian state;
- all the guarantees provided by the Latvian state with respect to the liabilities of the bank have been released;
- Parex has covered all expenses of the Latvian state and of the state-owned bank with respect to the financial assistance granted to it as provided in the agreement;
- the Latvian state has not already exercised its rights to sell Parex' shares to a third party investor (see point (g) above).

(16) According to the Latvian authorities, they found it necessary to secure the State's control of Parex. This is to be implemented through a change in ownership and hence eliminating the possibility for the two major shareholders to pass binding decisions and gain benefit from the measures. The remaining 15% minority shareholders were not affected by the measures.

Subordinated loan

(17) The Latvian state committed to provide subordinated loans with a maximum maturity of 5 years[15], since the capital adequacy ratio was close to the minimum required (see above). The total amount of subordinated loans that can be provided to Parex is limited to LVL 200 million.

(18) The subordinated loans' interest rate will be determined at the date of issue depending on the total value of the following parameters: *i)* 1 year interbank lending rate[16]; *ii)* a credit risk premium for 5-year senior loans determined as the median value of current 5 year CDS spreads for the rating category of the bank concerned (BB), based on a representative sample of banks defined by the Latvian Treasury[17]; *iii)* add-on fee of 50 bps; *iv)* 25 bps for the State Treasury as subordinated loan service fee and *v)* a credit risk premium of 200 bps accounting for the subordination effect and hence increased

[15] The minimum maturity for the subordinated loan to qualify as Tier 2 capital according to the Latvian legislation is 5 years.

[16] RIGIBID. The interbank rate is taken as a proxy for a risk-free interest rate.

[17] See footnote 19.

risk of the loan. The resulting fee varies, depending on interbank lending rate and CDS values and it will be set only upon granting of the subordinated loans. According to the Latvian authorities the resulting fee would range between 15 and 25%.

Guarantee arrangements to existing and new loans

(19) As mentioned above, the Latvian State undertook to issue guarantees covering existing syndicated loans in the amount of EUR 775 million, since the respective creditors would otherwise evoke a default event.[18] Latvia also undertook to guarantee new loans issued to refinance the syndicated loan maturing in February 2009 in the amount of EUR 275 million and with a maximum maturity of 3 years.

(20) As regards the guarantee of the existing loans, the Latvian authorities argued that guaranteeing the existing syndicated loan agreements would allow maintaining very attractive historical (pre-crisis) commercial conditions, i.e. EURIBOR+0.55% for the loan maturing on 19 February 2009 and EURIBOR+0.45% for the loan maturing on 26 June 2009. According to the Latvian authorities, given the current market situation, new borrowings even with the State guarantee would be significantly more expensive; in particular, the spread over interest rate swaps of the Republic of Latvia Eurobonds maturing in March 2018 was 4.4% and the credit default swaps for Latvia traded at about 9% as of 19 November 2008. Therefore, the Latvian authorities consider that providing the state guarantee to the existing syndicated loans does not result in an economic advantage for the respective creditors.

(21) As regards the fee for the guarantees on these loans the Latvian authorities submitted that the fee will be determined upon granting of the guarantees depending on the summed up value of the following parameters: *i)* the median value of current 5 year CDS spreads for the rating category of the bank concerned (BB), based on a representative sample of banks defined by the Latvian Treasury[19]; *ii)* add-on fee of 50 bps; and *iii)* 10 bps for the State Treasury as guarantee service fee. The resulting fee varies, depending on CDS values and it will be set only upon granting of the guarantees[20].

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18 In particular, pursuant to the loan agreements with the respective creditors, each of the following constitutes an event of default: (a) by or under the authority of any government, (i) the management of any Parex group company is wholly or partially displaced or the authority of any Parex group company in the conduct of its business is wholly or partially curtailed or (ii) all or a majority of the issued shares of any Parex group company or the whole or any part of its assets is seized, nationalised, expropriated or compulsorily acquired or (iii) the banking licences of any of the Parex group companies are revoked or suspended or made subject to conditions more onerous than were initially imposed; (b) any person, or group of persons acting in concert, acquires by purchase or by subscription 10 per cent or more in aggregate of the issued shares in Parex, without the prior consent of all the lenders unless such acquisition is by an international western financial institution, or its subsidiary, in each case of international repute and good standing with a Standard and Poor's rating of at least BBB+ (or the equivalent rating by Moody's or Fitch) in each case being incorporated in an OECD country; (c) if there is any change in circumstances which, in the opinion of an instructing group among the syndicated lenders, is of or might have a material adverse effect.

19 The Latvian authorities clarified that given that there are only a limited number of banks with the same rating category as Parex (BB as of 19 November 2008), the sample includes banks from all over the world. Only the most extreme values of the sample are eliminated, for instance, where CDS equals 4000 bps due to particular circumstances in that country or banking sector.

20 The fee stood at around 10.6% at 12 November 2008.

(22) The continuation of the guarantee arrangements beyond 6 months is explicitly subject to the Commission's approval of a prolongation of the measures as temporary rescue aid or their clearance as part of Parex' restructuring/liquidation package.

Short term liquidity measure

(23) Moreover, on 11 November 2008 the State Treasury deposited LVL 200 million with Parex in order to ensure sufficient liquidity. In result, the bank was provided with funds to acquire government debt securities, i.e. liquid collateral to use in central bank's operations, which it did not have at the time. The term of the deposit is one year and the interest rate was set at 20.27%. This rate was calculated as follows: 1 year RIGIBID rate at the time + risk premium (determined as 5 year median CDS value of quoted banks with the same rating category as Parex taken from Bloomberg database at the time[21]) + 50 bps + 25 bps. Parex can use the above funds to acquire government debt securities with a one-year maturity from the State Treasury. The debt securities can be used as collateral in order to attract cash reserves from the Bank of Latvia.

Behavioural constraints imposed on Parex

(24) The Latvian authorities have given a commitment that, as provided for in Chapter 11 of the investment agreement, Parex will have to fulfil appropriate conditions with respect to its activities in order to avoid undue distortions of competition due to the abovementioned public support measures.

(25) In particular, the Latvian authorities impose the following behavioural constraints on Parex:

a) "the proportional ratio of the size of Parex' mortgaged loan portfolio and the aggregate size of mortgaged loan portfolio of all credit institutions acting in Latvia (in accordance with information published by the Financial and Capital Market Commission, FCMC) for more than one consecutive calendar quarter may not exceed that proportional ratio of the size of the Parex' mortgaged loan portfolio and the aggregate size of mortgaged loan portfolio of all credit institutions acting in Latvia (in accordance with information published by FCMC) which existed on 30 September 2008";

b) "the proportional ratio of the size of the Parex' loan portfolio and the aggregate size of loan portfolio of all credit institutions acting in Latvia (in accordance with information published by FCMC) for more than one consecutive calendar quarter may not exceed that proportional ratio of the size of the Parex' loan portfolio and the aggregate size of loan portfolio of all credit institutions acting in Latvia (in accordance with information published by FCMC) which existed on 30 September 2008";

c) Parex, LHZB, and the two major shareholders have no rights, by means of public announcements or other marketing activities, to promote the business of the bank

[21] Also non-Eurozone banks are included in the sample considered, see also footnote 19.

referring to guarantees provided by Latvia and other instruments of the State aid which Parex might receive in accordance with the agreement;

d) during the validity of the agreement the aggregate amount of the Parex' assets of the balance sheet for any calendar quarter may not accrue proportionally more than the Latvian gross domestic product in accordance with the information provided by the Latvian Central Statistical Bureau.

e) FCMC undertakes, first, to monitor how the bank complies with the abovementioned behavioural constraints, second, to take necessary actions, if the bank fails to comply with, and, third, the Commission will be informed thereof.

f) Parex cannot acquire other companies and/or businesses and cannot undertake significant investments while it benefits from the aid.

3 POSITION OF LATVIA

(26) The Latvian authorities seek an urgent approval of rescue aid to Parex in order to support the liquidity and capital of this commercial bank. According to the Latvian authorities, the objectives of the measures are the protection of the national banking system from the impact of the international financial crisis and the restoration of confidence in the domestic banking system. The Latvian authorities underlined the urgency of the measures in order to prevent harmful spillover effects on the Latvian financial system and the Latvian economy as a whole.

(27) The Latvian authorities accept that the guarantee arrangements and the subordinated loans contain State aid elements. However, they do not consider the liquidity measure, i.e. the 1 year deposit of the Treasury enabling the bank to raise funds from the Bank of Latvia, to constitute aid. In this regard, the Latvian authorities argued that the deposit was provided, because the bank did not have sufficient liquid collateral and that the deposit rate is in line (if not above) market remuneration for such financial instruments.

(28) The Latvian authorities consider that the measures can be declared compatible with the common market to remedy a serious disturbance in the Latvian economy pursuant to Article 87(3)(b) EC. Given the significant position of Parex as second-largest bank in the Latvian financial system (see (2) and (4)), an insolvency of Parex would lead to serious disturbances in the Latvian economy.

(29) The Latvian authorities submit that all possible measures have been taken in order to ensure the Commission that the measure will not allow Parex to expand its business in a disproportionate manner. To this end, they have undertaken to impose the behavioural conditions set out in point (25) above.

(30) The Latvian authorities commit to seek the Commission's approval, should it be necessary that the measures continue beyond six months. They will also seek approval, if Parex needed more capital than envisaged under the loan measure or if the terms of the measures would need to be revised.

(31) Furthermore the Latvian authorities commit to send to the Commission a restructuring plan within 6 months for Parex or a liquidation plan in case Parex would be wound up.

(32) The Latvian authorities informed the Commission that they do not intend to sell Parex' shares to a third investor while maintaining the State's commitment to issue guarantees or to provide subordinated capital or with the respective State aid support in the bank resulting from these commitments.

(33) Pursuant to clause 7.5 in the agreement the selling price of Parex' shares to a third party will be determined "taking into account all costs and investments of the Purchaser [i.e. LHZB] and the Republic of Latvia in relation to the company". In this regard, the Latvian authorities clarified that the sale price would be established under market conditions and on no account below the market price.

4 ASSESSMENT

Existence of State Aid

(34) 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.

(35) Given that Parex is active in the financial sector, which is open to intense international competition any advantage from state resources to Parex would have the potential to affect intra-Community trade and to distort competition.

(36) First, the Commission agrees with the position of Latvia that the guarantee arrangements and the subordinated capital constitute aid to Parex pursuant to Article 87 (1) EC.

(37) The guarantee arrangements and the subordinated capital allow Parex to get the required capital as well as liquidity at advantageous conditions. This gives an economic advantage to Parex and strengthens its position compared to that of its competitors in Latvia and other Member States that are not benefitting from public support and must therefore be regarded as distorting competition and affecting trade between Member States. The advantage is provided through State resources and is selective since it only benefits one bank.

(38) In addition, as regards the subordinated capital, the Commission recalls that a market economy investor expects a return commensurate with the risk perceived for the investment under consideration.[22] This is particularly true in the current context for a bank with a credit rating below investment grade, where perceived risks are very high.

(39) Regarding the guarantee, the Commission observes that in the current circumstances of a financial crisis and in view of the bank's credit rating a market economy investor would not have granted such a guarantee to allow Parex to refinance.

(40) In view of the above, the Commission maintains that the State is providing guarantees and subordinated loans because no market economy operator was willing to provide the measures on comparable terms.

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22 Joined Cases T-228/99 and T-233/99 Westdeutsche Landesbank Girozentrale [2003] ECR II-435, para. 314.

(41) As regards the liquidity measure, the Commission, in spite of the arguments of Latvia, notes that Parex was lacking liquid collateral at the time and, thus, considers that the Latvian government deposited the funds taking into account the bank's liquidity needs, especially, at a time when no market investor was willing to provide liquidity in view of the fragile situation of the bank. Moreover, the Commission considers that the liquidity measure is part of a package of the support measures identified as aid and thus inherently linked to the entire package. Thus, the compatibility assessment addressing a serious disturbance in the Latvian economy must also be extended in this respect.

(42) As regards the partial nationalisation of Parex, the Commission notes that the price paid for the acquired shares is purely symbolic, i.e. 2 LVL (3 EUR), and the Commission was not made aware of any obligations the existing shareholders might have against the company or its creditors, of which they would be relieved due to this transaction. In such circumstances, the purchase of the shares from the existing shareholders does not in itself contain aid to the current shareholders.

(43) The agreement also stipulates that the current shareholders may reacquire the shares when at least 12 calendar months have passed after the closing date of the agreement, but only after all the State aid measures and the commitments provided by the Latvian state are repaid/released and upon payment of an additional fee of 1% of the whole amount of funds granted under the agreement. In relation to this buyback mechanism, the Commission notes that the shareholders are individuals. Therefore, it does not appear that any State aid would arise in the context of the repurchase. In any case, taking into account the time period covered by the decision this assessment is not part of the decision at hand.

Compatibility of the Financial Support Measures

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

(44) Latvia intends to provide subordinated loans and guarantees to Parex which is said to be a bank of systemic importance in Latvia. Given the present circumstances in the financial market, the Commission considers that it may be acceptable to examine these measures directly under the Treaty rules and in particular under Article 87 (3) (b) EC.

(45) Article 87 (3) (b) EC enables the Commission to declare aid compatible with the Common Market if it is "to remedy a serious disturbance in the economy of a Member State". The Commission recalls that the Court of First Instance has stressed that Article 87 (3) (b) EC needs to be applied restrictively and must tackle a disturbance in the entire economy of a Member State.[23]

[23] Cf. in principle case Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG Commission* [1999] ECR II-3663, para. 167. Confirmed in Commission Decision in case C 47/1996, *Crédit Lyonnais*, OJ 1998 L 221/28, point 10.1, Commission Decision in Case C28/2002 *Bankgesellschaft Berlin*, OJ 2005 L 116, page 1, points 153 *et seq* and Commission Decision in Case C50/2006 *BAWAG*, not yet published, points 166. See Commission Decision of 5 December 2007 in case NN 70/2007, *Northern Rock*, OJ C 43 of 16.2.2008, p. 1, Commission Decision of 30 April 2008 in case NN 25/2008, *Rescue aid to*

(46) The Commission considers that the present measures concern a Latvian bank being a significant part of the Latvian financial sector and thus the Latvian economy. The Commission does not dispute the analysis of Latvia that the current global financial crisis has made access to liquidity more difficult for financial institutions across the board and has also eroded confidence in the creditworthiness of counterparties. The Commission also considers that if the issues of lack of liquidity and lack of confidence are not addressed, they will result not only in difficulties for Parex alone but, due to the financial sector's pivotal role in providing financing to the rest of the economy, will also have a systemic and harmful spillover effect on the Latvian economy as a whole. The Commission does not dispute that the present measures are designed to address the problems of the lack of liquidity, pessimistic valuation of tradable instruments and lack of confidence in the bank that are currently striking Parex. In addition, the urgency of the measures was confirmed by a letter from the governor of the Latvian central bank. Therefore it finds that the measures aim at remedying a serious disturbance in the Latvian economy.

b) Conditions for compatibility under Article 87 (3) (b)

(47) In line with the Commission Communication on "The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis" (hereinafter "the Communication"), in order for such aid to be compatible, any aid or aid scheme must comply with general criteria for compatibility under Article 87 (3) EC, viewed in the light of the general objectives of the Treaty and in particular Articles 3 (1) (a) and 4 (2) EC, which imply compliance with the following conditions:[24]

a. *Appropriateness*: The aid has to be well targeted to its objective, i.e. in this case to remedy a serious disturbance in the entire economy. This would not be the case if the disturbance would also disappear in the absence of the measure or if the measure is not appropriate to remedy the disturbance.

b. *Necessity*: The aid measure must, in its amount and form, be necessary to achieve the objective. That implies that it must be of the minimum amount necessary to reach the objective, and take the form most appropriate to remedy the disturbance. In other words, if a lesser amount of aid or a measure in a less distortive form were sufficient to remedy a serious disturbance in the entire economy, the measures in question would not be necessary. This is confirmed by settled case law of the Court of Justice.[25]

c. *Proportionality*: The positive effects of the measures must be properly balanced against the distortions of competition, in order for the distortions to be limited to

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WestLB, OJ C 189 of 26.7.2008, p. 3, Commission Decision of 4 June 2008 in Case C9/2008 *SachsenLB*, not yet published.

[24] Cf. Commission decision of 10 October 2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, not yet published, at point 41.

[25] Cf. Case 730/79, *Philip Morris* [1980] ECR 2671. This line of authority has recently been reaffirmed by the Court of Justice in. Case C-390/06, *Nuova Agricast v Ministero delle Attività Produttive* of 15 April 2008, where the Court held that, "As is clear from Case 730/79 […], aid which improves the financial situation of the recipient undertaking without being necessary for the attainment of the objectives specified in Article 87(3) EC cannot be considered compatible with the common market […]."

the minimum necessary to reach the measures' objectives. This follows from Article 3 (1) g EC and Article 4 (1) and (2) EC, which provide that the Community shall ensure the proper functioning of an internal market with free competition. Therefore, Article 87 (1) EC prohibits all selective public measures that are capable of distorting trade between Member States. Any derogation under Article 87 (3) b) EC which authorises State aid must ensure that such aid must be limited to that necessary to achieve its stated objective, limiting to a minimum consequential distortions of competition.

(48) The third chapter of the Communication then translates these general principles into conditions specific for guarantees and the fourth chapter for recapitalisation schemes. The principles contained therein apply *mutatis mutandis* also to individual cases. In the next paragraphs, the Commission will therefore assess the compatibility of the notified measure with these criteria.

c) Assessment of the granting of subordinated loans

(49) The objective of granting subordinated loans qualifying as Tier 2 capital to Parex is to enable the bank to continue to satisfy the capital adequacy ratio and to ensure that it is sufficiently capitalised so as to better withstand potential losses from the revaluation of the financial instruments held and to increase provisions for loan impairment due to the deteriorating conditions in the Latvian economy.

(50) According to the Latvian authorities, the quality of Parex' assets, equity pool and efficiency indices are satisfactory. The Commission understands that urgent measures were needed to keep the bank afloat and to prevent spillover effects into the Latvian financial sector and beyond. The Commission's current assessment is without prejudice to the assessment it would make if the measures were needed beyond 6 months. The subordinated loans are thus intended to prevent the bank from getting further into difficulties as a result of the existing ongoing crisis.

(51) The subordinated loans, which are to be granted to Parex are limited to the minimum necessary in scope and time.

(52) As regards scope, the Commission noted previously that different measures might be needed depending on circumstances of a particular Member State or a bank to restore confidence in the banking sector[26]. Indeed not all financial institutions in the different Member States may at the moment experience the same distress because of extreme conditions in financial markets. While some might only suffer from a shortage of liquidity, others might be more exposed to fair-value losses. However, the problem of write-downs cannot be solved solely with a guarantee on debt but also requires further capital measures aimed at restoring the trust of third parties in Parex. In this respect the

[26] See Commission decision of 10 October 2008 in Case NN 51/2008 *Guarantee scheme for banks in Denmark*, not yet published, paragraph 47; Commission decision of 13 October 2008 in Case N 507/2008 *Guarantee scheme for banks in the United Kingdom*, not yet published, paragraphs 46 *et seq*.; Commission decision of 13 October 2008 in Case N 481/2008 *Guarantee scheme for banks in Ireland*, not yet published, paragraphs 59 *et seq*.

Commission considers that the provision of the subordinated loans is an appropriate measure in this case[27].

(53) In addition, the Commission takes note of the limitation of the subordinated loans to the amount of up to 200 mln LVL (€ 285 mln) and the commitment of the Latvian authorities to provide subordinated loans to Parex only to the extent this is needed to satisfy minimum capital adequacy requirements.

(54) As regards limitation in time, the Commission notes positively that the time window for granting the aid measure is only six months.

(55) The Latvian authorities undertake to grant subordinated loans with a maximum maturity of 5 years. In this regard, the Commission notes that the minimum maturity for the subordinated loans to qualify as Tier 2 capital according to the Latvian legislation is 5 years. The aid measure is therefore also limited to the minimum necessary as regards maturity. It thus fulfils the necessity criterion.

(56) As regards proportionality, the distortions of competition are minimised by a number of clearly defined and contractually agreed behavioural safeguards. Adequate safeguards inter alia need to ensure that the State must, despite the current market conditions, obtain an adequate minimum return on its investment[28] in order to limit distortions of competition. This is achieved in this case through an adequately high annual interest rate for the subordinated loans (see point (18) above), in line with a market-oriented valuation. In this regard, the Commission takes into account the fact, that there are no CDS data for Parex. In the absence of such data, the Commission considers acceptable the methodology proposed by the Latvian authorities, based on the median of the current CDS spread for the banks with the same rating category. The Commission also notes that as on 21 November 2008, the application of this methodology resulted in an interest rate of around 25%, which is considered acceptable taking into account the specificities of the case in consideration. In particular, the Commission notes that the price includes a significant mark-up on the risk free rate to take into account the bank's debt rating, which was downgraded to BB, i.e. below investment grade and its individual rating which was downgraded to F. In reaching its conclusion that the measure is limited in scope, the Commission has also taken into account the type of capital provided and its limited duration as well as the commitment to present either a restructuring or a liquidation plan within 6 months.

(57) The appropriateness of the fee in the current circumstances is without prejudice to the position the Commission may take if the measures are still needed after six months or if the terms of the measures are changed by Latvia and renotified to the Commission.

(58) Finally, the measure is combined with several behavioural constraints which help to ensure that the bank does not expand its activities while aided by the State[29]. This comprises a limitation of the expansion of activities against clear benchmarks and no acquisition of businesses or companies being permitted to the bank (see point (25) above).

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[27] Commission decision of 13 October 2008 in Case N 507/2008 *Guarantee scheme for banks in the United Kingdom*, not yet published, paragraph 49.

[28] See Joined Cases T-228/99 and T-233/99 *Westdeutsche Landesbank Girozentrale* [2003] ECR II-435, paragraph 314.

[29] A similar principle is contained in point 44 of the R&R guidelines.

d) Assessment of the guarantee arrangements

(59) The objective of the guarantee arrangements is to provide a safety net for investors in specific existing (see (19) above) and newly issued debt for the bank, so that it can have sufficient access to liquidity. This is a reaction to the international market conditions in which even healthy financial institutions are having trouble gaining access to liquidity. The Commission has established that such a guarantee should help to overcome these difficulties by allowing a revival of interbank lending and considers it therefore to be an appropriate means[30].

(60) As regards necessity, the guarantee mechanism, whereby a safety net is established to cover specific existing and newly issued debt, is limited to the minimum necessary in scope and time.

(61) As regards scope, the Commission does not dispute that the guarantees are needed by a number of banks in order to attract liquidity in the current market circumstances and more generally to restore confidence among lenders and from the public[31]. Reassuring retail deposits appears to be not sufficient as it does not restore confidence among institutional investors. It is the latter investors that provide liquidity of a longer duration to the bank ad hence stability for its funding. The Commission notes positively that Latvia is limiting the guarantee to debts where a default event was evidenced and to newly issued debt needed to refinance specific current liabilities, i.e. the ones which mature in the short run and where difficulties of refinancing may be experienced due to the ongoing financial crisis. In particular, Latvia committed that the guarantee arrangements are limited to cover the outstanding syndicated loans with a total amount of EUR 775 million as well as the refinancing of the loan expiring in February 2009. Given this targeting, the measure can be regarded as appropriate to support the liquidity requirements of Parex.

(62) The Commission also notes positively that not all the existing debt is covered by the guarantee. In particular, with this measure Latvia aims to provide a guarantee for the existing syndicated loans of Parex only because of the default claim and a guarantee for a new loan to enable the bank to re-finance itself in order to settle its obligations from the syndicated loan maturing within 6 months.

(63) As regards limitation in time, the Commission notes positively that Parex will initially have only a window of six months to issue the new debt that will benefit from the guarantee. In addition, the State guarantee will apply to such newly issued debt for up to three years. These limitations in time correspond to what the Commission currently considers acceptable.[32]

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[30] See Commission decision of 10 October 2008 in Case NN 51/2008 *Guarantee scheme for banks in Denmark*, not yet published, paragraph 42; Commission decision of 13 October 2008 in Case N 507/2008 *Guarantee scheme for banks in the United Kingdom*, not yet published, paragraph 56; Commission decision of 13 October 2008 in Case N 481/2008 *Guarantee scheme for banks in Ireland*, not yet published, paragraph 59.

[31] See Commission decision of 10 October 2008 in Case NN 51/2008 Guarantee scheme for banks in Denmark, not yet published, paragraph 47.

[32] See Commission decision of 27 October 2008 in Case N 512/2008 *Rescue package for credit institutions in Germany*, not yet published.

(64) As regards proportionality, the distortion of competition by the guarantee arrangement is minimised by various safeguards. Above all, the aid amount is minimised through a market-oriented premium, which is above the premium resulting from the application of the European Central Bank's recommendation of 20 October 2008 (hereunder "the ECB recommendation").

(65) Moreover, Latvia imposes several behavioural constraints on Parex in order to limit the distortions of competition (see also point (25)).

(66) If the bank does not succeed to obtain the new loans to refinance the syndicated loan, maturing in February 2009, with the terms as described above (see points (63),(64)), the Latvian authorities will notify a modified measure to the Commission for its approval.

e) Assessment of the liquidity measure

(67) The objective of the liquidity measure was to provide needed liquidity to the bank. This is a reaction to the international market conditions, where all financial institutions are having trouble gaining access to liquidity. The Commission has established that such a liquidity measure should help to overcome these difficulties by allowing a revival of interbank lending and considers it therefore to be an appropriate means[33].

(68) As regards necessity, the liquidity measure, is limited to the minimum necessary in scope and time.

(69) As regards scope, the Commission does not dispute that liquidity measures are needed by a number of banks in the current market circumstances and more generally to restore confidence among lenders and from the public.

(70) As regards proportionality, the distortion of competition by the guarantee arrangement is minimised by various safeguards. Above all, the aid amount is minimised through a market-oriented premium, which follows a less favourable fee calculation mechanism than provided in the ECB recommendation.

(71) Moreover, Latvia imposes several behavioural constraints on Parex in order to limit the distortions of competition (see also point (25)).

f) General requirements for the compatibility of aid schemes under Article 87(3)(b)

(72) The Commission notes that all the measures are limited in time and hence are shaped in accordance with the European state aid rules, with the access window being limited initially to a period of six months with a possibility of extension should the crisis persist.

(73) The Commission takes note of the commitment provided by the Latvian authorities to submit to the Commission either a restructuring or liquidation plan within 6 months of granting of the first state aid measure. The Commission, however, considers that such a plan would not need to be provided if, first, the measures are terminated, i.e. the

[33] Commission decision of 13 October 2008 in Case N 507/2008 *Guarantee scheme for banks in the United Kingdom*, not yet published.

subordinated loan has been reimbursed in full, the deposit has been withdrawn and the guarantees have been released within the abovementioned period of 6 months without having been called, and, second, proof is submitted to the Commission.

(74) On the basis of the above, the described measures can be considered compatible with the Common market based on Article 87 (3) (b) EC.

5 DECISION

The Commission finds that the abovementioned measures are compatible with the Common market and has accordingly decided not to raise objections.

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 to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site.

http://ec.europa.eu/community_law/state_aids/index.htm.

Your request should be sent by registered letter or fax to:

European Commission
Directorate-General for Competition
State aid Greffe
Rue de la Loi/Wetstraat, 200
B-1049 Brussels
Fax No: (+32)-2-296.12.42

Yours faithfully,

For the Commission

Olli Rehn
Member of the Commission