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News

Latvia: **Bridge Collapse**

by Pauls Raudseps
3 December 2008

The government's recent takeover of a major Latvian bank dealt a blow to the country's ambitions to act as a regional financial center connecting East and West.

RIGA | Bear Stearns. Lehman Brothers. Dexia. Fortis. Parex ...

Latvia's second biggest bank has joined the list of institutions humbled by the worldwide financial crisis and added to the burden of Latvia's suddenly shrinking economy and buckling state finances.

A small player on the international scene, Parex has an outsized reputation not only in Latvia, but in the wider world of the former Soviet Union. Two former Latvian Komsomol (Communist Youth League) functionaries – Valerijs Kargins and Viktors Krasovickis – secured one of the first licenses to run a foreign currency exchange in the USSR even before Latvia was completely independent. Their exchange kiosk in Riga's central railway station grew into a bank with 3 billion lats (\$5.4 billion) in assets and branches in 14 countries.

Kargins and Krasovickis did not hesitate to use the connections they had made in the communist nomenklatura during the waning years of Soviet power and worked to solidify their political influence after Latvia regained its independence. Two former prime ministers have been members of their advisory council, a former prosecutor general sits on the board, and their connections almost undoubtedly played a significant role in building their business in the 1990s. Kargins was widely considered one of Latvia's "oligarchs" – the handful of people whose position at the nexus of business and politics let them amass large fortunes and outsized political influence.

But at 10 p.m. on Saturday, 8 November, it all collapsed. After a closed meeting of the cabinet lasting four hours, Prime Minister Ivars Godmanis emerged to announce that the government was purchasing 51 percent of Parex's stock for 2 lats – one for Kargins and

one for Krasovickis. The remaining 34 percent that the two owned would be pledged as security to the government to guarantee against any losses in case the financial condition of the bank was worse than reflected in its official balance sheet. As this article went to press, the government was considering taking over that share as well.

Fifteen percent owned by various minority shareholders would remain untouched. It was quite a comedown for Kargins and Krasovickis, who had rejected an offer to sell Parex for something like 1 billion euros at the beginning of the year. What happened?

A FAST FALL

Parex was well-known for attracting depositors from the former Soviet Union for whom Latvia was emotionally still the *sovetskaya zagranitsa*, the “Soviet abroad” – a place that was relatively easy to get to, where people spoke Russian, yet that provided the legal structures of a Western country and protection from the predatory practices of their own governments. In the early 1990s Parex played on this image, running advertisements on Russian television with a tagline that was as good as a nudge and a wink: “We’re closer than Switzerland.”

Later, as the U.S. Treasury Department became increasingly aggressive against money laundering, Parex’s owners did not like to be reminded of this wily slogan, yet they never gave up their focus on attracting money from the East. The bank was the model for the kind of business that many hoped would make Latvia a regional financial center, a “bridge” between East and West.

As long as the commodities boom was generating massive amounts of cash for Russia, Ukraine, and points beyond, and Latvia maintained its position as the fastest growing economy in the European Union, this strategy for attracting funds and making money seemed like a winner. But, as for so many others, the global financial crisis that followed the collapse of Lehman Brothers in mid-September upended Parex’s position.

To save their banking industries, one European government after another extended large aid packages, but no help was forthcoming for local banks from the Latvian government, which was struggling to make budget cuts in the face of a massive economic slowdown (GDP fell 4.2 percent year on year in the third quarter of 2008, the sharpest decline in the European Union). Parex was also vulnerable because of two loans put up jointly by more than 60 banks, worth 775 million euros, which will come due in 2009. In the worsening financial environment, it was not clear that the bank would be able to roll them over, as it could have just a year ago, and doubts about its ability to repay the loans began to create anxiety both in the bank and among its larger foreign depositors. And when the Swedish government announced on 21 October that it would provide a large support package for its banks, local depositors in Latvia also had a much safer alternative to Parex, as the first and third largest banks in Latvia are subsidiaries of the Swedish banks Swedbank and SEB.

Parex started hemorrhaging cash. According to the Latvian bank regulator, in the six

weeks before the government takeover the bank lost 240 million lats (\$427 million) in deposits. In the first week of November its liquidity ratio (how much cash a bank has available to cover short-term liabilities such as deposits) was only slightly above the 30 percent minimum required for the bank to be considered solvent.

Parex, with more than 500,000 clients (in a country of 2.3 million) and assets close to 20 percent of the country's GDP, was manifestly too big to fail. So on 8 November the government stepped in and promised to inject 200 million lats into the bank and guarantee any loans the bank had to take out in order to restore liquidity.

SHAKEN CONFIDENCE

Domestically the government's move seems to have worked. The run on Parex leading up to the takeover had involved large depositors pulling their money out. The population as a whole was largely unaware of the potential problems at the bank and, to everyone's relief, reacted calmly to the government's Saturday night surprise.

The same cannot be said of international observers. With the government already struggling to control a budget deficit and the economy steadily worsening, in the following days Fitch and Standard and Poor's cut Latvia's credit rating and threatened further downgrades, potentially putting Latvia's bonds over the line separating investment grade from junk. The government is talking with the banking groups that lent the joint loans, hoping to convince them to roll them over, but the complex talks are not progressing quickly.

As a result, less than two weeks after taking over Parex, on 20 November, Latvia began negotiations with the International Monetary Fund on an aid package to preserve the stability of its financial system. The fiscal discipline that the IMF is sure to impose on the imploding state budget, while necessary, will increase the pain of a recession that started this summer and is expected to continue for most of next year.

It is more than a little ironic that this crisis has been given such a powerful push by the very business model that many saw as Latvia's road to rapid economic growth. Perhaps being closer than Switzerland is not such an advantage after all.