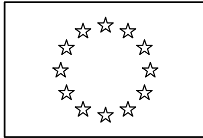

EUROPEAN COMMISSION

Brussels, 11.5.2009
C(2009) 3860 final

Subject: State aid N 189/2009 – 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 (hereinafter, "Parex" or "the bank") designed to support the stability of the financial system, which was approved on 24 November 2008 (hereinafter: "first Parex decision")[1]. On 26 January 2009, Latvia informed the Commission about several changes to the public support measures to JSC Parex Banka, which were approved on 11 February 2009[2] (hereinafter "second Parex decision"). On 29 March 2009, Latvia notified to the Commission the need for further changes to recapitalisation measure approved on 24 November 2008[3]. The Commission requested further information on 7 April, 28 April 2009, 5 May 2009 and 7 May 2009. The Latvian authorities replied on 15 April, 21 April 2009, 30 April 2009, 6 May 2009 and 8 May 2009 respectively.

II. DESCRIPTION

The original measures[4]

2. In response to the severe liquidity difficulties experienced by 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 notified

[1] See Commission decision of 24 November 2008 in case NN68/2008 *Public support measures to JSC Parex Banka* – not yet published.
[2] See Commission decision of 11 February 2009 in case NN 3/2009 Modification of public support measures to JSC Parex Banka – not yet published.
[3] As amended by the second Parex decision.
[4] Ibid footnotes 1 and 2.

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measures aim at maintaining the stability of the financial system and remedying a serious disturbance to the economy of Latvia.

3. Parex was nationalised through acquisition of a 84.83% stake by the Government of Latvia[5] in November and December 2008 (see also below). The previously approved public support measures for Parex are 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[6] with a maximum maturity of 5 years, which was not carried out to date;

   (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. Thereafter, the overall maximum amount of the liquidity facility was increased to LVL 1.5 billion. 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.

The persistence of the bank's difficulties

4. Parex, as the largest Latvian bank without a strong foreign parent, suffered most from the lack of trust in the Latvian financial sector with a loss in depositor confidence. The run on deposits peaked at a daily outflow of EUR 100 million which resulted in a fall in deposits of 36% compared to end 2007. Parex sought government assistance in early November 2008 when it faced a severe liquidity crisis. Latvian state initially took a 51% stake. However, trust was not restored and the deposit run continued. This forced the government to acquire the remaining 34% held by the bank's founders.

5. In total, the Latvian state acquired 55,365,116 shares, which represent 84.83% of the bank's paid-up share capital, at a symbolic total purchase price of 2 LVL (around 3 EUR). Limits on deposit withdrawals (partial deposit freeze) were imposed and these may be kept in place until mid 2009.

6. On 5 December 2008, a new Chief Executive Officer was appointed with a remit to restructure Parex and to sell the bank to a strategic investor. The new Supervisory Board was recently elected and is currently in the process of approving the bank's strategy, re-writing the charter and approving revised policies and procedures.

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5 The shares were initially acquired by Latvian Mortgage and Land Bank (hereafter "LHZB"), the state-owned bank on behalf of the Latvian State. In February 2009, LHZB, the former State representing shareholder of Parex Bank, acquired 200,000 shares (0.31% of capital) from a minority shareholder AB Svenska Handelsbanken for a symbolic price of LVL 0.01. Pursuant to the purchase agreement of 25 February 2009 the shares owned by LHZB (85,15%) were transferred to Latvian Privatization Agency at a total purchase price at around 3 EUR (2 LVL, 0.01 EUR). All shares were subsequently transferred to the Privatization Agency. Changes in the register of shareholders were made on 27 February 2009.

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

7. On 20 March 2009 the Latvian supervisory authority, the Financial and Capital Market Commission (hereinafter "FCMC" or "Regulator") adopted new regulations on internal capital adequacy assessment process, namely the Latvian Regulations for calculating the minimum capital requirements (hereinafter "Regulations"). These regulations came into force on 25 March 2009. Pursuant to the letter of 6 May 2009 of the FCMC and the Bank of Latvia, based on these Regulations, the minimum capital adequacy ratio (hereinafter "CAR") of Parex required to ensure its operation during the rescue phase should be 11% at bank level.

8. As of YE 08 total shareholder's equity fell by 65% to LVL 77 million mainly because of increased loan loss provisions and losses on the securities portfolio. As of YE 08, Parex's CAR and Parex's Group CAR was only 4.1 and 3.1% respectively. Therefore, the bank has not been fulfilling its regulatory obligations for several months already. Given this background, the previously approved subordinated term debt measure would not be sufficient to enable the bank to reach the required CAR. Parex's Loan to value (LTV) ratios are more conservative than those of other major banks operating in Latvia, and the fact that Parex significantly increased provisions in 2008, which amount to 6.4% of gross loan portfolio (GLP), well above the Latvian banking market provisioning of 2.1% reported by the FCMC[7]. Net loss from trading in securities amounted to EUR 18.3 million as of YE 08. This reflects the rapidly deteriorating global capital markets environment. In 2008, a proportion of the securities were reclassified from available for sale (AFS) to hold to maturity (HTM) because of illiquid markets. Following a further review of and change in provisioning methodology, Parex has increased provisioning on its securities book to EUR 42.7 million.

Description of the changes to the measures

9. Following the diligence exercise and the changed legal requirements, there was a need to inject significant capital, notably also in the form of Tier 1 capital, into the bank to enable it to achieve the minimum CAR.

10. Hence, the Latvian authorities reconsidered the **amount and the form** of the capital injection needed as approved by the Commission on 24 November 2008[8]. Notably, the Latvian state intends to recapitalise the bank, by providing both, Tier 1 and Tier 2 capital. The Latvian authorities initially notified their intentions to strengthen Parex's capital base by contributing additional capital, to the effect that Parex's CAR should reach approximately 13 % at the bank level, which would imply CAR of around 12% at the group level (hereafter CAR at bank level is meant, if not specified otherwise). However, the Latvian authorities accept that a level of capitalisation of 11 % for Parex would suffice in the rescue period (10% for the group). The measures at issue are consequently limited to the provision of capital necessary to achieve and maintain the CAR of 11% over the period covered by this decision, i.e. rescue phase.

11. The FCMC considers this level to correspond to the minimum CAR required for Parex from a regulatory perspective. At present the total amount that would need to be injected to achieve this CAR is estimated at LVL 191.020 million. However, if during the rescue

[7] The figures are based on management, i.e. prior to audited, accounts for 2008.

[8] The first Parex decision was amended by the second Parex decision, but only with regard to interest rate mechanism for the subordinated term debt.

phase more capital is needed to maintain the CAR at 11%, Latvia may inject it as long as other terms of the measures at issue remain unchanged.

12. To ensure that the use of State funds is minimized, the proportion between Tier 1 and Tier 2 capital funds is set in a way that the use of Tier 2 capital is maximised taking into account respective provisions set in the Regulations[9]. At present the respective amounts would correspond to an investment of LVL 140.750 million in the form of ordinary shares, qualifying as Tier 1 capital, and LVL 50.270 million in the form of subordinated term debt, qualifying as Tier 2 capital. If, however further capital injections are necessary to preserve CAR of 11% during the rescue phase due to the currently unexpected further provisioning, the same proportion between both capital forms maximising the amount of Tier 2 capital in respect of Tier 1 will be preserved. The State will purchase the newly issued ordinary shares with voting rights for the par value of LVL 1. After the injection the State will own 95.30%. No distribution of profit as dividends is foreseen in the near future. This is in line with the aim to strengthen, and preserve bank's capital base and takes into account the fact that part of the shares is currently owned by private shareholders and sale of part of the State shares to a third party investor may occur[10].

13. As regards the terms of the subordinated term debt, with the exception of the changed amount, other terms of the measure, including the fee calculation mechanism, remain the same as approved in the second Parex decision of 11 February 2009.[11]

14. As regards the **remuneration of the ordinary shares**, the Latvian authorities submitted that they would essentially apply the European Central Banks' (hereunder "the ECB") recommendations for the pricing of recapitalisation instruments of 20 November 2008 in calculating the required rate of return for Tier 1 capital. Given that Latvia is not a euro area Member State, this fee element was adjusted. Thus, it depends on the cost of financing of the Latvian state.

15. In sum, the required rate of the return will be determined as total value of following parameters: *i)* the real costs of State Treasury loan funds (at the moment determined as an annual yield of government domestic T-bills), *ii)* equity risk premium of 5%, iii) add-on fee of 1%[12]. The required rate of the return will be gained from the sale of the ordinary shares to the final investor.

16. The Latvian authorities consider that this rate is achievable. To demonstrate this, the Latvian authorities compare the weighted average cost per share owned by the State following the injection to the market share price or its estimate when the former is not observable.

17. In estimating the weighted average cost per share at the time of the injection, the Latvian authorities would take into account the cost of already issued shares purchased by them

[9] The Regulation specifies that when calculating Tier 2 capital, the total of the subordinated capital and of the preference shares shall not exceed 50% of the Tier 1 capital.

[10] In particular, the Latvian authorities and EBRD have entered into the share purchase agreement on 16th of April 2009. According to the share purchase agreement, EBRD acquires part of the outstanding ordinary shares in AS Parex banka so that the EBRD owns 25%+1 share of the total share capital. The share price is 1 LVL per share. The Parex's business plan as prepared by the EBRD concludes that an appropriate rate of return in the medium term would be achieved.

[11] Amending the first Parex decision.

[12] Indicative current level: 18th March 2009 average weighted yield at the multi-price auction for government domestic 1Y T-bills of 8,275% + 5% + 1% = 14.275%.

from the previous shareholders for a symbolic price (LVL 2, see paragraphs 8 and 9 of the second Parex decision) and the cost of new shares acquired through the planned capital injection. The Latvian authorities consider that without shares being taken over by the State, the initial liquidity support to Parex would not have been provided. As such, the takeover of the shares can be seen as an integral part of Parex's rescue measures, i.e. it cannot be viewed in isolation from the further rescue measures implemented, including restoration of the bank's capital. Accordingly, based on the substance of the matter, i.e. the takeover being a precondition for the State's support, the Latvian authorities are of the opinion that the takeover should be viewed, and the respective calculations made, in conjunction with the subsequent increases in share capital by the State.

18. Given that Parex's shares are not tradable on the market, market price of its shares is not established. Therefore, it is claimed that Net Assets Value (hereinafter "NAV") per share could be used as an estimate of their market value. NAV calculations take account of all provisions actually made by the bank up to end of March 2009. As such, the provisioning takes due account of the extensive due diligence report prepared by PwC[13].

19. Following this approach, the weighted average cost for one share is LVL 0.72[14] and this cost compares to NAV of LVL 1.01 per share following the recapitalisation. The NAV of Parex prior to the capital injection exceeds the total share capital. Hence the NAV per share exceeds the nominal price of the share.

20. Therefore, the State will receive a discount of around 29% on the ordinary shares to be acquired. This discount from the NAV per share is significantly higher than the abovementioned required rate of return on the ordinary shares.

21. The Latvian authorities submitted that it is their intention that the State would sell Parex's shares as soon as possible once the exit price is reasonable and achievable, but not later than after a period of three years after the first rescue measures were provided to Parex. Given that the adequate remuneration for the recapitalisation is linked to the exit price, the sooner the exit will take place, the lower the minimum exit price will be. The Latvian authorities claim that, as appears from the table below, the commitment of the Latvian state to sell its stake in Parex within three years provides a sufficient certainty that the required rate of return is likely to be achieved, notably, since high provisioning on the loan book is already included in the NAV.

Table 1: **The simulation of the expected sales price of the shares[15]**

Holding period (full years)	Minimum sales price (at the end of the year)
1	0.82
2	0.94
3	1.07
4	1.22
5	1.40

[13] Financial, Tax and IT due diligence report prepared by an independent auditor, PricewaterhouseCoopers SIA.

[14] Provided calculations are dependent on the current estimate of the envisaged capital injection and may vary to a limited extent if in the end more (or less) shares are purchased by the state to fulfil the CAR of 11%.

[15] The parameters used for the simulation are the current level of 14.275% for the required rate of return and the current estimate of the number of ordinary shares (140 750 000) that would need to be acquired by the State to reach the CAR level of 11%.

III. Position of Latvia

22. In line with the first Parex decision, 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 since Parex is considered to be a bank of systemic importance in Latvia. This is confirmed by the letter of 21 April 2009 of the Bank of Latvia and the FCMC.

23. Latvia submits that, due to increased loan loss provisions and losses on the securities portfolio, it was necessary to revise the amount and the form of the capital injection needed. The letter of 6 May 2009 of the FCMC and the Bank of Latvia provides that the abovementioned recapitalisation measures are imperatively needed to restore public confidence in Parex and to ensure that the bank complies with the legal requirements. In addition, the FCMC and the Bank of Latvia certify that the CAR of 11% at the level of the bank corresponds to the minimum needed to keep the bank afloat during the rescue phase.

24. The Latvian authorities reconfirm their commitment to notify to the Commission a restructuring plan by 11 May 2009.

IV. Assessment

State aid character of the amended measures

25. 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.

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

Compatibility of the amended measures

Application of Article 87(3)(b) EC

27. The Commission found the original measures to be compatible with the common market under Article 87(3)(b) of the EC Treaty. Given the bank's systemic importance and that the amended measures are identical to the original ones with regard to the pursued objective as well as the fact that 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.

Assessment of the amendments to the measures

28. The intended recapitalisation measures will be implemented in accordance with the 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").[16]

29. As regards the **amount of the recapitalisation**, the Commission takes into account the abovementioned letter of the FCMC and the Bank of Latvia, which provides that the CAR of 11% corresponds to the minimum needed to keep the bank afloat during rescue phase. On the basis of this letter, the Commission considers that the amount of the recapitalisation can be regarded as the minimum necessary. The Commission also notes positively that Latvia minimises State support by providing maximum Tier 2 capital eligible. Consequently, the Commission finds that the recapitalisation measures serve the purpose of keeping the bank afloat until the long-term restructuring plan is drawn up and hence the competition distortion appears to be limited.

30. As regards the **remuneration for the ordinary shares**, the Commission agrees with the Latvian authorities that the return on the ordinary shares should be assessed by taking account, on the one hand, of the acquisition costs of all the shares held by the State (including the earlier acquisition of 85.15% of the shares then in issue for a symbolic price)[17] and, on the other hand, the amount likely to be realised on the disposal of all such shares. The Commission notes that the State acquired the shares it already holds for a symbolic price (i.e. substantially lower than NAV per share). Following this approach, the weighted average cost for one share is estimated to be LVL 0.72 under current amount of ordinary shares to be acquired by the State[18] and this cost compares to a current estimate of NAV of LVL 1.01[19] per share following the recapitalisation. In this regard, the Commission takes note that the estimated NAV takes into account a high level of provisioning following the due diligence report prepared by an independent auditor. Consequently, this means that the State receives a discount of 29%[20] from NAV i.e. the real underlying value of the shares. The Commission notes that on this basis, the remuneration should not be lower than the required rate of return (see paragraphs 14-15 above).

31. In view of the prevailing conditions in the financial markets, the Commission considers it unlikely that the Latvian government would be able to realize the benefit of the initial discount of around 29% very shortly after the purchase. Therefore, the Commission gives more weight to the required rate of return for the ordinary shares. The Commission, nevertheless, considers that given the size of the discount from the estimated market value of the shares, it can be reasonably expected that the State will gain a sufficient return on its investment once the shares are sold to a strategic investor to receive the abovementioned required return on capital. Such a return would be at least as high as that required for fundamentally sound banks benefitting from State support measures in Latvia and other Member States. Nonetheless, the expected return for ordinary shares will be reassessed in the context of the restructuring plan and appropriate conclusions will be drawn about the extent of restructuring required.[21]

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16 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).

17 Ibid footnotes 1, 2.

18 Ibid footnote 14.

19 Ibid footnote 14.

20 Ibid footnote 14.

21 See point 44 of the Recapitalisation Communication.

32. It has to be recalled that the Commission already established in its previous decisions that Parex is considered not to be a fundamentally sound bank. In view of Parex's difficulties, the Commission would, in principle, expect a higher remuneration to be charged to Parex, due to its risk profile[22].

33. However, in line with Recapitalisation Communication,[23] 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.

34. 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. The Commission's acceptance of this level of remuneration is therefore subject to reappraisal in the light of the restructuring plan that is to be submitted. 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. This assessment is without prejudice to a position the Commission may take with regard to this measure in the context of the analysis of the restructuring plan that the Latvian authorities committed to present.

35. In addition, the Latvian authorities committed that it is their intention that the State would sell Parex's shares as soon as possible once the exit price is reasonable and achievable, but not later than after a period of three years after the first rescue measures were provided to Parex. Furthermore, given that the adequate remuneration for recapitalisation is linked to the exit price, the sooner the exit will take place, the lower the minimum exit price will be. Therefore, it is reasonable to expect that the State will seek an early exit. The Commission considers that these constitute an exit strategy for the State and hence can be regarded as a sufficient exit incentive in accordance with the Recapitalisation Communication.

36. As stated above, a limited recapitalisation amount is considered to be an adequate safeguard to minimise the competition distortions caused by the aid. In addition the State, despite the current market conditions, should obtain an adequate minimum return on the investment.

37. Taking into account the commitment of the Latvian authorities to present a restructuring plan by 11 May 2009 the envisaged recapitalisation measures are compatible under Article 87(3) (b) EC to keep the bank afloat for the rescue period pending the assessment of the restructuring plan. This assessment is without prejudice to that which the Commission will reach following the analysis of the restructuring plan if these measures are maintained in it.

[22] See Commission decision of 11 February 2009 in case NN 3/2009 Modification of public support measures to JSC Parex Banka – not yet published, at point 33.

[23] See point 15 of the Recapitalisation Communication.

38. In addition, the Commission recalls that in accordance with the Recapitalisation Communication certain restructuring measures were already implemented by changing the management and corporate governance of the bank[24].

39. 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

40. The Commission concludes that the notified amended measures are compatible with the Common market and has accordingly decided not to raise objections against them. This decision applies for the rescue phase ending on 11 May 2009. Upon the submission of a coherent and substantiated restructuring plan by 11 May, the present approval will be automatically prolonged until the Commission reaches its decision concerning the plan.

41. 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

[24] See point 44 of the Recapitalisation Communication.