FINANCE
LATVIA
ASSOCIATION

Position of the financial industry of Latvia on proposed methods for regulating bank profits as part of the inflation reduction programme implemented by the European Central Bank; its impact on lending and financial sustainability – bank capital, borrowers' credit history, and development of the national economy

Introduction

A successful economy that attracts investors is characterised by predictability. This includes, among other things, predictable state policy in matters of taxation.

As responsible long-standing market players, participants in the financial industry understand that the state budget requires additional financing to pursue various priorities. However, in search of common ground, it is necessary to avoid populist means of budget revenue generation that would be unacceptable in economically developed nations, and means that are not commonly used. Action scenarios pertaining to EURIBOR growth should also be proposed, so as to prevent long-term negative impact on the finance industry and on national economic development, including on subjects such as the availability of credit and the credit histories of borrowers.

The Finance Latvia Association (hereinafter referred to as the Association) has always stood for open, effective and performance-oriented cooperation in a format characteristic of the financial sector, i.e. professional discussions on matters of importance to the industry. It is the Association's opinion that neither the proposals for a special tax to be imposed on the finance industry nor the action scenarios proposed regarding the growth of EURIBOR as a result of the inflation mitigation measures implemented by the European Central Bank with regard to mortgage borrowers have been subjected to proper critical evaluation. This is evidenced by the fact that no discussions have taken place on these matters, for example in working groups that would also include industry experts, and where politicians or representatives of the legislator would hear the arguments of the industry. Such consultations with industry experts would have promoted the understanding that the imposition of a new tax or implementation of intended scenarios pertaining to EURIBOR could not facilitate lending and ensure national economic growth in a way that would avoid posing a potential threat to financial stability, to competition among financial service providers, and to the credit histories of borrowers, and so their opportunities for future borrowing.

With the aforementioned observations in mind, the Association is convinced that the argumentation provided by the industry, and the conclusions drawn from it, will be of use to politicians and legislators, as well as businesses and residents, in informing their future decisions. The Association reiterates its offer of constructive cooperation with government, seeking to eliminate the promotion of populist proposals that may cause direct harm to the domestic financial system, the national economy and the welfare of residents.

Contents

I. Industry investment in the development of society and the national economy in general I–4

II. Introduction of a new tax II–6

Importance of credit institutions' capital in facilitating lending II–6

Impact of the tax on business development and economic growth II–7

Highly capitalised banks are a precondition for implementing the green transition II–8

Negative long-term cumulative impact of increasing taxation II–8

Banking profitability should be considered with a long-term horizon II–9

Negative impact of the tax on the investment environment in Latvia II–10

Negative impact of the tax on the competitiveness of the financial market II–11

The tax will restrict new players' entry into the market II–12

Banking-specific contributions II–12

Impact of the shadow economy on national economic development II–13

Tax as a barrier to lending growth II–13

Industry proposals for increasing the rate of lending II–15

III. Mortgage loans and EURIBOR III–17

Peculiarities of the activities of credit institutions compared to other forms of business III–17

Awareness of borrowers III–18

On data-driven decisions III–18

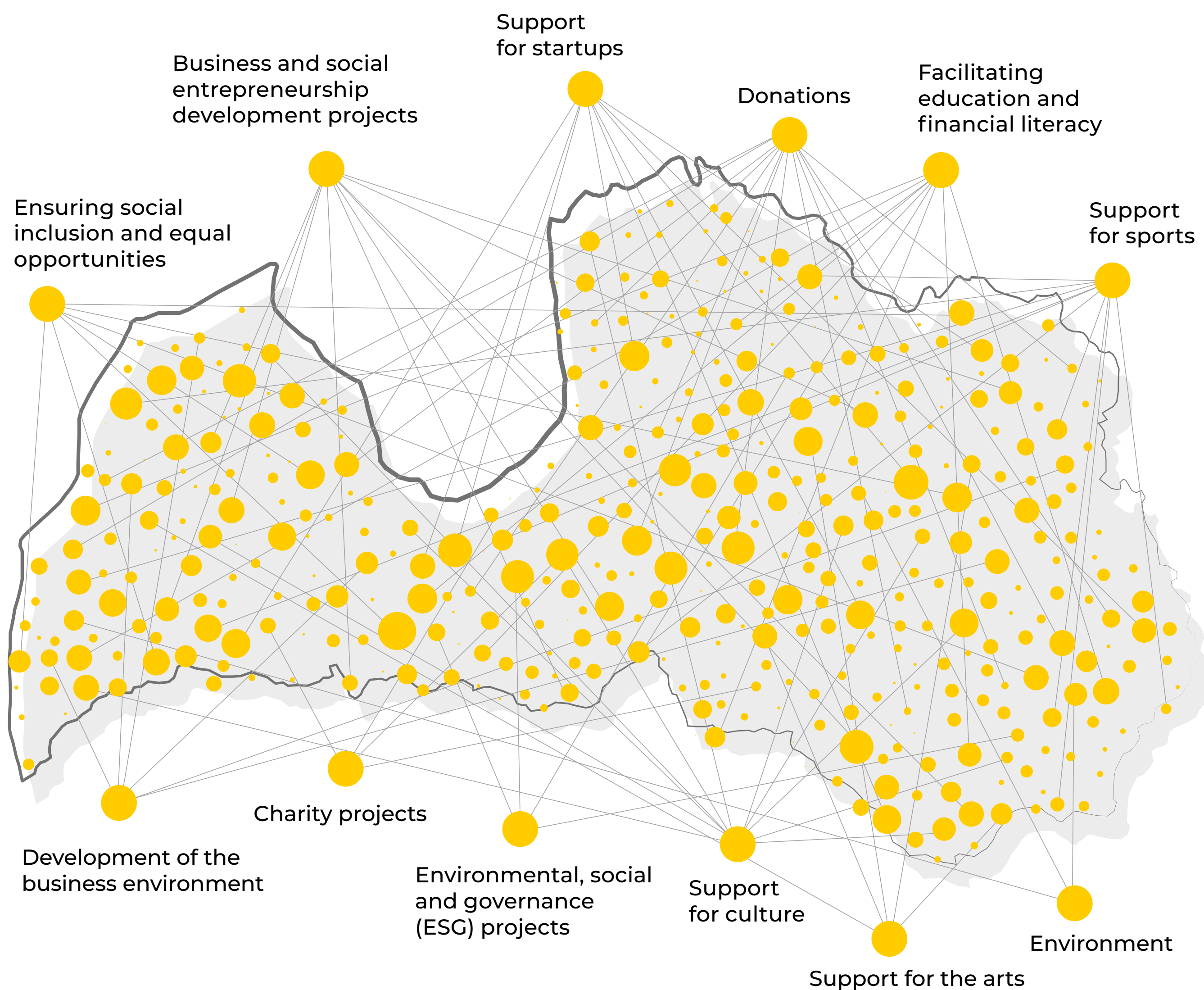
On the goal and consequences of potential solutions III–19

I. Industry investment in the development of society and the national economy in general

Because in the public space incomplete, often one-sided information is presented on the operation of credit institutions, focusing on the profits generated in the short term, i.e. within a given economic cycle, we would like to use this document in order to remind readers how credit institutions contribute to the national economy, social matters, and the development of state and international infrastructure, among other things.

Firstly, the Association would like to underscore that banks either donate or issue funds to a varied multitude of charity foundation projects and development initiatives, such as:

- business and social entrepreneurship development projects
- ensuring social inclusion and equal opportunities
- facilitating education and financial literacy
- environmental, social and governance (ESG) projects
- development of the business environment
- charity projects
- support for startups
- support for sports, culture and the arts
- support for environmental remediation and development



The Association underscores that credit institutions in Latvia have, in 2022 and 2023 alone, allocated over EUR 1.6 million towards supporting a variety of social projects and various initiatives, with over EUR 10 million in allocations slated by the end of this year. We believe that our contribution to society is indispensable, and hope that credit institutions will remain able to provide assistance and drive development across multiple socially significant projects, varying in content and essence.

Secondly, in addition to the vast support that members of the Association have extended to social projects, credit institutions also provide assistance in other ways. The following are just a few examples:

- with the active participation of banks, the question of attribution of the funds of historically liquidated companies has been resolved. A unified understanding on the attribution of the funds of such companies, and the contribution thereof to the state budget, has been accomplished.
- guidelines have been drafted for improving the availability of financial services, entailing substantial transformations to the servicing of people with disabilities or temporary medical conditions, including substantial investments in infrastructure
- a regulatory framework for the operation of student training companies has been developed and submitted to the competent authorities. The Association has secured support among policy-makers for the assertion that special regulation (particularly tax regulation) must be developed for student training companies, using the Estonian model as an example.
- mortgage loans that came about as a result of the financial crisis, constituting around EUR 500 million, have been discharged
- credit institutions have concluded an interbank agreement on refinancing – without this, client mobility would have been encumbered even more
- the credit institutions that provide services in the payment module of the State Regional Development Agency (enabling convenient collection of taxes, duties, fines etc. by the state) do not require payment from the state, and have received none for a number of years. On average, a million transactions are prepared for payment free of charge to their clients per year.

To summarise the aforementioned, the Association observes that the contributions of its members to the development of society and the national economy point to the importance of the financial system in the functioning and development of the domestic economy. Credit institutions remain hopeful of continued amicable cooperation.

II. Introduction of a new tax

The idea of implementing a windfall tax was voiced in Latvia after politicians in Lithuania started discussing it. Credit institutions in Latvia have not been provided with any information on the intended tax – neither a rate nor a calculation formula – but only a general indication that it would be "similar to the way things are done Lithuania". Banks are thus precluded from accurately calculating the impact of the expected taxation on lending volumes and on national economic development. An opinion has been voiced in the public space that a windfall tax would be implemented as a temporary instrument for balancing the state budget, with no mention of the scope of state budget balancing or the timing of either implementation or cancellation of the tax. Thus, the Association is unable to field comprehensive argumentation on the matter of the windfall tax, although it is ready, on a conceptual level, to provide its opinion about the negative impact that implementing such a tax would have on lending volumes and on national economic development.

The Association believes that the implementation of a new tax would further worsen the already poor business environment in Latvia, and decrease investor interest in Latvia as a safe business investment region, particularly in its financial sector. The Association urges politicians, legislators, entrepreneurs, residents and the media to listen to the industry's arguments, become aware of the risks that may manifest with the imposition of such a law, and to evaluate such risks adequately.

Importance of credit institutions' capital in facilitating lending

The availability of capital, considered and responsible borrowing, and a mature financial sector are the factors that enable national economic development, which is inexorably linked to the improvement of welfare – for the state, for business and for each household.

The finance industry is heavily tied to economic cycles. When entrepreneurs and private individuals are doing well, they strive for further improvements and tend to borrow from banks in pursuit of set targets; they make investments, generate more profits and repay their loans, and everyone stands to benefit as a result. The reverse is also true. During the 2009–2011 period, which we recall as a time of economic crisis, the losses of the banking industry exceeded EUR 1.8 billion – vastly more than what credit institutions had made in profits during the preceding economic cycle (i.e. after 2004, when Latvia became a European Union member-state). The aforementioned losses were sustained within just a few years but took twice as long – until 2017 – to recoup.

Credit institutions in Latvia are currently well capitalised. Capital provisions exceeding the requirements instituted by competent authorities are maintained in order for banks to maintain the necessary state assistance in difficult times, while being able to issue loans and provide other financial services. The Financial Stability Report[1] by the Bank of Latvia indicates that "The financial system in Latvia remains stable, and the capacity of credit institutions to absorb shocks is good – they generally have good provisions for capital activity and liquidity. The shock-absorbing capacity of the banking sector is expected to continue improving, since the resilience of credit institutions is reinforced by rising profits" (Bank of Latvia, 2023)[2]. The Euro Area Statistics[3] also confirm that lending in Latvia is rising at a rate greater than in most other European Union countries.

One should, however, be cognizant that the imposition of a banking windfall tax would impair banks' capacity to attract capital. As a result of such a decision, credit institutions would be forced to either reduce the volume of loans being issued in order to maintain high capitalisation, or to decrease their capital provisions in order to maintain lending at present levels. In other words, such a decision would not accomplish an increase in the pace of lending. Here, we would like to remind readers that the economy of Latvia is financed primarily by credit institutions. The effect of lending on the economic cycle is particularly great because companies and households have difficulties finding alternative means of attracting capital on equivalent terms.

At the peak of an economic cycle, access to capital for investments (including opportunities in capital markets, through issues of stocks or bonds) is easiest for businesses, and they have higher equities. The decision to implement a windfall tax would decrease the degree of protection that the banking sector would have in the event of a possible crisis. During an economic downturn, when companies receive less income and have more difficulties attracting investment, bank financing becomes critical. Credit institutions establish "safety nets" for such a downturn period during the growth phase of an economic cycle. Capital provisions are used in order to cover losses and ensure financing continuity, as well as to provide remedies to borrowers facing difficulties.

[1] *https://datnes.latvijasbanka.lv/fsp/FSP_2023_LV.pdf?_gl=1*1hfuuxw*_ga*MTc1MjE1MzY1LjE2NzI3MzAxMzg.*_ga_F8V1V8BEFY*MTY5MjAxNDcyNS4xMy4xLjE2OTIwMTQ3MzkuNDYuMC4w*

[2] *https://bank.lv/aktualitates-banklv/zinas-un-raksti/jaunumi/16514-publicets-jaunakais-latvijas-bankas-finansu-stabilitates-parskats*

[3] *https://www.euro-area-statistics.org/banks-balance-sheet-loans?cr=eur&lg=en&page=2&charts=M..N.A.A20T.A.I.U2.2240.Z01.A+M..N.A.A20.A.I.U2.2250.Z01.A+M..N.A.A21.A.I.U2.2250.Z01.A&template=6*

The high capitalisation of banks in Latvia has enabled them to weather the fallout of the latest two crises – the Covid-19 pandemic and the war waged in Ukraine by Russia. The Association stresses that, during the energy crisis resulting from the war in Ukraine in 2022, credit institutions issued financing to bolster energy security. Financing was allocated to companies within the energy system and to private businesses, as well as to municipal suppliers of thermal energy.

The Association points out that banks, like any other business, should generate a profit, so that no member of the financial market has any doubts regarding the feasibility or the competitiveness of their business models, while depositors can access their funds held with banks whenever needed. In this regard, a clear example would be the case of Credit Suisse – a bank that had been unable to maintain the level of profitability adequate to its operation. Getting into difficulties, it was forced to borrow CHF 50 billion from the state but was no longer able to win back the trust of its clients, and ended up being taken over by UBS, another market leader. The bank's problems in this case came from a business that was not making a profit. The business model was not sustainable, and eventually had a negative impact on the performance of the bank and on society at large (forecasts of collective layoffs, loan restructuring which would directly impact residents and companies etc.). Latvia has learned quite a few bitter lessons in the history of its financial sector as well; we must not forget them, and we must be able to learn from the mistakes of other countries.

The profits of a credit institution help secure the trust of its investors, business partners, depositors, and clients. Residents want to be sure that their savings are secure, and choose to hold their funds with banks that make a profit rather than those operating at a loss. The national economy requires well-capitalised, capable banks that can continue to borrow and to finance businesses during economic downturns. It is these banks that will able to support households and residents who might face solvency issues in a crisis.

One final point on the matter of banking capital is the planning aspect. Quite recently – in 2021 and early 2022 – we saw a period of negative rates that persisted for too long as a result of decisions made in matters of monetary policy. The fact that the European Central Bank (hereinafter referred to as the ECB) is raising rates is a new development, and credit institutions are adjusting to the situation considering their operational strategies, risk assumptions and binding industry regulations. Notably, credit institutions in Latvia were able to shoulder losses sustained as a result of the negative rates without passing them on to clients. Within less than a year, the situation has changed starkly, and the finance industry is facing a state of affairs that could not have been predicted by prominent economists or by the central banks of European Union member states. Agreements concluded previously, and their respective terms, would not change, since the agreements had been developed on account of economic cycles. This is a stark example of how decisively situations may change, and how little we can know in advance. The finance industry is unable to rely on "getting over sudden, unforeseen shocks 'in one way or another'". The capital held by banks and profitable banking institutions do not guarantee that the industry will be able to survive certain situations and certain economic periods.

Impact of the tax on business development and economic growth

In the ECB's "Financial Stability Review 2021", participants of the ECB and the International Monetary Fund evaluated the effect that lending supply had on economies. During the 1999–2019 period, lending growth in the Eurozone decreased by 0.9%, and economic growth was approximately 0.18% lower (Barauskaitė Griškevičienė et al., 2021)[4]. We can therefore conclude that a 1% reduction in the volume of loans is linked to a 0.2% decrease in GDP. This is the key parameter used in the analysis of economic impact provided below. In normal circumstances, the supply of loans has a substantial effect on economic growth.

Because financing of the Latvian economy is mostly dependent on banking activities, one may assume that a decrease in lending capacity would impact the economy by no less than the Eurozone average.

Business activities in Latvia are financed primarily using funding issued by banks. At the end of 1Q2023, the aggregate lending portfolio of banks in Latvia exceeded EUR 15 billion (loans issued to companies almost reaching EUR 9 billion and loans issued to individuals being EUR 6 billion)[5]. Thus, the role that banks in Latvia play in financing companies is particularly great. Credit institutions have made a substantial contribution to the welfare of Latvian residents and the development of local businesses. Due to capital adequacy requirements, this growth has required a large amount of capital (including provisions), which reached around EUR 2.7 billion as of 31 December 2022[6]. Credit institutions have been investing this capital in their own equity in order to drive the development of the Latvian economy. A large share of this capital has been accumulated as a result of reinvesting (capitalising) the profits of banks.

[4] *Barauskaite Griškevičienė, Kristina, Anh DM Nguyen, Linda Fache Rousová and Lorenzo Cappiello (2021). The impact of loan and market-based credit supply shocks on euro area GDP growth. Financial Stability Review, November 2021.*

[5] *https://www.financelatvia.eu/news/fna-pirmaja-ceturksni-izsniegto-kreditu-apjoms-pieaudzis-par-6-izsniegti-15-miljardi-eiro/*

[6] *https://kompass.bank.lv/bankas/kapitala-pietiekamiba*

Large and international companies have easier access to capital on financial markets and by borrowing from international financial institutions (such as the European Investment Bank) than smaller ones. However, one should be aware that the impact of contracting credit supply will be felt most by small and medium-sized local businesses, which do not have the capability to borrow internationally or on capital markets. At this time, with Latvia being part of a region susceptible to significantly elevated geopolitical risks, borrowing on foreign markets is more complicated and expensive than previously. A contraction of local lending capacity will worsen the borrowing terms and access to financing for Latvian business. As access to loans shrinks, some businesses become incapable of pursuing their development in a competitive environment, and this will consequently affect the amount of tax revenues. Households also have fewer consumer and mortgage loans etc.

In its assessment of the situation in Lithuania, the ECB indicated that[7]:

- the temporary banking solidarity contribution adopted by the Lithuanian government could lead to negative consequences, making credit institutions less resilient to economic shocks, and may hamstring the country's economic growth
- the temporary solidarity contribution for excess banking profits may, in the opinion of the ECB, pose an obstacle to the attraction of new investment, which would reduce the capacity for lending to fund economic activities. Such a tax could result in diminished willingness among both local and foreign investors to invest in credit institutions, since the temporary solidarity contribution reduces potential returns
- credit institutions have the stable capital foundation necessary in order to fulfil their role as lending intermediaries within the economy. Higher costs and reduced credit supply may impair real economic growth.

Highly capitalised banks are a precondition for implementing the green transition

The European Green Deal, approved in 2020, is a package of European Commission policy initiatives with the target of achieving climate neutrality across the European Union by 2050. This initiative included the adoption of the so-called Taxonomy Regulation (EU) 2020/8521, which aims to facilitate private-sector investments in sustainable green projects and to demotivate investments in projects that are not sustainable.

The Association draws attention to a few other factors that have considerable impact. The State Audit Service's report[8] concludes that work towards sustainable development goals in Latvia generally takes place without process leadership, a specific plan, allocation of tasks or division of responsibilities. As a result, public understanding of the goals and their significance remains poor. If no further changes are made, the Organization for Economic Cooperation and Development estimates that by 2030 Latvia will have achieved just 30, or 18%, of all the sustainable development targets.

Also notable are the lack of clear state policy and the inability to implement innovations and digital transformation programmes sufficiently quickly. This applies broadly to the achievement of current climate goals, i.e. the Green Deal, the harmonisation of relevant policies, and the implementation of a circular economy, which would make entrepreneurs aware of how their businesses would be transformed, and enable new businesses to be created.

The green transition is only possible with support from banks, and one of its essential components is the reconstruction of buildings to make them more energy efficient. The Financial Stability Report of the Bank of Latvia also underscores the necessity of increasing the pace of building renovations, including considerable investments in improving energy efficiency and facilitating the construction of new buildings. The informative report drafted by the Ministry of Economics, "Long-term Strategy for Renovation of Buildings"[9] (2020) states that the overall funding necessary for building refurbishments is measured in billions of euros, and cannot be secured without a large amount of bank financing. Notably, the participation of banks in implementing the green transition would be under threat if they are burdened by windfall taxation or by price-limiting factors.

Negative long-term cumulative impact of increasing taxation

Politicians have so far spoken about a banking windfall tax as a temporary instrument for the purpose of balancing the state budget. However, communications disseminated to the public have not mentioned to what extent the state budget would thereby be balanced, and how such a tax would eventually be repealed – once the goal is met, or after a certain period of time.

[7] *https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52023AB0009*
[8] State Audit Office 28.02.2023 compliance report "Are the preconditions created in Latvia for achieving the UN Sustainable Development Goals?"
[9] *https://energy.ec.europa.eu/system/files/2020-11/lv_2020_ltrs_0.pdf*

The information so far shared by politicians and disseminated publicly regarding a banking windfall tax as a tool for balancing the state budget, and the lack of any detailed information being provided (such as on amounts, targets or timing), create doubt regarding whether any arguments concerning the tax are in fact being assessed.

One should be aware that the implementation of a one-off tax has substantial, far-reaching consequences. The lending contraction effect of a banking windfall tax will continue for years to come as a result of investment deficit, which may end up costing the economy and the state budget tens of millions of euros. This capital will not be recouped within a single year. Reduced capital will result in weaker economic development and a lower volume of new loans. If annual changes to taxes are planned, the impact will be even more dramatic. The effects will build up cumulatively year after year, progressively slowing down economic growth, and reducing the volume of new loans and overall tax revenues in the long term.

Banking profitability should be considered with a long-term horizon

While in the eyes of the public, the profits of some banks may appear excessive and their returns on equity may seem very high, the long-term profitability of banks is actually low in comparison to the real economy. If we consider the banking industry of Latvia since the year 2004, the profits of banks have averaged about EUR 133 million per year, for an average return on equity (hereinafter referred to as ROE) of 6.7%. This indicator is considered lower than many other industries. Return on equity in the banking industries in Scandinavian countries and many OECD member-states outside the Eurozone, such as Canada, the U.S.A., Chile, Israel, New Zealand, Australia and the Czech Republic, exceeds 10%.

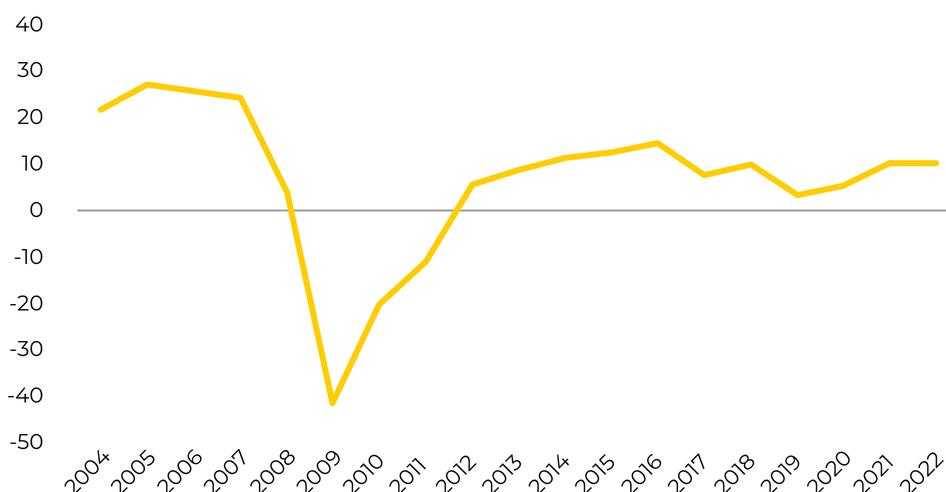


Figure 1

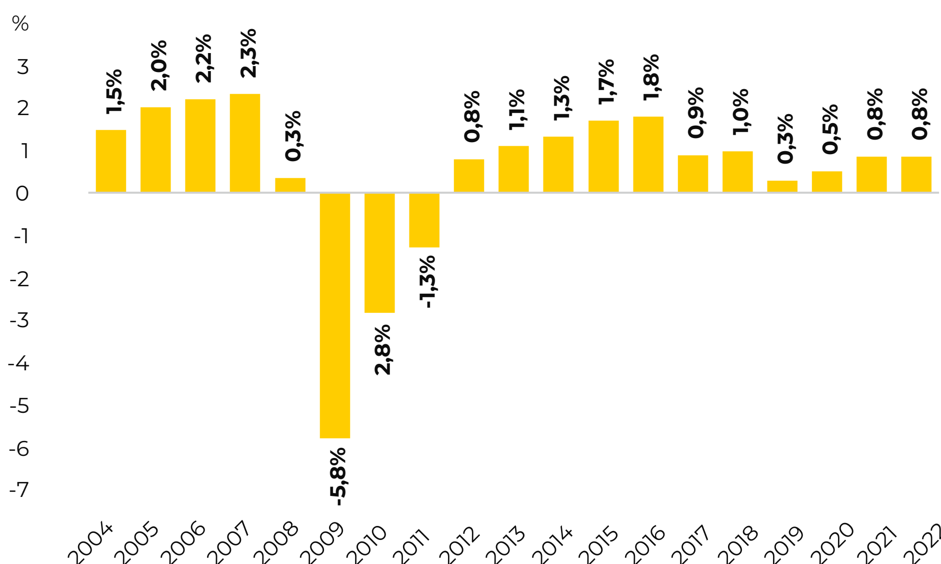


Figure 2

Figure 1 reflects that the banking industry is cyclical, with unstable profitability. This requires capital provision for weaker economic periods. So far, the accumulation of capital buffers in the banking industry has proven its worth, as banks in Latvia did not require external support to overcome the latest two crises (Covid-19, Russia's war in Ukraine).

Windfall profits in the banking sector were generated as a result of a sharp increase in interest rates by the ECB, a measure aimed at curbing inflation in the European Union. With a view to the near future, one should be cognizant that, given higher interest rates, loan interest payments will also increase and, in a negative phase of the economic cycle, loan losses will increase as well. Considering historical data and the uncertain economic environment, there is no reason to believe that high banking profitability would remain at the current high levels in the years to come.

The windfall tax imposed on banks in Lithuania has already been referred to as a Marxist economic approach that could substantially worsen the country's competitiveness. In a hypothetical isolated environment, such experimentation would remain within the boundaries of a specific economy, but in an open world capital has no borders – it flows to where profit opportunities are greater and fixed expenses, which include taxes, are lower. Therefore, following the introduction of a windfall tax in our region, credit institutions will prefer to finance companies that operate in neighbouring states, which will make them the main long-term beneficiaries of such a measure.

Negative impact of the tax on the investment environment in Latvia

The decision to apply supplementary taxation to a single private-sector industry will have a negative effect on foreign investors' perceptions of the investment environment in Latvia. Specifically, by adopting such a decision, politicians would give a clear signal of their willingness to "plug holes" in the country's budget by targeting profitable players in any industry. The adoption of such a decision is a relatively simpler, and more popular, pathway than combating the shadow economy or rooting out real corruption, which require much more hard, thankless work that often goes unnoticed.

The International Monetary Fund's analysis of the situation in Lithuania remarked[10] that, in today's unstable international financial market climate, maintaining financial stability is a major priority. Frequent *ad hoc* changes to taxation in industries that have a significant share of foreign investment weaken the reputation of Lithuania as a stable, predictable and competitive tax recipient.

In early June, the sudden worsening of Latvia's competitiveness was a topic of widespread discussion, and was noted in the International Institute for Management Development (IIMD) Global Competitiveness Centre study. Last year, Latvia was able to climb to the 35th position in this ranking of 64 countries, but stands at number 51 this year, lagging significantly behind both Estonia (26th) and Lithuania (32nd). Of course, the development of any study entails some more or less subjective factors that may affect performance, but the fact that Latvian economic policy is lagging behind is evident from other assessments as well.

For instance, according to a study by the Economist Intelligence Unit, which focuses on the business environment, Latvia is among the countries that have undergone a considerable decrease in the business environment assessment index in the span of the last year. Latvia fell by six positions in the index, mostly because of a worsening labour market situation – the emigration of young specialists and lack of employee skills were cited as factors. The Foreign Investors' Council in Latvia recently published its annual investment environment index, which documented the opinions of investors, and presented an assessment that the investment environment had rather worsened than improved. "Investors believe that the country is in a state of moderate chaos, with no understanding of which way the ship is being steered," said Arnis Sauka, professor at the Riga School of Economics, in his comments to the media on these index findings.

Importantly, entrepreneurs themselves have raised red flags regarding growth opportunities or obstacles to growth in Latvia. Businesspeople cite excessive bureaucratisation, a lack of national policy, and the state's inability to implement innovations and digital transformation programmes sufficiently quickly. These are crucial for the next, eagerly awaited round of lending.

One particularly daunting piece of news related to the possibility of increasing pace of lending is the very poor evaluation by foreign investors. The investment environment in Latvia has worsened, according to Foreign Investment Environment Index from the Foreign Investors' Council in Latvia (FICIL) – one of the conclusions it mentions is the perception of moderate chaos and a lack of specific priorities in the country.

The Association's own Lending Index for Businesses indicates that the capability and willingness of banks in Latvia to finance enterprise, as well as the ability of entrepreneurs to borrow, have improved in the past year; however, the willingness of business to solicit loans has been growing much more slowly. Perhaps many entrepreneurs only develop to the extent that our enterprise environment will accommodate their development without presenting excessive risk. Such entrepreneur attitudes are worrying

[10] *https://www.imf.org/en/News/Articles/2023/06/12/cs-lithuania-2023*

because they increase the risk of failure to acquire funding as part of planned support programmes (Recovery and Resilience Facility funding must be allocated by 2026).

Predictable tax policy that is conducive to business is one of the most powerful instruments in the hands of any government. Investors evaluate tax rates and taxation procedures when they compare different economies from a development standpoint. Taxes may decrease the willingness of local entrepreneurs to establish companies or, on the contrary, become a means of driving more enterprising people to go into business. Thus, experiments with taxation carry a heavy price. The idea of a so-called banking windfall tax means that investors will no longer be able to count on having tax policy that is predictable and consistent with the government declaration. Existing investments could be lost (due to capital flight), and attracting new capital investments and foreign companies to Latvia would become much more difficult.

Negative impact of the tax on the competitiveness of the financial market

Profit is an indicator of the financial health of any company, including credit institutions. Profit should not be cast in a negative light if it has been made in compliance with the law and brings benefit to the public. The contribution of the banking and finance sectors to the development of the national economy by ensuring a variety of financing and investment options is beyond doubt.

If some of the profits made by banks were to be diverted towards supplementing the state budget, it would beg the question of why the discussion only concerns a single industry, i.e. banking. The profits of banks and their taxation should be viewed in the context of profits in other capital-intensive industries, and a fair attitude should be maintained. It is worth keeping in mind that penalising the banking industry will have a negative impact on the entire economy of Latvia and on local businesses in particular. A 23-year overview of the banking industry in Latvia indicates that the average profits of banks were EUR 125 million per year, with a return on equity (ROE) of 5.7%, which is a lower indicator than many other sectors. A review of the historical profitability of banks should consider the fact that some credit institutions that only service foreign (non-resident) clients have operated in Latvia for a long period of time, with returns on equity incomparably greater than the industry average and the relevant indicators in neighbouring states.

The average five-year ROE in banking across Europe ranges from negative values in e.g. Cyprus and Greece (2017–2021 data) to an astounding 13% in Hungary and nearly 12% in Romania. Evidently, return on equity varies by region and country. During the same (2017–2021) period, the ROE of Latvian banks averaged 7.2%, significantly behind Estonia (8.8%) and Lithuania (11.3%)[11]. The indicator has been comparatively higher in the past two years, as the volume of loans issued in Latvia has increased. A comparison of return on equity data in banking and relevant data from other industries reveals that the average returns across all other sectors of the Latvian national economy during the period of 2017–2021 reached 12.7%[12], or nearly twice the ROE in the banking sector.

In addition to the lack of a dutiful analysis of the overall economic cycle and consideration for the fact that other industries do not face the same capital adequacy requirements as banks do, there has been no mention of evaluating the implementation of a windfall tax in other industries, such as the application of a similar tax to major infrastructure and energy companies (Latvenergo etc.), even though the banking segment is also characterised by high rates of capital investments in the order of hundreds of millions of euros. The profits of banks should be assessed in comparison to the profits of other capital-intensive industries. We also draw attention to the fact that capital requirements in the past 10 years have increased by one and a half times on average, and this increase is expected to continue in subsequent years, forcing banks to establish new buffers and expand existing ones. To enable lending at the same scale as previously, credit institutions must increase their capital provisions by half.

Banks are also required to maintain MREL (minimum requirements for own funds and eligible liabilities) instruments that can, whenever necessary, be used to recapitalise a credit institution and implement other regulatory activities should payment difficulties arise. This requirement increases capital requirements by at least 20%. Credit institutions have mostly fulfilled the rising capital requirements by reinvesting profits. Therefore, credit institutions are not on an equal footing with other participants in the financial sector, such as consumer lenders.

[11] Source: European Central Bank. *https://sdw.ecb.europa.eu/browseTable.do?org.apache.struts.taglib.html.TOKEN=af2081f723bb76f40b92fe2b-40f634a7&df=true&ec=1&dc=&oc=0&pb=1&rc=0&DATASET=0&removeItem=&removedItemList=&mergeFilter=&activeTab=CBD2&showHide=&-MAX_DOWNLOAD_SERIES=500&SERIES_MAX_NUM=50&node=SEARCHRESULTS&q=CBD2.A.%3F.W0.67._Z._Z.A.A.I2003._Z._Z._Z._Z._Z._Z.PC&type=series*

[12] Source: Central Statistical Bureau.

The tax will restrict new players' entry into the market

Credit institutions face some of the highest regulatory barriers, which keep new players from entering the Latvian market. In the past 10 years, multiple players have left the market (Krājbanka, GE Money Bank, Trasta komercbanka, Danske Bank, AS LHV Pank Latvijas filiāle, UniCredit Bank, AB LV, PNB Bank, Baltic International Bank), and a number of other market players have merged (DNB and Nordea, Expobank and Signet Bank, Industra and Privatbank).

Any player establishing a new bank must consider that return on equity will initially be lower due to the lack of the scale effect. With a new tax in place, the break-even time for a newcomer bank would be extended further, and new market players would be faced with an even greater barrier to entry.

Banking-specific contributions

In 2022, credit institutions in Latvia paid more than EUR 94 million directly into the state budget, including EUR 89 million in labour taxes. This makes the banking sector one of the largest payers of labour taxes, and it currently employs over 6,000 people.

The Association notes that credit institutions also make a variety of industry-specific contributions, including EUR 21.7 million to the Deposit Guarantee Fund and 5.46 to the Single Resolution Fund (a fund composed of contributions by member-state credit institutions and established by the European Banking Union) in the past year alone. Contributions to these funds are constantly increasing. In April 2023, the Council of the Deposit Guarantee Fund of Latvia decided to double the annual contribution from 2022. Credit institutions further paid the Financial and Capital Markets Commission EUR 7.98 million for supervision of banking activities in 2022, totalling 8% of the contributions made by financial and capital market players. In total, the Association notes that credit institutions paid over EUR 128 million in taxes and other specific contributions in that single year.

Furthermore, the Association notes another major expense item it believes should be repealed. The Association understands the inflation mitigation measures implemented by the ECB and the Bank of Latvia, but indicates that, in addition to rising interest rates, decreasing risks across Latvia's credit institution sector in the past few years, and the irrefutable improvements in financial stability, there is reason to expect (in light of reasons described below) that the fixed costs of operation for credit institutions would decrease – in particular those costs which pertain to supervision of credit institution activities, which has been implemented by the Bank of Latvia since 2023. The risks have gone down, but expenses on maintaining the oversight mechanism have remained unchanged – the highest in the Baltic states.

Firstly, for a number of years now, a proportion of banks' contributions for supervision has been allocated to covering the costs of supervising other financial sector players. The Association reiterates that this procedure is not sustainable and should be revised as soon as is practicable. All financial service providers supervised by the Bank of Latvia should be able to cover the costs of their supervision in full.

Secondly, the budget of the Bank of Latvia supervisory function includes a major expense item: contributions to a variety of international organisations (institutions) such as the European Banking Authority. These payments are increased annually, and the trend will certainly continue in the coming years, as the scope of activities and tasks performed by these international organisations expands. Participation in such institutions is important to the country as a whole, which is why other countries cover such contributions from the state budget.

Thirdly, the Bank of Latvia allocates a lot of effort to drafting policy planning documents and regulatory enactments (primarily laws). The Association believes that this function should not be performed by the supervisory authority but by the institution in charge of shaping financial sector policy, i.e. the Ministry of Finance.

Fourthly, the Association reiterates that the financial stability contribution does not succeed in accomplishing the associated tasks, and credit institutions are currently making regular contributions to the Single Resolution Fund, which was established for regulating credit institutions and restoring their operation. We note that no such contributions exist in the other two Baltic states; they only exist in Latvia.

Finally, the argumentation so far has been that the costs of banking supervision in Latvia are greater because the country is host to multiple credit institutions with high risks of money laundering, requiring governance oversight. Risks have been lowered considerably but oversight expenses have not, ignoring the fact that, as part of the so-called capital overhaul, credit institutions now have new supervisory bodies in charge of preventing money laundering. The Association believes that its proposals would ensure sustainable, comprehensive maintenance of the supervisory function of the Bank of Latvia, and a degree of financial stability that facilitates the competitiveness and sustainability of all financial institutions in Latvia, not just banks. The Association believes that it should cease to be the case that Latvia has the highest supervision costs in the Baltics. The Financial and Capital Markets Commission and the Bank of Latvia, as institutions pursuing a common goal, should consider ways of reducing supervisory costs.

Impact of the shadow economy on national economic development

Shadow economic activity, the accumulation of various debts (including alimony), and disproportionate reliance on large volumes of cash funds – convenient though they might be for both individuals and legal entities, remaining relatively unimpeded and treated with understanding by a large proportion of society and businesses, and even supported at times –exclude a substantial proportion of economic actors from access to credit. According to an observation by the Financial Intelligence Unit, with a relatively high rate of shadow economic activities, the need to legalise the proceeds of illegal activities within the national economy of Latvia increases.[13] Companies routinely enter insolvency proceedings with no property (~60%), and thousands of businesses are liquidated according to a simplified procedure annually. The Supreme Court has already adopted two ancillary decisions urging government to bring order to this area.[14]

According to our own estimates and data gleaned from annual reports, only about 20,000 of all companies in Latvia are actually eligible for consideration of loan applications. This figure basically corresponds with information publicised by the SRS about the number of companies that make payments to the state budget.[15] The involvement of banks in financing the economy is thus directly proportional to the scale of the so-called transparent economy.

The greatest flaw that continues to slow down economic development (including lending) at the corporate level is the pervasiveness of the shadow economy (26.6% in Latvia, 23% in Lithuania, 19% in Estonia). Capital in Latvia is concentrated in so-called legacy industries or in the hands of people of dubious repute. This creates reputational risks for banks, which would prefer not to have their names linked to capital of uncertain origin. To reiterate: only about 20,000 companies in Latvia are worthy of credit. The others are tied up with high or moderate risk, although at least some of them could potentially return to the "green lending zone" and receive development loans. Real action by economic policy-makers is required to decrease the scale of the shadow economy and to educate entrepreneurs about the opportunities for development that they are denying themselves. The development of the state and of commerce is supported by taxation mechanisms, but action needs to be taken in order to reduce the relative share of the shadow economy.

The state must continue its work on reducing the bureaucratic burden on companies, develop a competitive tax regime, and improve the legal environment. In all these matters, the Association will always be a trustworthy partner because such measures would be aimed at increasing the confidence of business, boosting growth ambitions and, consequently, demand for financing, while also increasing the trust that each and every resident has in the state.

Tax as a barrier to lending growth

Inflation in the Eurozone is not decreasing as quickly as initially forecasted. The ECB is taking further steps to mitigate inflation, which includes raising interest rates. In the case of lending, this has the effect of lowering demand for loans and decreasing volume of borrowing. The policy implemented by the ECB has had the following consequences:

- the interest rate revenues of credit institutions, including income from loans issued to clients, have increased substantially
- borrowers' payments to service loan obligations have risen

To reduce the impact of the ECB's policies on borrowers, credit institutions in Latvia are accommodating clients by implementing a variety of measures such as:

- decreasing or waiving lending service fees when clients have to introduce changes to an agreement
- lowering interest rates on "green" loans
- raising rates on term deposits when the ECB adopted decisions to raise base rates
- providing savings account services of a kind unique to the Baltics

Despite the policies enacted by the ECB, the volume of loans issued by credit institutions in Latvia exceeded 15.4 billion euros as of 30 June 2023.

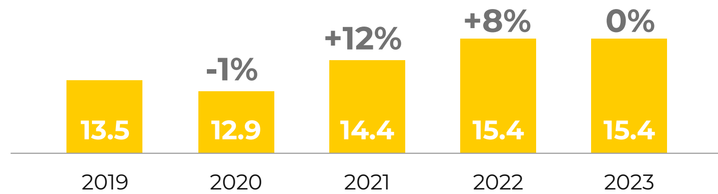
[13] See: *https://fid.gov.lv/uploads/files/Dokumenti/Riska%20zi%C5%86ojumi/Nacion%C4%81l%C4%81%20NILLTPF%20risku%20nov%C4%93rt%C4%93juma%20zi%C5%86ojuma%20kopsavilkums.pdf*

[14] See: *https://www.financelatvia.eu/wp-content/uploads/2022/12/mn-vl-materials-diskusijai.pdf*

[15] See: *https://www.db.lv/zinas/no-130-000-registretiem-uznemumiem-nodoklus-pilniba-maksa-vien-20-000-510619*

Lending trends in Latvia

The volume of loans issued by commercial banks exceeds €15.4 billion



€9 billion

loans issued to companies

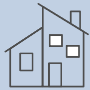
€6 billion

loans issued to private individuals

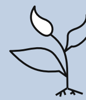
~€4,7 billion

- **For the purchase of a dwelling or land**
- **for the repair of the dwelling**

THE BIGGEST BORROWERS IN 2023



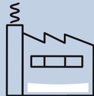
Real estate companies
€1655 million



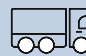
Agricultural and forestry companies
€895 million

Trading companies
€750 million

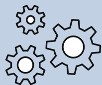
Energy companies
€392 million



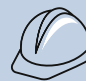
Processing industry companies
€668 million



Transport and logistics
€493 million



Administrative and servicing institutions
€207 million



Building companies
€257 million

The balance of the portfolio of commercial banks as of July 31, 2023

Contrary to recently voiced opinion and regardless of the ECB's policies, which have logically had the effect of slowing down demand, the results indicate an increase in volume of lending across the small, medium and large enterprise segments. Credit institutions continue to grant financing to businesses in Riga and beyond. At the end of June this year, loans granted to companies registered outside Riga totalled 39% of the total volume of loans.

The information compiled and research conducted by the Association dispel the myth that credit institutions are not providing credit. The data directly show that Latvian credit institutions have continued to lend successfully across Latvia, in spite of the policy pursued by the ECB.

The Association notes that increased growth of lending is not just the responsibility of credit institutions. Rising volume of lending hinges on a country's business environment, the scale of the shadow economy, the degree of legitimate expectation that entrepreneurs have, and other factors that influence business activities and demand for loans.

Another point of note is that, to facilitate borrower activities and increase the volume of lending as economic development resumes, the Association has devised and presented to state authorities an action plan for facilitating lending. The industry has defined three priority areas as having the greatest lending potential – weatherisation of blocks of flats, green lending, and financing for private-public partnership projects. According to industry estimates, EUR 3.3 billion in financial sector funding is available for lending in these areas in 2023. The industry's lending plan included references to action that the public sector should take, since its active involvement is of paramount importance to executing this plan, and the Association is hopeful that the necessary steps will be taken.

Industry proposals for increasing the rate of lending

It is a generally known fact that the regulation of lending became much stricter in the wake of the previous financial crisis in order to protect borrowers, credit institutions and depositors. However, lending has become more cumbersome, as a result of which the competitiveness of the European Union has decreased in this sector. The Association has been pointing out to competent institutions for a long time a number of legal reasons for why development of lending has been lagging, but this activity has not achieved meaningful action by the authorities to improve regulation.

The Association stresses the fact that the problems in regulation, in combination with other circumstances, have considerably delayed the development of lending in Latvia. The regulation of credit institutions represents only some of the factors that affect lending in the national economy and the availability of financial services. There is an indirect, but quite substantial effect from other regulations as well, such as those specifying the operations of corporations, matters of pledges and collateral, debt collection etc. For over 10 years, the Association has been stressing that, unless comprehensive, effective solutions are introduced to resolve issues with the legal environment (not just regarding regulatory enactments, but – more importantly – the practical application of regulations), then the issues that are already clear to see today will inevitably lead to:

- low risk appetites, being the only way for credit institutions to manage risk in a controlled fashion
- higher costs of lending

It is of critical importance to make changes to the regulations on corporate operations, pledges and control, debt collection and related matters.

As the priority that credit institutions have as secured creditors is reduced, and the business environment still fails to exhibit a sufficiently high degree of responsibility and a conscientious, good-faith culture of fulfilling obligations, lending remains subject to elevated risks. This could result in higher interest rates due to the expectation of non-recoverable losses. The current legal environment does not foster assurance that lost funds will be recovered effectively and within a reasonable period of time.

We reiterate that shadow economic activity, the accumulation of various debts (including alimony), and disproportionate reliance on large volumes of cash funds – convenient though they might be for both individuals and legal entities, remaining relatively unimpeded and treated with understanding by a large proportion of society and businesses, and even supported at times – exclude a substantial proportion of economic actors from access to credit.

Credit institutions have urged the possibility of notaries handling all activities related to the Land Register themselves to be considered – which would help reduce corroboration costs and promote mobility on the housing market – or of allowing re-registration of bank pledges using a secure electronic signature only. The reduction of Land Register duties should continue, since these fees often deter people from deciding to acquire heating.

On multiple occasions, the Association has indicated to the responsible authorities the mentioned regulatory flaws – which act as a major hindrance to increasing the pace of lending – but has not seen public sector action in this regard so far.

Summary/conclusions

- Banks in Latvia are currently well capitalised. Capital buffers in excess of regulatory requirements are maintained so that banks do not need state support in difficult times and can continue to issue loans.
- The imposition of a banking windfall tax would impair banks' capacity to attract capital. As a result of such a decision, banks would be forced to either reduce the amount of loans being issued in order to maintain high capitalisation, or to decrease their capital buffers in order to maintain lending at present levels. Such a decision would not accomplish an increase in the pace of lending.
- With reduced capital, the banking sector becomes less protected and less capable of financing the economy, particularly in periods of economic downturn, when the impact of (non-)lending is particularly severe.
- The economy of Latvia is financed primarily by banks[16]. Businesses and households are having difficulties finding alternative means of attracting capital on equivalent terms. Therefore the new tax will reduce the volume of new lending and thus the growth of businesses.
- The lending contraction effect of a banking windfall tax would continue for years to come as a result of investment deficit.
- Increased tax burdens would force banks to revise their business models, which could result in reduced availability of services to clients and/or higher prices. A new tax would also have a major impact on the future growth opportunities of local banks, which are currently growing at a very fast pace but depend much more heavily than international players on access to equity. As a result, competition on the Latvian banking market could decrease.

[16] World Bank statistics indicate that the volume of loans issued to the private sector constituted 31.2% of GDP in 2021: *https://data.worldbank.org/indicator/FS.AST.PRVT.GD.ZS?locations=EU-LV&name_desc=false*

- The decision to apply supplementary taxation to a single private-sector industry would have a negative effect on foreign investors' perceptions of investment opportunities in Latvia. Specifically, by adopting such a decision, politicians would give a clear signal of their willingness to "plug holes" in the country's budget by targeting profitable businesses. The adoption of such a decision is a relatively simpler, and more populist, pathway than combating the shadow economy, which requires much more hard, thankless work that often goes unnoticed.
- The profits projected for the banking industry in 2023 are exceptional and result from the sharp ECB interest rate hike, aiming to curb high inflation across the European Union. In subsequent years, profit indicators will most likely be significantly lower.
- A new tax would delay the success of the "green transition" to greater energy efficiency, including private-public partnership projects – the priorities defined by the financial sector[17]. The implementation of such projects hinges on the availability of credit resources, which depend on the volume of available capital.
- The Association underscores that the long-term effect of policies implemented in certain areas has a significant effect on the attitudes of entrepreneurs. Politicians should take political responsibility for not having political strategies and implementation plans in areas that matter to entrepreneurs. The performance of banks in Lithuania and Estonia indicates greater demand for financing, which is grounded in the implementation of more consistent political strategies.

Recommendations:

To summarise the aforementioned, the Association reiterates that increasing growth of lending is not the sole responsibility of credit institutions. It is and will remain dependent upon the business environment, the scale of the shadow economy, entrepreneurs' legitimate expectation and other factors that influence business activities and demand for loans. **Consequently, the Association makes several recommendations to supplement its numerous prior calls for improved legal regulation.**

1. The Association encourages further work on curbing the shadow economy and reducing the bureaucratic burden on companies, developing a competitive tax regime, improving the legal environment to facilitate businesses' confidence, growth ambitions and demand for financing, as well as to boost the level of trust that residents have in the state.
2. The Association proposes the development of a tax mechanism to promote the energy efficiency of apartment buildings, e.g. by providing real estate tax relief for energy-efficient properties, and enhancing procedures to simplify decision-making on questions regarding improving the energy efficiency of blocks of flats.
3. There is also great lending potential in the financing of public-private partnership projects; there are few such projects at the moment. The Association suggests increasing the capacities of construction companies and project developers. There are not enough large, capable construction companies or project developers in Latvia to meet the experience, capability, capital and reputational demands for implementing projects of such a magnitude.
4. The Association notes that regulations should ensure that all participants of the financial market cover the costs of their supervision, eliminating mutual subsidies. The Association further suggests covering payments for Latvia's participation in international organisations from the state budget rather than the budget of the Bank of Latvia.
5. The Association believes that, as a supervisory authority, the Bank of Latvia should not be involved with the development of policy planning documentation and regulations, primarily laws. The Association recommends immediate action to have the Bank of Latvia transfer this function to the Ministry of Finance, which is in charge of financial sector policymaking.
6. The Association once again, having considered the proposals to amend the tax regime for credit institutions, recommends cancellation of the financial stability fee because it does not meet its specified goals; furthermore, credit institutions are currently making regular payments to the single resolution fund, which was established with the specific purpose of regulating credit institutions and restoring operations. This sort of fee does not apply in either Estonia or Lithuania; it is unique to Latvia.
7. The Association's position is that the situation with Latvia having the highest supervision costs in the Baltics should not be allowed to persist. The Financial and Capital Markets Commission and the Bank of Latvia, two institutions united in the same line of work, should take care to reduce supervisory expenses as well. The Association urges these institutions, in cooperation with other competent institutions, to act immediately so that, within the framework of existing regulation – or by amending it if necessary – the burden of monitoring (regulatory) costs is reduced for credit institutions, thereby enabling banks to reduce their operational expenses and provide greater support to their clients by seeking sustainable and socially responsible solutions.
8. The Association reiterates its support for considering a proposal that would have notaries carry out all actions pertaining to the Land Register. In the Association's opinion, the implementation of such a proposal would help reduce corroboration costs and promote mobility on the housing market. The Association further encourages consideration of the proposal to allow re-registration of bank pledges using a secure electronic signature only. Land Register duties, which often deter people from deciding to purchase housing, need to be further reduced.

[17] *https://www.financelatvia.eu/news/kreditesanas-kapinasanai-bankas-pieejami-33-miljardi-eiro-nozare-definejusi-prioritaros-virzienus/*

III. Mortgage loans and EURIBOR

In addition to publicly voiced proposals to implement a windfall tax, politicians have made announcements[18] of possible action scenarios for supporting mortgage borrowers in an environment with rising EURIBOR rates. Jānis Reirs, chairman of the Saeima Budget and Financial (Taxation) Committee, has proposed two potential solutions for reducing mortgage interest payments:

- having the law, temporarily, define a specific lower rate instead of EURIBOR, which could range from 1.5 to 2 per cent
- impose a temporary, or fixed-term, moratorium on interest rates set by credit institutions

Signatures are currently being gathered on the public initiative platform Manabalss.lv to submit an initiative to the Saeima seeking to prevent banks from raising EURIBOR rates on previously issued loans[19].

The Association believes that the aforementioned proposals could have a cumulative effect on capital and liquidity, both during the current lending cycle and in subsequent cycles. In other words, the windfall tax being considered by politicians would reduce the funds which credit institutions have available for issuing loans and which they require for managing risks, while restrictions on fixed and/or floating interest rates would simultaneously limit the source of income and capacity to manage interest rate risk, which would result in cumulative effects that could ultimately lead to solvency issues. These proposals and initiatives regarding matters of mortgage lending are related, so the Association believes it necessary to explain what significant risks could manifest if the relevant solutions and/or initiatives are adopted, and begins by stating general considerations.

Peculiarities of the activities of credit institutions compared to other forms of business

In developing or amending legal regulations which, among other things, target or apply to credit institutions, one should consider that the effects of regulation cannot be assessed in a narrow sense limited to specific financial institutions – spanning, for instance, the largest credit institutions in Latvia based on total assets. The impact of regulation should be evaluated with regard to the entire financial sector – "The business activities of a credit institution are considered in the context of potential impact on the entire financial sector and on the national economy as a whole."[20] This consideration stems from a number of clarifications provided by the Constitutional Court: "The operations of a credit institution are always evaluated in the context of its potential impact on the entire financial sector and on the national economy, ensuring the stability of the financial sector and the protection of depositors' interests."[21]

The capability of a credit institution to provide various financial services to individuals, and to provide credit to the national economy at large, stems from multiple factors, which include the volume of deposits held by the credit institution, the risks it has taken on, and the flexibilities that enable the management of these risks without artificial barriers. One of the operational indicators for a credit institution is its capital adequacy. A credit institution is obliged to maintain capital at levels sufficient to ensure the coverage of all significant risks inherent to its activities, as well as to enable the coverage of losses in the event of potential adverse events. In determining the amount of capital necessary for risk coverage (risk weighting), a credit institution evaluates the substantial risks inherent to its activities, including credit risk.

The commercial activities of credit institutions are highly specific, so comparing them to other forms of capital adequacy is inappropriate. The peculiarities of this activity stem from the fact that credit institutions operate with the funds entrusted to them as deposits attracted from clients. It is critical for a credit institution to be able to operate while managing the risks inherent to its activities. In its case law, the Constitutional Court has also indicated that "an essential element of the commercial activities of a credit institution is adequate risk management, which is related to the subsequent lending of these funds to other parties or to other financial markets"[22]. Thus, in discussions with the public sector, the Association has always asserted the necessity for legal regulations that would enable effective risk management without producing an excessive administrative burden. The proposals made by the Association for increasing the pace of lending, including the establishment of a legal framework for more effective risk management, are provided in the section dedicated to industry proposals for increasing the pace of lending.

[18] LSM.lv – "Reirs: the law should temporarily reduce interest payments under mortgage loans". Retrieved from *https://www.lsm.lv/raksts/zinas/ekonomika/10.08.2023-reirs-likuma-uz-laiku-janosaka-samazinati-procentu-maksajumi-hipotekarajiem-kreditiem.a519661/*

[19] Manabalss.lv – "Prevent banks from raising EURIBOR rates on existing loans." Retrieved from: *https://manabalss.lv/euribor-likmes-kompensacija-hipotekas-kreditnemejiem/*

[20] Constitutional Court decision No. 2010-60-01 of 30 March 2011, Paragraph 22.

[21] Constitutional Court decision No. 2012-07-01 of 1 March 2012, Paragraph 15.2.

[22] Constitutional Court decision No. 2014-02-01 of 13 June 2014, Paragraph 14.4.

Awareness of borrowers

EURIBOR stands for Euro Interbank Offered Rate. It is the average interest rate at which European banks borrow funds from one another on the European Union interbank market. EURIBOR is the *de facto* purchase price a bank is due to pay for a short-term loan, and it is often referred to as the cost of money. Credit institutions use such funds to issue loans to other parties, and in this case EURIBOR represents part of the overall interest rate on various loans issued by credit institutions to individuals and companies, i.e. the variable component of an interest rate.

Current public discussion most frequently includes mention of borrowers allegedly surprised by the increase in monthly loan payments due to the EURIBOR increase. Therefore, politicians are turning to credit institutions for explanations. The Association clarifies that the current legal regulations oblige credit institutions, prior to issuing a loan, to notify a potential borrower about the potential risks of floating rates. For instance, a Cabinet regulation[23] specifies that a credit institution is obliged to include clear, unambiguous indications to this effect, according to the attachment to the aforementioned regulation (see example below).

6. Amount of each instalment

[..] EUR

Your income may change. Please consider whether you will still be able to afford your monthly repayment instalments if your income falls,

The interest rate on this loan may change. This means that the amount of the instalments you are due to pay may either increase or decrease. The monthly payment specified herein will remain unchanged for the specific period for which EURIBOR is determined. Subsequently, the amount of a monthly instalment will change at the end of each such period, and will depend on the EURIBOR value valid at the time. For instance, if the six-month EURIBOR increases to 5.448% per annum (which would be the highest value this rate has had since 01.01.2001), your instalments could increase to [..].

Cabinet Regulation No. 691 of 25 October 2016
"Regulations Regarding Consumer Credit", Annex 2, Chapter 6

On data-driven decisions

Legal regulations specify that the basis for issuing each loan is an assessment of the capability of a borrower to fulfil the obligations undertaken in the event of substantially increased interest rates and reduced income. Credit institutions observe the principles of responsible lending, which include the range of actions to be taken in order to seek the best solutions for clients facing payment difficulties on a case-by-case basis.

This effective approach remains unchanged. In deciding on support measures for mortgage borrower, the facts of the matter should be considered, and the decision should be grounded in data. Although the credit portfolio is trending upward in overall size, the general borrowing levels among Latvian residents are the lowest of all economically developed countries. This leads to the conclusion that negative effects of the European Central Bank's interest rate increase will be lower in Latvia than in other OECD member-states.

The raising of interest rates may result in certain borrowers facing difficulties with their monthly payments. However, as is evident from the data analysis conducted by the Association, the number of such persons is not high, and such cases should be subjected to a proportionate individual response, as already stipulated in the applicable legislation – instead of granting support to those with large savings and sizeable income.

The Association's data analysis indicates that mortgage loans in Latvia have been taken out by no more than 124,420 parties (including both borrowers and co-borrowers), with the total residual value of the loans at EUR 4.6 billion. For an average of 72% of borrowers, the monthly payment has increased by EUR 100 or less, and monthly payments in under 60% of agreements total less than EUR 350. An analysis of the credit portfolio reveals that the number of borrowers in arrears on their payments is less than 0.5% and has not been increasing. The number of borrowers facing possible difficulties in the foreseeable future will not exceed 1%, and such a quantity would be better served by a case-by-case approach, as opposed to a moratorium for all borrowers as seen during the Covid-19 pandemic. This is corroborated by the debt-service-to-income ratio (DSTI), which is less than 25% across the portfolio on average, with the maximum threshold value being 40%.

We would further like to stress that banks are already working with clients facing payment difficulties (such as loss of work, prolonged illness, dramatically reduced income in the family etc.), and are seeking solutions that best match each particular situation, helping resolve the payment difficulties with a long-term perspective.

[23] Cabinet Regulation No. 691 of 25 October 2016 "Regulations Regarding Consumer Credit".

The number of bank clients with the potential for payment difficulties has not increased – as a matter of fact, it is lower than in the previous year.

The most typical solutions (which may also be combined and applied simultaneously) offered by banks and chosen by clients are:

- deferral of principal repayment
- extension of the term of an agreement
- merging small loans into one larger loan
- other individual solutions (e.g. interest rate revision)

Notably, bank clients refuse refinancing solutions because they would prefer their loans not to be registered as delinquent.

In the past 20 years, EURIBOR has three times been at or above present levels. Economically developed countries have not fundamentally altered the principles on which the financial system operates, and have not accepted proposals to artificially limit EURIBOR rates.

On the goal and consequences of potential solutions

Because the proposed solutions (temporarily replacing the EURIBOR with another, legislatively determined rate; instituting a fixed interest rate ceiling in the form of a moratorium; freezing of periodic EURIBOR fluctuations for loan agreements concluded previously) have the goal of reducing interest rate payments under mortgage loans, the Association presumes that the purpose of such state intervention is to protect the welfare of vulnerable groups of society, i.e. protecting them from increases in monthly mortgage loan payments.

The Association notes that the proposed solutions would substantially exceed this goal – the support would target all borrowers, regardless of their solvency at the time. State support should not be generalised and applicable to everyone, because its purpose is effective resolution of specific issues, or facilitating the development of certain social groups or sectors of the economy. Some of the proposals, or combinations thereof, would infringe upon credit institutions' right to own property under Article 105 of the Constitution, requiring review of the constitutionality of such solutions, particularly whether the set goal is achievable by other means. In assessing whether the goal may be achieved by other means, especially means that would pose a lesser infringement of the rights and legitimate interests of other parties, it is essential to note this: the Constitutional Court indicates that "a more sparing measure is none other than such means by which the legitimate goal may be accomplished to at least the same standard of quality"[24].

If the legislator adopts one of the solutions currently being discussed, which would oblige credit institutions to reduce or freeze some interest rate component, this would not only subject the state to the risk of potentially infringing credit institutions' right to own property, it would also produce negative consequences for borrowers. In other words, unless an individual assessment of each borrower is carried out with the aim of seeking the best solution for overcoming payment difficulties in the face of increasing loan instalment totals, and a general state-mandated solution is applied for all borrowers, there is a high risk of such loans being classified as forborne exposures going forward.

Loans with lowered interest rates would, according to ECB requirements, be defined as forbearance (i.e. loans refinanced due to financial difficulties) under EU Regulation No. 575/2013 (hereinafter referred to as CRR) Article 47b, and the reduced interest rates for affected clients would qualify as indicators of default (CRR Article 178; EBA/GL/2016/07). The Association indicates the ensuing consequences would be as follows:

- Indicators such as restructured obligations and delinquency status would negatively impact a client's capacity to borrow for multiple years. Further borrowing by individuals in Latvia would be made more difficult in general.
- Widespread application of restructuring and delinquency status would cause chaos in the Bank of Latvia Credit Register, complicating reporting and precluding the differentiation of clients who had had their loans restructured for rightful reasons from affected clients. The quality of mortgage loan portfolios would no longer be amenable for objective assessment, and the requirements of CRR could not be satisfied.
- A major negative impact on bank capital (it would need to be tripled) and provisions for expected credit losses is expected, which would make meeting capital adequacy requirements more difficult. The Single Resolution Board has defined the individual minimum requirement for own funds and eligible liabilities (MREL), which is expressed as a percentage of the total value of risk-bearing transactions; fulfilling this requirement in new circumstances would require banks to borrow additional funds at the current cost of resources on the market. Meanwhile, banks would have to at least partly compensate for the artificial EURIBOR reduction imposed by the state at the expense of interest rate premiums. As a result, new lending would become more expensive and/or less extensive.

[24] Constitutional Court decision No. 2004-18-0106 of 13 May 2005, Paragraph 19.

- Additional capital requirements would impair the opportunities for credit institutions to establish additional capital provisions and increase their resilience to further economic shocks; this would, in turn, have a negative effect on the entire banking industry and on financial stability.[25]
- At the 19 July 2023 session of the banking Macro-Supervision Council, during a discussion of major systemic risks to financial stability, and the macro-supervision policy activities necessary to facilitate financial stability, the conclusion was reached that the financial indicators of the banking sector are positive, and the present circumstances are suitable for increasing resilience in the banking sector. The Macro-Supervision Council therefore proposes the introduction of a so-called positive neutral counter-cyclical capital buffer[26], a measure that has been gaining increasing international support. The Macro-Supervision Council suggests the adoption of a decision whereby the requirement of a counter-cyclical capital buffer set at 0.5% would take effect in December 2024 and be increased to 1.0% in June 2025.
- EURIBOR capping and fixation could bring bank activities into non-compliance with external regulatory requirements, which oblige banks to factor all lending-related expenses into the cost of credit that an institution forecasts until the next revaluation date or the maturity of a loan – including the cost of capital (economic capital as well as regulatory capital requirements) and resources.[27]
- EURIBOR capping and fixation would reduce rates on deposits because, if loans bring in lower income, lower rates will be paid on deposits as well.
- EURIBOR capping and fixation would make the issue of new loans unprofitable for a credit institution, because investing in the bonds of other countries would bring better returns.

The Association brings attention to the fact that the goals being pursued by politicians may appear noble – decreasing the amount of monthly interest payments on loans by for borrowers – but that such a local interpretation of how "waiving some part of profits on interest rates" would not make a loan forborne, which is not grounded in regulation, does not change the generally accepted understanding of what constitutes a forborne loan.

It is the Association's opinion that the proposed action scenarios pertaining to the increased EURIBOR for mortgage borrowers have not been subjected to adequate evaluation. This is corroborated by the lack of discussion organised on the matter in e.g. working groups that would include industry experts, and have politicians or representatives of the legislator to hear the arguments of the industry. Such consultation with industry experts would have facilitated an understanding of how implementing the scenarios related to EURIBOR would not promote lending or ensure growth of the national economy in a way that does not pose a potential threat to financial stability, competition among providers of financial services, and the credit histories of borrowers, i.e. their ability to borrow going forward. Appropriately organised discussions would have enabled industry representatives to indicate specific goals that might manifest if one of the proposed scenarios were to be adopted.

Summary/conclusions

- The current proposals may have a cumulative impact on capital and liquidity during the current lending cycle and in subsequent cycles. Arbitrary limitations on fixed and/or floating interest rates will halt revenues and affect the capacity to manage interest rate risk, the cumulative effect of which could ultimately lead to solvency issues.
- Some of the solutions proposed, or combinations thereof, may infringe credit institutions' right to own property, and would therefore require a constitutionality review.
- The legal regulations of credit institutions already stipulate that, prior to issuing a loan, information must be given to a potential borrower about the potential risks of floating rates, and clients must be aware of these risks.
- Banks are open to cooperation with clients that have encountered payment difficulties, and propose a variety of solutions to them.
- An analysis of the credit portfolios reveals that the number of borrowers in arrears has not been increasing. The number of borrowers possibly facing difficulties in the foreseeable future should not exceed 1%, and such a quantity would be better served by a case-by-case approach, as opposed to a moratorium for all borrowers as was seen during the Covid-19 pandemic.
- The overall rate of lending among residents of Latvia is at the lowest level of all economically developed countries, so the negative effects of the interest rate increase by the European Central Bank are expected to be less pronounced in Latvia compared to other OECD member-states.

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[25] Note: this conclusion stems from "Opinion of the European Central Bank of 4 April 2023 on the imposition of a temporary solidarity contribution (CON/2023/9)". Retrieved from: *https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52023AB0009*

[26] Bank of Latvia: Macro-Supervision Council believes circumstances are valid for increasing capital provisions in the credit institution sector. Retrieved from: *https://bank.lv/aktualitates-banklv/zinas-un-raksti/jaunumi/16537-makrouzraudzibas-padomes-vertejuma-ir-piemeroti-apstakli-kreditiestazu-sektora-kapitala-rezervju-papildinasanai*

[27] Note: see Financial and Capital Markets Commission normative regulation No. 242 "Normative regulations for managing credit risk" Clause 69.[1] and European Banking Authority Guidelines on loan origination and monitoring (EBA/GL/2020/06) Paragraph 202.

- There is a high risk that – if no individual assessment of the situation of each borrower is carried out in order to seek the most suitable solution for overcoming difficulties with payments in the face of increasing loan instalments, but instead a single state-mandated solution is implemented that applies to all borrowers – such loans will subsequently be considered restructured loans.
- Loans with lowered interest rates are, according to ECB requirements, defined as restructured due to existing or potential financial difficulties encountered by clients, and a reduction in interest rates for affected clients would be qualified as a sign of default. Default status would impact a client's borrowing opportunities for many years.
- Wholesale application of restructuring and default status would cause chaos in the Credit Register of the Bank of Latvia, complicating reporting and precluding the differentiation of clients who had had their loans restructured for rightful reasons from affected clients. The quality of mortgage loan portfolios would no longer be amenable for objective assessment, and the requirements of CRR could not be satisfied.
- A major negative effect on banks' capital and provisions for expected credit losses would greatly complicate adherence to capital adequacy requirements.
- Financial indicators in the banking sector reflect successful operation and enable further improvements to resilience in the banking sector. This is corroborated by the proposal of the Macro-Supervision Council to introduce a positive natural counter-cyclical capital buffer[28] – a measure that has been gaining increasing international support.
- EURIBOR capping and fixing may bring the activities of banks into non-compliance with external regulatory requirements, which oblige banks to factor all lending-related expenses into the cost of credit, according to each credit institution's forecasts until the nearest revaluation date or until loan maturity.

Proposals

1. The Association encourages politicians and the legislator to evaluate the arguments put forward by the financial sector – and major potential risks that might manifest if the proposed solutions and/or initiatives are implemented – before further decisions are made.
2. The Association encourages the clients of credit institutions that might face payment difficulties to contact the banks that have issued loans to them, and to agree upon solutions to their situations.

[28] Bank of Latvia: Macro-Supervision Council believes circumstances are valid for increasing capital provisions in the credit institution sector. Retrieved from: *https://bank.lv/aktualitates-banklv/zinas-un-raksti/jaunumi/16537-makrouzraudzibas-padomes-vertejuma-ir-piemeroti-apstakli-kreditiestazu-sektora-kapitala-rezervju-papildinasanai*