ISSN 1691–1202

FINANCIAL STABILITY REPORT

2 • 2003

LATVIJAS BANKA

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Sources: the Central Statistical Bureau of Latvia, the Financial and Capital Market Commission, the Latvian Leasing Association, LURSOFT (Database of the Republic of Latvia Register of Enterprises) and the Bank of Latvia.

Charts have been compiled on the basis of data provided by the Bank of Latvia (Charts 1–11, 14, 18, 21–23 and 27–31), the Financial and Capital Market Commission (Charts 12, 13, 15–17, 19 and 20), the Central Statistical Bureau of Latvia (Charts 24 and 26), LURSOFT (Chart 25), Eesti Pank, Banco de España, Sveriges Riksbank, *Bank of England and the European Central Bank (Chart 28), and the Latvian Leasing Association (Charts 29 and 32–34). Tables have been compiled on the basis of data provided by the Bank of Latvia (Tables 1–3) and the Financial and Capital Market Commission (Table 3).*

CONTENTS

EXECUTIVE SUMMARY

In the second half of 2003, Latvia's economy continued to develop buoyantly. In comparison with the previous period, the increase of inflation was primarily driven by the high euro exchange rate, growth in administratively regulated prices and changes in the rates of excise duty and value added tax. Although economic development in Europe remained sluggish, demand for Latvian goods increased on external markets and competitiveness was preserved. However, with domestic demand and, consequently, also imports of goods expanding rapidly, the current account deficit grew in 2003. The growing current account deficit that is financed from foreign capital deepens the dependence of Latvia's economy on investors' risk assessment and aggravates risks. Therefore, it is important to further reduce the budget deficit and maintain high lending standards of banks, limiting the growth of private consumption.

The second half of 2003 was marked by banks increasingly diversifying their corporate loan portfolios, with loans expanding to sectors where banks have lower exposure (real estate, renting and business activities, construction, and agriculture, hunting and forestry). Corporate sector credit risk diminished, as enterprises developed successfully and the financial indicators of trade sector enterprises, which are the major borrowers from banks, improved.

Banks' exposure to households was relatively low, and the household debt-to-disposable income ratio was also lower than in other countries; therefore, the risks related to these loans do not pose any threat to the stability of the banking sector. With foreign currency denominated loans expanding, currency and interest rate risk exposures of households grow.

Stabilisation of the overall margin and the rapid expansion of lending reflected further tightening of competition, as banks continued to attract new clients by offering better terms and conditions for loans (longer maturity, free of charge evaluation of loan application and early repayment possibilities).

With banks continuing to expand their borrowing abroad, the dependence of Latvian banking sector and, consequently, also economy on non-resident capital grew. Non-resident related credit risk, in turn, remained low as claims on non-resident non-banks were relatively modest.

Although competition increased, bank profitability remained high and asset quality continued to improve, partly driven by expansion of lending.

In 2003, capitalisation level of banks decreased, albeit remaining above the required minimum and will be sufficient to cover contingent losses, if necessary. Further expansion of loan portfolio, however, will require an increase in the banks' capital.

Expansion of lending pushed up liquidity risk slightly; nevertheless, overall liquidity ratios were sufficiently high, especially for banks servicing non-residents.

In 2003, the leasing and factoring portfolio of leasing companies developed at a slower pace than banks' loan portfolio, as leasing companies specialise in granting short-term leases; therefore, leases for purchasing real estate did not increase significantly.

1. EXTERNAL ECONOMIC ENVIRONMENT AND ECONOMIC DEVELOPMENTS IN LATVIA

Although economic development in Europe remained sluggish, demand for Latvian goods increased on external markets and competitiveness was maintained.

In the second half of 2003, global economy started to recover. Economic activity in the US, Japan and the euro area picked up. The key interest rates in the US and the euro area, however, remained unchanged, whereas the Bank of England, in response to the steep growth in demand, raised its repo rate by 25 basis points (to 3.75%).

Optimism dominated the stock markets fostered by continuously improving economic indicators. Despite the occurrence of several corporate scandals in Europe and in the US, stock markets continued to expand.

The most significant changes in the foreign exchange markets started at the end of September 2003. One of the impulses for such market developments was the view held by finance ministers and central bank representatives of the largest world countries that the financial markets required higher exchange rate flexibility. During the last two months of 2003, the US dollar weakened considerably against all major currencies in the foreign exchange markets.

According to producer survey data, a rapid recovery of the US industrial sector continued in the second half of 2003. The industrial production output grew, and business confidence in the US services sector and consumer confidence also improved. Nevertheless, GDP growth rate was slower in the fourth quarter (4.0%) in comparison with the record-high rise in the previous quarter (8.2%). Private consumption remained one of the main driving forces of GDP growth; however, its growth rate also decelerated, partly because of the less pronounced tax cuts effects at the end of the year compared to the third quarter. With a sharp increase in exports, the trade deficit shrank significantly. Analysts explain this unexpected rise in exports with the strengthening of the global demand (especially in Asia) and the significant depreciation of the US dollar. The labour market still remained sluggish. Initial jobless claims started to decrease gradually, and the number of new jobs remained broadly unchanged at the end of the year. The US Federal Reserve repeatedly stressed that improvement of the labour market is one of the most significant prerequisites for raising the base rate. In the absence of such improvement, the target for the federal funds rate set by the US Federal Reserve has remained low (1.0%).

Euro area economy developed at a slower pace; in the third and the fourth quarter of 2003, GDP grew by 0.3% and 0.6%, respectively. The outcomes of the business confidence survey in manufacturing and services improved in the last months of 2003. According to the surveys of the European Commission, consumer confidence remained broadly unchanged in the third and the fourth quarter. Consumers became slightly more pessimistic in assessing their future financial position; yet, the overall evaluation of the economic situation remained unchanged and that of employment prospects even improved.

During the last months of 2003, the economic activity in the UK accelerated. A rapidly increasing retail trade turnover indicated that GDP growth was driven by private consumption. Denmark and Sweden also experienced expansion of the economic activity.

The economies of the Central and Eastern Europe continued their recovery in the second half of 2003, significantly influenced by improving terms of trade and external economic environment. The strong euro still had a favourable impact on Polish exporters. Private consumption also remained high, positively influencing both the domestic producers and the services sector. Annual growth rates of the industrial production output and retail trade turnover remained high. Hungary continued to enjoy an expanding economic activity, due to both improved export opportunities and relatively high domestic demand. In Slovenia, growth rates of exports and industrial production output increased slightly at the end of the year. Domestic demand in Slovakia, in turn, remained low due to steep price increases, whereas the overall economic growth was mainly driven by a significant boost in exports.

Stimulated by domestic demand and expanding exports, Estonia's economy continued to grow. Nevertheless, the annual GDP growth rate was lower year-on-year. The industrial production growth rate was still relatively high at the end of the year; exports were facilitated by growing activity of foreign subcontractors. Positive trends were observed also in transit services where oil transit as well as other freight transit increased. Growth in the construction volume and a steep rise in registration of new transport vehicles indirectly pointed to expansion of investment.

Lithuania enjoyed an especially robust economic growth in the second half of the year. The annual GDP growth rate rose up to 10.6% in the fourth quarter, and almost all economic sectors developed buoyantly, driven by both domestic and external demand. Manufacturing, construction and trade were the main contributors to the GDP growth. The strong euro and a drop in prices for certain groups of products (for example, telecommunications services), however, contributed to continuing consumer price deflation in Lithuania.

Economic growth in Russia also accelerated significantly during the second half of 2003. Private consumption was fostered by an increase in real disposable income of the population due to higher wages and salaries as well as repayments of wage arrears. Exports and industrial production developed at a rather quick pace.

In the second half of the year, Latvia continued to enjoy robust economic growth: GDP grew by 7.5% in 2003. Inflation stood higher than in the previous periods, the annual average reaching 2.9%. The price rise was significantly influenced by amendments to the Law "On Value Added Tax" stipulating application of a 9% value added tax rate to several types of services. Administratively regulated prices (gas and heating tariffs) also went up. The rise in prices on food products was mainly determined by the appreciation of the euro and unfavourable weather conditions. The euro appreciation fuelled also a rise in prices on transport vehicles. The unemployment rate remained relatively high. Although economic activity in Europe remained sluggish, demand for Latvian goods increased on external markets and competitiveness was maintained. However, with domestic demand and, consequently, also imports of goods expanding rapidly, the current account deficit of the balance of payments deteriorated in 2003 and reached 9.2% of GDP. In 2003, the general government consolidated budget deficit amounted to 1.8% of GDP. The budget deficit, growing current account deficit and short-term foreign capital inflows into the banking sector have increased the dependence of Latvian economy on non-resident savings and aggravate macroeconomic risks. Therefore, it is important to further reduce the budget deficit and maintain high lending standards of banks, limiting the growth in private consumption.

2. CREDIT RISK CONCENTRATION ON THE DOMESTIC MARKET

Sectoral diversification of the banks' loan portfolio increased, the exposure to household loans and mortgage lending continued to expand.

Loans to domestic non-banks stood at 40.4% of GDP or 2 646.0 million lats (excluding transit credit) at the end of 2003. The bulk of loans was granted to domestic enterprises (see Chart 1), although the share of those loans in total loan portfolio declined during the year with the surge in lending to households. Loans to non-bank financial institutions (mainly leasing companies) were relatively modest, and their share in total loan portfolio decreased. The share of loans to central government in total loan portfolio was also low; nevertheless, it increased alongside refinancing a part of the Government's external debt on the domestic market.

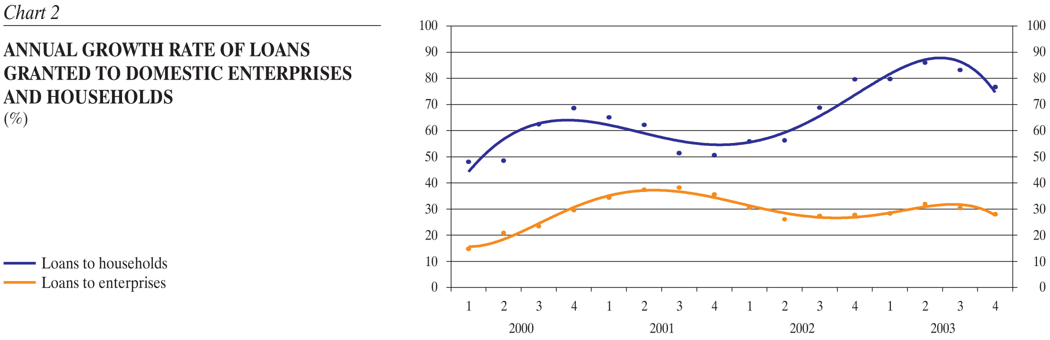
Chart 1

PROFILE OF LOANS GRANTED TO DOMESTIC NON-BANKS
(at end of 2003)

A slight slowdown in credit expansion in the second half of 2003 (see Chart 2) was underpinned by the following factors:
– base effect;
– the need for the banks to maintain the minimum capital and liquidity requirements. Credit expansion in 2002 and 2003 exceeded equity growth, causing a slight decline in the banks' capital adequacy ratio. For the large banks[1] it was close to the minimum margin of 10% already in 2002, whereas for the remaining banks, the expansion of lending caused it shrink notably since the second half of 2002. Hence, the capital adequacy ratios of the large banks and other banks almost levelled out at the end of 2003. Though still high, the banks' liquidity ratio decreased as well;
– interest rate developments. The fall in interest rates underlay the steep increase in loans during the preceding periods. In the last months of 2003, interest rates were stable; however, a slight rise in interest rates on the US dollar loans is forecast within the near future. Hence, the expected interest rate developments will no longer fuel such a significant growth in lending.

Chart 2

ANNUAL GROWTH RATE OF LOANS GRANTED TO DOMESTIC ENTERPRISES AND HOUSEHOLDS
(%)



[1] Banks are divided into three groups on the basis of their assets: large banks (with their assets exceeding 400 million lats), medium-sized banks (with assets within the range of 130 million lats to 400 million lats) and small banks (with their assets below 130 million lats).

Loans to domestic non-financial enterprises at the end of 2003 had grown by 28.0% year-on-year and amounted to 22.9% {20.4%}[1] of GDP. The level of bank concentration in this market segment remained broadly unchanged; the market share of three leaders was 59.8% of total loans (1.0 percentage points less than at the end of 2002). Data on market shares of banks suggest that the large banks face strong competition from certain medium-sized banks. Hence, the market share of medium-sized banks expanded markedly in 2003, due to their lower prices on services, aggressive marketing policy and funds attracted from their parent banks and other foreign banks. Just as at the end of 2002, for eight banks exposure to domestic enterprises exceeded 20% of the assets (see Table 1). Total assets of the banks constitute almost one half of the total banking sector assets and under adverse conditions their problems may have a negative impact on the overall banking sector indicators. Nevertheless, credit risks are mitigated by improved risk management of banks and diversification of their loan portfolios. For banks with higher exposure to the corporate sector, exposure to one economic sector does not exceed 30% of total loans granted to enterprises.

Table 1

BREAKDOWN OF BANKS BY EXPOSURE TO ECONOMIC SECTORS
(at end of 2003 {at end of 2002}; %)

	<10	10–20	>20
Loans to enterprises	8 {5}	6 {9}	8 {8}
Loans to non-bank financial institutions	20 {19}	2 {2}	0 {1}
Loans to households	13 {15}	6 {5}	3 {2}
incl. loans for house purchase	18 {20}	2 {0}	2 {2}

In the second half of 2003, the sectoral profile of banks' loan portfolio changed significantly. Banks increased exposure to real estate, renting and business activities (due to expanding construction of industrial and office buildings, infrastructure, apartment blocks and private houses), agriculture, hunting and forestry, as well as construction (see Table 2). Lending to trade, manufacturing and transport, storage and communication grew at a slower pace and their share in banks' loan portfolio decreased. This development was positive from the point of view of risk diversification, as a higher growth rate of loans was characteristic of rapidly expanding sectors (real estate, construction) and their share in the loan portfolio

Table 2

LOANS GRANTED TO ENTERPRISES OF SOME ECONOMIC SECTORS
(at end of 2003 {at end of 2002}; %)

	Annual growth	Share in loans granted to non-financial enterprises	Share in bank total assets
Agriculture, hunting and forestry	47.6 {29.2}	6.6 {5.7}	1.7 {1.5}
Manufacturing	13.4 {17.4}	17.6 {19.9}	4.6 {5.3}
Construction	35.0 {11.9}	7.8 {7.4}	2.0 {2.0}
Wholesale and retail trade	16.4 {21.0}	24.1 {26.5}	6.3 {7.0}
Transport, storage and communication	4.9 {23.9}	9.9 {12.1}	2.6 {3.2}
Real estate, renting and business activities	78.1 {–}	14.6 {10.5}	3.8 {2.8}

[1] {} – indicator of the corresponding period of the previous year.

was low, and taking into account certain degree of saturation in retail trade and the complex situation with oil transit and manufacture of food products.

At the end of 2003, loans to domestic households were 76.7% higher year-on-year and stood at 11.6% {7.5%} of GDP. Lending to domestic households was dominated by loans for house purchases which grew by 104.9% totalling 7.4% {4.1%} of GDP. The level of bank concentration in the household segment somewhat decreased, and the market share of three leaders of this market segment constituted 55.9% of total loans which is 2.0 percentage points less than at the end of 2002. Just as in the enterprise segment, medium-sized banks successfully competed with large banks in the area of household lending, expanding their market share. During the year, the number of banks with an exposure to household loans of over 20% of their assets increased to three. The assets of those banks, however, comprised only 8.4% of the total banking sector assets. In another six banks, the exposure to such loans was 10–20% of their assets. The remaining banks have invested a relatively small part of their assets in this market segment. For that reason, the credit risk has remained rather low yet has a tendency to build up gradually, with the exposure to households growing for some banks and household debt increasing (see Section 9). The credit risks of several banks have been aggravated by the fact that a significant part of loans to households has been granted in the US dollars. With changing the lats peg to the euro in 2005, currency risk of households whose earnings are not in the US dollars but that have borrowed in this currency will grow, and in the event of adverse developments the quality of bank loans may be impaired. In order to mitigate this risk, banks frequently require higher downpayment, set higher risk premium and loan ceilings.

At the end of 2003, loans to non-bank financial institutions stood 16.2% higher year-on-year and comprised 4.4% {4.2%} of banks' assets. Loans to domestic non-bank financial institutions were granted by separate large and medium-sized banks, and some of them also held shares in those financial enterprises. Since the majority of loans were granted directly to leasing companies, the performance of leasing companies has been analysed in Section 10 of this Report.

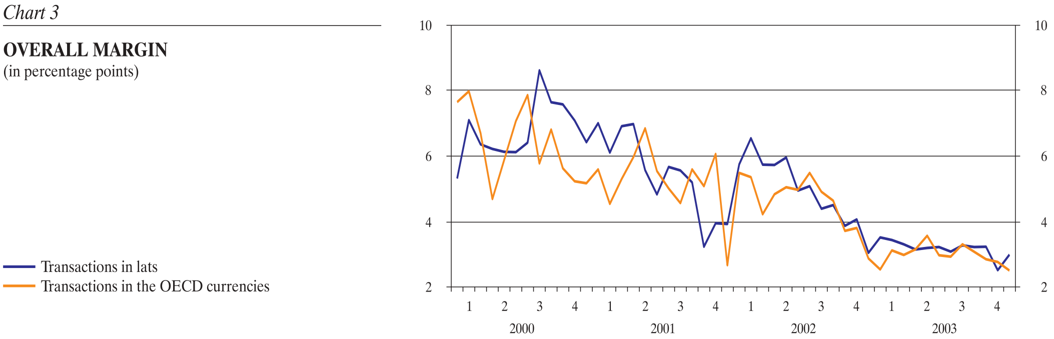
3. THE OVERALL MARGIN

The overall margin stabilised.

In the second half of 2003, the overall margin (as the new lending interest rate minus the new deposit interest rate) remained broadly unchanged (see Chart 3); however, it narrowed slightly in comparison with the end of 2002, with that on transactions in lats and the OECD currencies reaching 3.0 and 2.5 percentage points, respectively. The most significant narrowing of the interest rate margin was registered in the household segment; hence, the interest rate margin for

Chart 3

OVERALL MARGIN
(in percentage points)



enterprises and households almost levelled out. Stabilisation of the overall margin and the rapid credit expansion reflected further tightening of competition, as banks continued to attract new clients by offering better terms and conditions for loans (longer maturity, free of charge evaluation of loan application and early repayment possibilities).

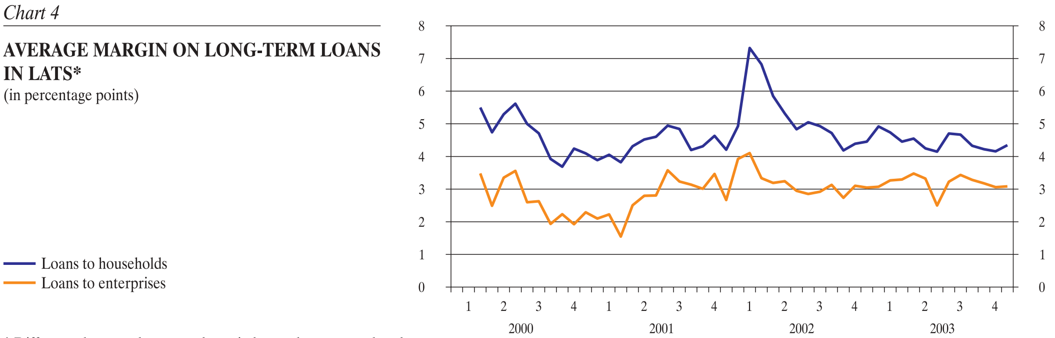
Box 1. Alternative investment into financial and capital market and risk premium

When assessing the alternative types of investing into financial and capital market, long-term interest rates on loans are usually compared with the interest rates on government long-term securities[1], while short-term interest rates are compared with the money market interest rates[2], with which the funds can be placed on the interbank market.

In 2003, the long-term government bond yields remained considerably lower than the long-term interest rates on loans both in the enterprise (by 3.1 percentage points) and household segment (by 4.3 percentage points; see Chart 4). Rapid development of the long-term loan market was driven by higher interest rates on long-term loans in lats (especially for households) and a limited offer of securities.

Chart 4

AVERAGE MARGIN ON LONG-TERM LOANS IN LATS*
(in percentage points)

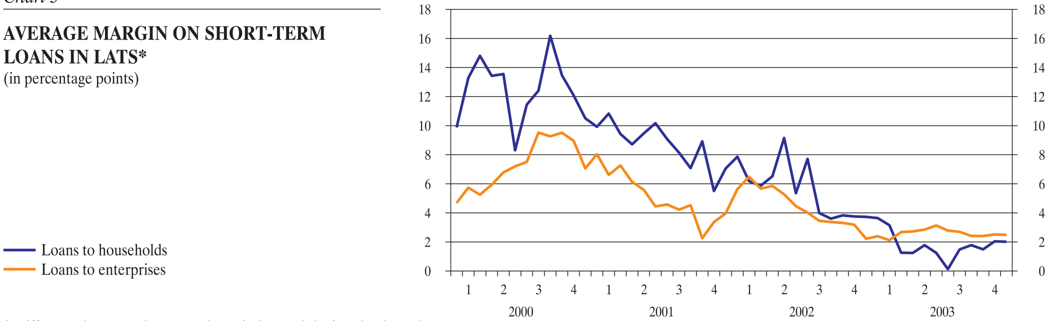


* Difference between long-term loans in lats and goverment bonds

The weighted average interest rate on short-term loans granted in lats was slightly higher than the interbank market rate (at the end of 2003, 2.5 and 2.0 percentage points for enterprises and households, respectively). This was promoted by tight competition in the banking sector and favourable economic conditions that encouraged reduction of the risk premium (see Chart 5).

Chart 5

AVERAGE MARGIN ON SHORT-TERM LOANS IN LATS*
(in percentage points)



* Difference between short-term loans in lats and the interbank market rate.

[1] Ask rate for fixed income government bonds with the initial maturity of 5 years, quoted on Riga Stock Exchange.
[2] 3-months money market interest rate index RIGIBID.

4. BUSINESS WITH NON-RESIDENTS

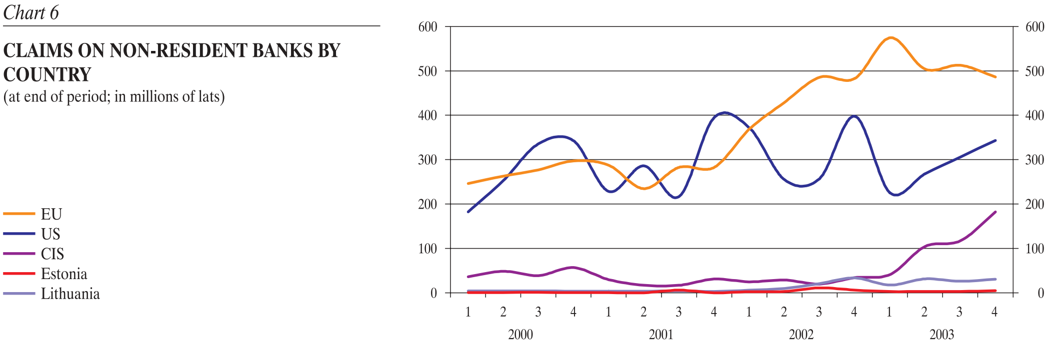
The dependence of Latvia's economy on foreign capital increased.

At the end of 2003, banking sector claims on non-residents accounted for 38.5% {40.6%} of total assets, and the share of liabilities to non-residents were 55.2% {54.3%} of total liabilities. The importance of non-residents in banks' financing continued to grow, with liabilities to foreign banks (including parent companies) expanding rapidly, and those funds were invested in lending to domestic private sector. Deposits attracted from non-resident non-banks continued to grow as well, and some banks servicing non-residents continued to invest part of the deposits domestically.

At the end of 2003, claims on non-resident banks totalled 1 120.4 million lats {972.9 million lats} or 84.5% of total claims on banks. As before, the major debtors of Latvian banks still were the US and EU credit institutions (see Chart 6) with which Latvian banks have their correspondent accounts (343.3 million lats {397.7 million lats} and 486.1 million lats {482.9 million lats}, respectively). Claims on the CIS countries increased significantly reaching 182.1 million lats {34.1 million lats} by the end of 2003, as a result of the Bank of Russia's resolution of April 2003 to exclude Latvia from the list of countries and territories with which foreign exchange operations are under special control. Claims on credit institutions of other Baltic countries were relatively modest.

Chart 6

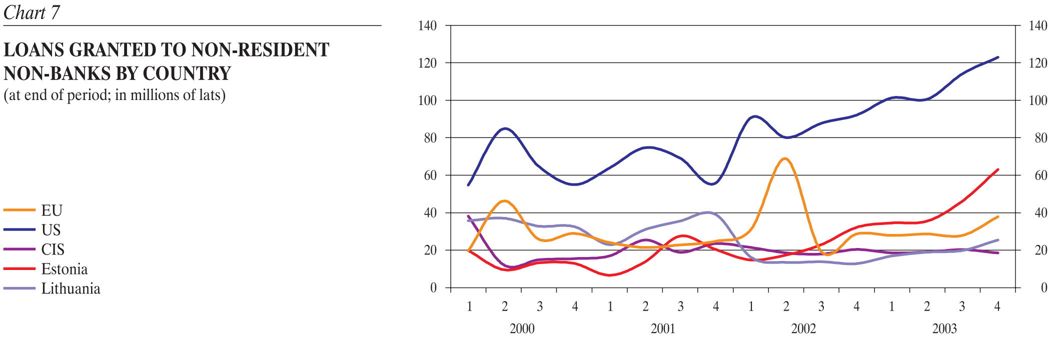
CLAIMS ON NON-RESIDENT BANKS BY COUNTRY
(at end of period; in millions of lats)



Loans granted to non-resident non-banks totalled 350.1 million lats {234.9 million lats} or 11.7% of total loans at the end of 2003. About one third of these loans were granted to US residents. Loans granted to the residents of Estonia and Lithuania nearly doubled during the year and accounted for one fourth of the loans granted to non-residents at the end of 2003 (see Chart 7). This points to the competitiveness of the Latvian banks and strengthening of their positions in the Baltic markets. Loans granted to EU residents also expanded and accounted for one tenth of the loans granted to non-residents at the end of 2003. Loans to non-banks of the CIS countries decreased in 2003 and constituted only 5% of total loans to non-resident

Chart 7

LOANS GRANTED TO NON-RESIDENT NON-BANKS BY COUNTRY
(at end of period; in millions of lats)

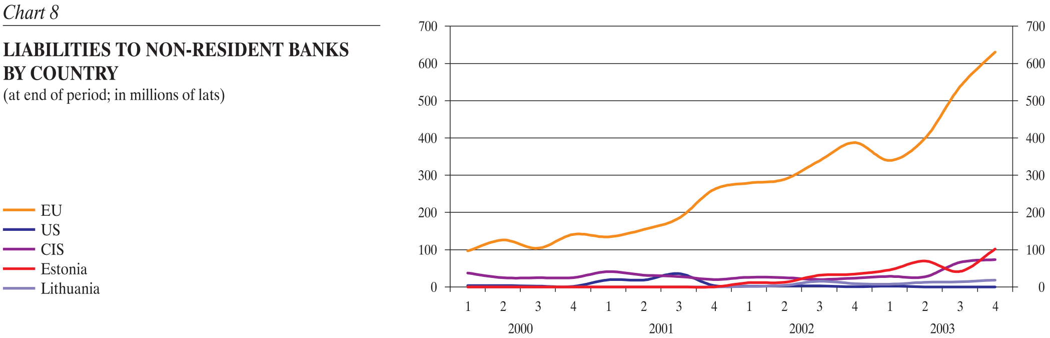


non-banks. The risk associated with loans granted to the non-resident non-bank sector was insignificant, since the exposures were relatively small.

At the end of 2003, the liabilities to non-resident banks stood 77.0% higher than at the end of 2002 (871.1 million lats, including 575.3 million lats of parent company loans or 80.7% of total liabilities to banks). Almost three fourths of these liabilities were liabilities to EU banks, as several Latvian banks are subsidiaries of EU banks and a branch of an EU country bank operates in Latvia (see Chart 8). Liabilities to banks of other countries were fairly low, although a rise in liabilities to the CIS and Estonian banks was observed in the second half of 2003, which can mainly be explained by the profile of the shareholders of the Latvian banks.

Chart 8

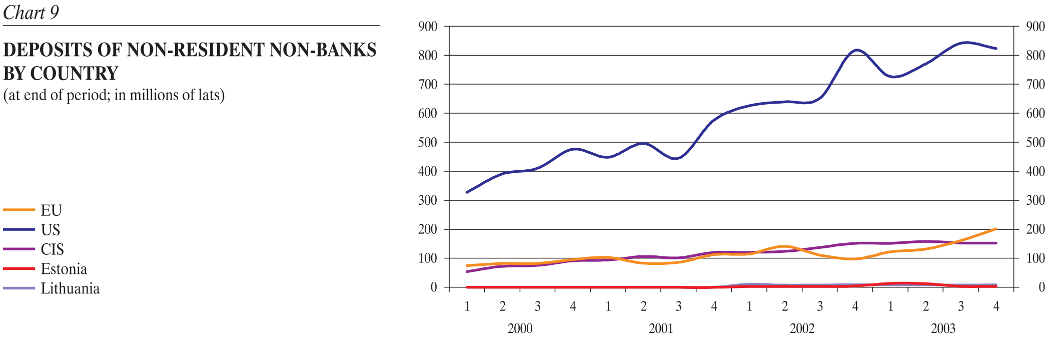
LIABILITIES TO NON-RESIDENT BANKS BY COUNTRY
(at end of period; in millions of lats)



Deposits attracted from non-resident non-banks reached 1 999.1 million lats {1 667.9 million lats} or 53.6% of total non-bank deposits at the end of 2003. Over 41.2% of those deposits were attracted from the US, 10.1% from the EU countries and 7.6% from the CIS countries (see Chart 9). Deposits attracted from residents of Estonia and Lithuania were insignificant. In 14 banks, deposits of non-resident non-banks accounted for over 20% of the banks' liabilities. Although this points to the presence of certain risks, it has to be taken into consideration that the capital adequacy and liquidity ratios of these banks are high and above the banking sector average. The share of liquid assets of those banks in total assets was over 50%, well above the relevant ratios of other banks. The capital adequacy ratio of banks servicing non-residents also exceeded that of other banks by 1.5 percentage points on average. In some systemically insignificant banks, however, the liquidity risk related to non-resident deposits was somewhat higher, as they used part of the non-resident deposits to grant loans to domestic clients and their liquidity ratios, while still in compliance with the regulatory requirements, were lower than the banking sector average.

Chart 9

DEPOSITS OF NON-RESIDENT NON-BANKS BY COUNTRY
(at end of period; in millions of lats)



With net claims on non-resident credit institutions decreasing and deposits attracted from non-resident non-banks expanding, net foreign assets of banks fell to –748.6 million lats {–425.7 million lats} (see Charts 10 and 11) in 2003.

Chart 10

TRANSACTIONS WITH NON-RESIDENTS
(at end of period; in millions of lats)

Shares and other variable income securities of non-residents
Fixed income debt securities of non-residents
Loans to non-resident non-banks
Net claims on non-resident credit institutions
Deposits of non-resident non-banks

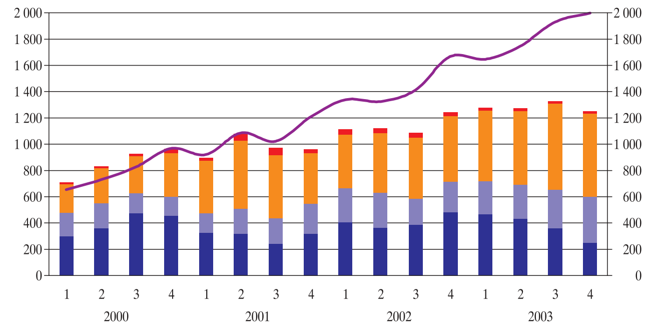
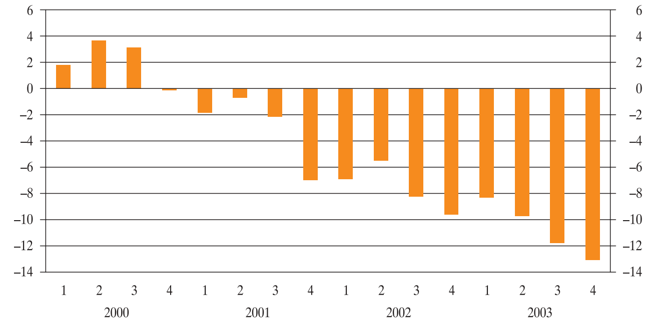


Chart 11

BANKS' NET FOREIGN ASSETS
(at end of period; % of assets)



5. BANK PROFITABILITY

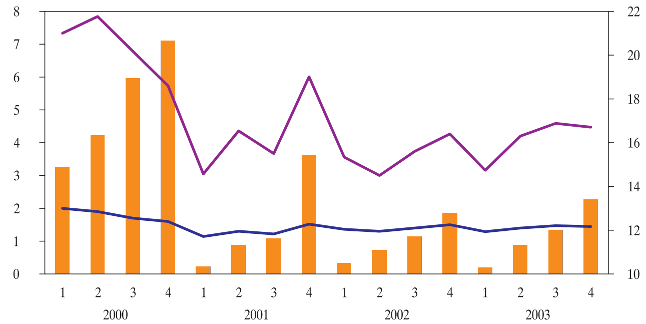
Bank profitability ratios improved.

In 2003, profits of the banking sector grew (27.0% year-on-year) totalling 71.5 million lats after taxes. The return on equity (ROE) reached 16.7%, whereas the return on assets (ROA) diminished slightly and was 1.4% (see Chart 12). In 2003, written-off loans totalled 10.9 million lats. The increase in written-off loans relates to writing off such non-performing loans for which special loan loss provisions were made previously. The return on equity varied quite considerably across the groups of banks (see Chart 13). A higher return on equity was characteristic mainly of large banks and medium-sized niche banks. This ratio was considerably lower for medium-sized universal banks, which, as a result of their rapid development, incurred larger operating costs. Nevertheless, it was positive for all banks (see Table 3).

Chart 12

PROFITABILITY RATIOS
(%)

Loans written-off to losses (cumulative from the beginning of the year) to capital and reserves
ROA
ROE (right-hand scale)



Total interest income of banks grew by 9.1% year-on-year. The drop in interest rates on loans had almost no impact on bank profitability, as it was offset by a rapid growth in bank loans granted to non-banks (income from interest on loans

Chart 13

RETURN ON EQUITY (ROE) BY BANK GROUP[1]
(at end of 2003)

• Bank group average
— Banking sector average

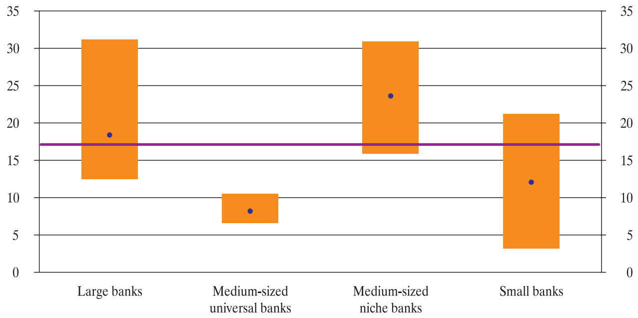


Table 3

BREAKDOWN OF BANKS BY GROUP BASED ON THEIR PROFITABILITY RATIOS
(at end of 2003)

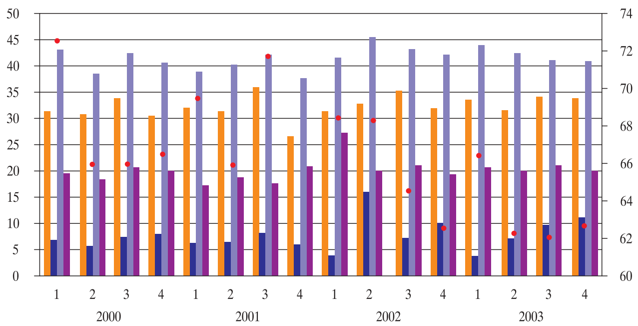
Return on equity (%)	Market share of banks in total assets (%)	Number of banks
<5	0.8	2
≥5–10	13.4	6
≥10–15	22.5	3
≥15–20	25.8	6
≥20	37.5	5

granted to non-banks increased by 12.0%). The development of the global securities market pushed up the Latvian banks' interest income from securities by 13.8%, whereas the income from interest on claims on credit institutions and the central bank fell by 7.9% as the interbank market interest rates shrank. Interest expenditure remained broadly unchanged. Net interest income increased by 16.1% and accounted for 33.2% of total income (see Chart 14).

Chart 14

INCOME AND COST PROFILE
(%)

Net interest income to total income
Net income from currency trading and its revaluation to total income
Operating costs and intangible asset amortisation to total income
Net commissions and fees to total income
• Cost-to-income ratio (right-hand scale)



Net commissions and fees grew by 17.7% and amounted to 20.4% {19.9%} of total income. The rise in commissions and fees was driven by an increase in the number of banks' clients.

The income from foreign currency trading grew by 52.2%, driven by the exchange rate volatility of major currencies, high trading turnover and expansion of currency swaps. In 2003, the share of net income from foreign currency trading and income from foreign currency revaluation in total income remained unchanged year-on-year (9.2%).

With the banking sector expanding, operating costs increased considerably (by 14.7%, including a rise of 13.5% in personnel wages and salaries, of 12.4% in wages and salaries of the boards and executive boards and of 15.3% in other

[1] Return on equity has been calculated based on the "Regulation on the Preparation of Public Quarterly Reports of Credit Institutions" of the Financial and Capital Market Commission.

operating costs). The pickup of operating costs was related to an increase in the number of employees and branches (settlement groups etc.). The share of operating costs and amortisation of intangible assets in total income, however, declined slightly (to 42.0%).

Banks' income grew more markedly than expenditure; therefore, the cost-to-income ratio improved amounting to 63.2%.[1]

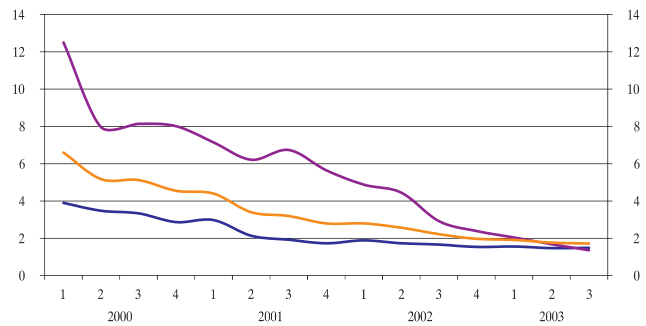
Changes in cost-to-income ratios by banks suggest that over the course of the year the majority of banks managed to improve their cost efficiency. The cost efficiency ratio of the large banks was higher overall than the banking sector average. Lower efficiency was characteristic of some rapidly expanding banks with high operating costs and several medium-sized and small banks suffering from competition from other banks. Only eight banks displayed slightly deteriorated cost efficiency.

Non-performing loans decreased.

The quality of banks' assets continued to improve. The percentage of non-performing loans net of loan loss provisions contracted to 0.9% {2.4%} of banks' equity (see Chart 15). The ratio of non-performing loans and loan loss provisions to total loans granted to non-banks also continued to decline and at the end of 2003 stood at 1.4% {2.0%} and 1.2% {1.5%}, respectively. The number of non-performing loans to non-banks decreased both year-on-year and over the end of June 2003, reaching an all time low.

Chart 15

NON-PERFORMING LOANS TO NON-BANKS AND LOAN LOSS PROVISIONS
(%)



Non-performing loans to non-banks to total loans to non-banks
Loan loss provisions to total loans to non-banks
Non-performing loans to non-banks net of provisions to banks' capital and reserves

6. BANK CAPITAL ADEQUACY

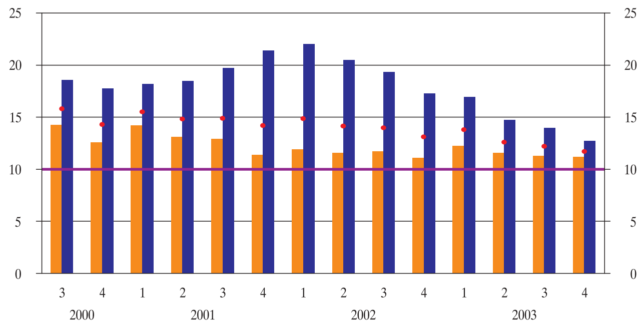
The level of bank capitalisation was compliant with the regulatory requirements.

The capital adequacy ratio (CAR) has been on a decline since the end of 2002, with the credit risk capital requirement growing more rapidly than equity and the market risk capital requirement also increasing, albeit rather insignificantly. Nevertheless, the CAR still exceeded the minimum limit (10%), accounting for 11.7% {14.0%} at the end of 2003 (see Chart 16). The CAR of large banks was lower; yet since 2002 there has been a tendency for the CAR to level out across banks, with that of small and medium-sized banks declining and that of large banks remaining broadly unchanged. Thus, the CAR of small and medium-sized banks was almost on a par with that of large banks (12.7% {17.3%} and 11.2% {11.1%}, respectively), and the number of banks with a CAR below 15% increased (see Chart 17).

[1] Cost-to-income ratio has been calculated based on the ECB methodology: (operating costs + intangible asset and fixed asset depreciation and disposal + other ordinary expenditure)/(net interest income + income from dividends + net commissions and fees + profit/loss from trades of financial instruments + financial instrument revaluation result + other ordinary income) x 100.

Chart 16

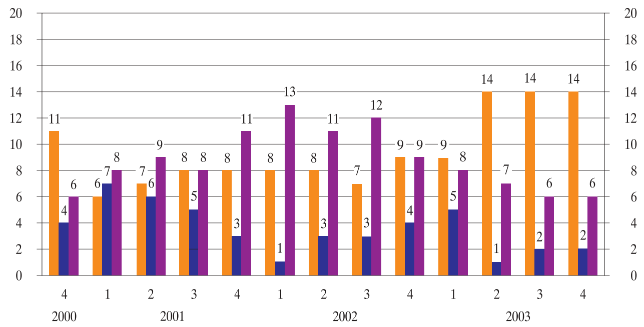
CAPITAL ADEQUACY RATIO
(at end of period; %)



Large banks
Other banks
Overall capital adequacy ratio
Minimum requirement

Chart 17

BREAKDOWN OF BANKS BY CAPITAL ADEQUACY RATIO



< 15%
≥ 15–20%
≥ 20%

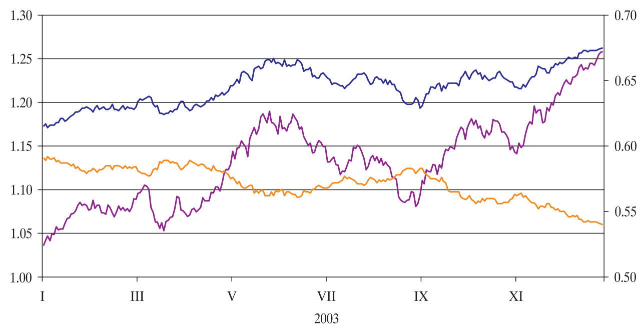
7. FOREIGN EXCHANGE RISK OF BANKS

Foreign currency positions of banks were balanced, and the high exchange rate volatility had no significant impact on the financial position of the banks.

In the second half of 2003, foreign exchange risk attracted special attention. Within the last two months of 2003, the US dollar depreciated almost 10% against the euro, losing one fifth of its value to euro in the course of the year (see Chart 18). Pegging of the lats to the SDR currency basket containing both the US dollar as well as the euro decreases the fluctuation of the lats against each of those currencies by almost half of their mutual fluctuations. About two thirds of the banking sector liabilities in Latvia consist of foreign currency liabilities, primarily in the US dollars and euros. Latvian banks to a large extent have limited the foreign exchange risk by balancing the currency structure of their assets and liabilities, and thus maintaining low currency exposures. This is also stipulated under the Law on Credit Institutions which contains a provision that the net open foreign currency position of a credit institution per foreign currency may not exceed 10% of equity and 20% of equity in all foreign currencies together.

Chart 18

EXCHANGE RATE DEVELOPMENTS



EUR/USD
EUR/LVL (right-hand scale)
USD/LVL (right-hand scale)

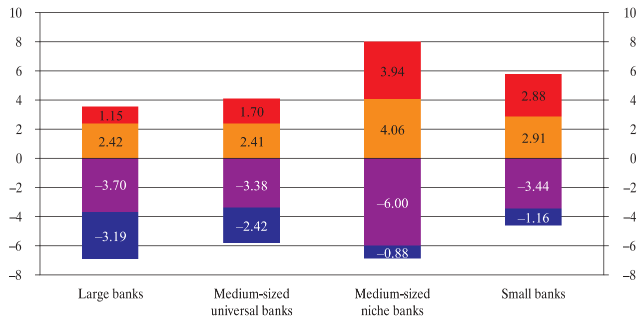
Medium-sized niche banks placed the attracted funds in foreign currencies (mainly the US dollars) in the OECD countries. The foreign exchange risk for banks active on the domestic market was low, even if the foreign exchange risk of their clients was on the rise, as about half of the domestic loans have been granted in foreign currencies. Hence, the banks' exposures in major foreign currencies (the US dollar and euro) were relatively low (see Chart 19).

Chart 19

AVERAGE WEIGHTED NET OPEN POSITIONS IN MAJOR FOREIGN CURRENCIES BY BANK GROUP

(at end of 2003; % of banks' capital and reserves)

Euro short positions
US dollar short positions
Euro long positions
US dollar long positions



At the end of 2003, net open positions in major currencies (the US dollar and euro) of nine banks which, by the size of their assets, form almost half of the banking sector, were set in one direction: either long positions or short positions in both currencies. The foreign exchange risk of those banks related to mutual fluctuations of the US dollar and the euro was thus mitigated even further, as gains or losses from changes in one currency exchange rate would be partly offset by adverse changes in the other currency exchange rate.

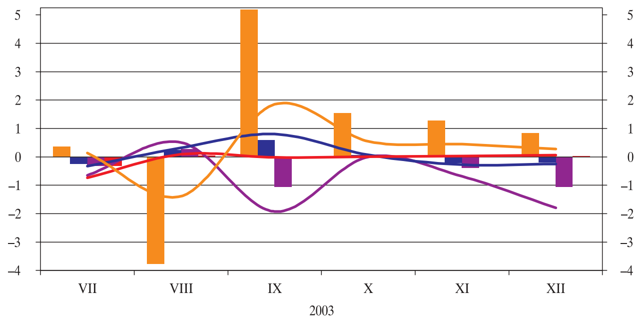
In the second half of 2003, the monthly gains or losses from foreign currency revaluation in each of the groups of banks did not exceed 2% of their capital and reserves (see Chart 20).

Chart 20

PROFIT/LOSS AS THE RESULT OF FOREIGN CURRENCY REVALUATION BY BANK GROUP

(in millions of lats; left-hand scale)
Large banks
Medium-sized universal banks
Medium-sized niche banks
Small banks

(% of capital and reserves; right-hand scale)
Large banks
Medium-sized universal banks
Medium-sized niche banks
Small banks



It can be therefore concluded that the high volatility of the US dollar and the euro exchange rates had no significant impact on the financial position of Latvian banks. Nevertheless, the tendency of the clients of banks active on the domestic market to undertake foreign exchange risk by borrowing in foreign currency may have adverse side effects.

Households that increasingly take foreign currency denominated mortgage loans from banks (primarily in the US dollars), are quite exposed to foreign exchange risk, because, unlike enterprises, they do not have much opportunity to earn foreign currency income or resort to other ways of hedging foreign exchange risk. Hence, household-related credit risk of the banks has been growing. Banks have been increasing the share of mortgage not covered by the loan or the risk premium.

8. BANK LIQUIDITY

All groups of banks maintained high liquidity; however, there is a marked tendency for it to decline.

High liquidity was characteristic of the Latvian banking sector, considerably exceeding the minimum level (30%) set by the Financial and Capital Market Commission.[1] At the end of 2003, the liquidity ratio of the banking sector stood at 57.9% {62.1%}.

To assess bank liquidity by currency and group of banks, a short-term liquidity ratio[2] was calculated. It declined during the year and stood at 63.7% {72.0%} at the end of 2003 (see Chart 21). Despite of the fall, the liquidity ratio remained high. The share of liquid assets[3] in total assets shrank to 33.5% {38.0%} (see Chart 22), mainly driven by a rapid pickup in loans granted to non-banks. As regards the short-term liquidity ratio by currency, a decline was reported for both the lats as well as foreign currencies. The liquidity of the lats is contingent upon the strategy used by the banks to maintain the minimum reserve requirement set by the Bank of Latvia. The decrease in the lats' liquidity was determined by the decline in demand deposits in lats with the Bank of Latvia. The share of demand liabilities in total liabilities grew more rapidly than the liquid assets. Foreign currency liquidity declined, as with the lending expansion, the growth of liquid assets was more moderate (foreign government securities portfolio contracted) than that of the demand deposits.

Chart 21

THE BANKING SECTOR'S SHORT-TERM LIQUIDITY RATIO
(%)

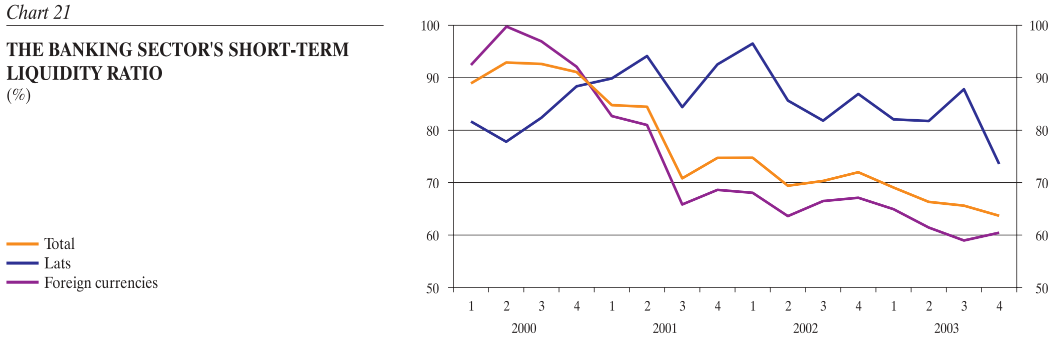
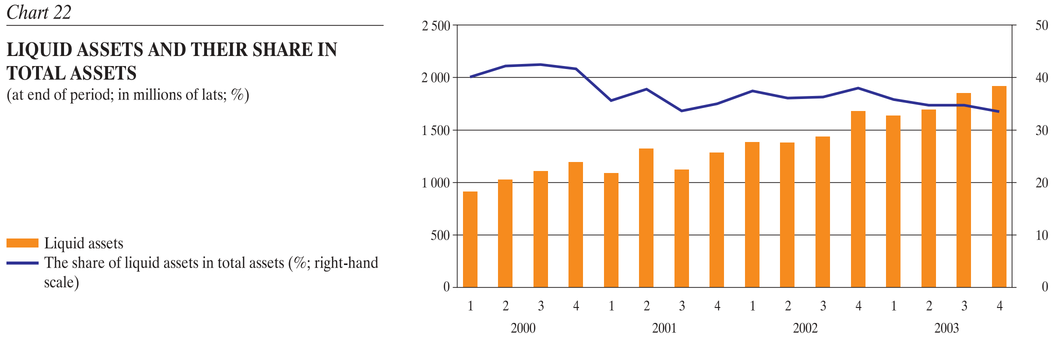


Chart 22

LIQUID ASSETS AND THEIR SHARE IN TOTAL ASSETS
(at end of period; in millions of lats; %)



With the growth of lending, the non-bank loan-to-deposit ratio rose to 80.3% {68.9%} at the end of 2003. For resident transactions, this ratio was 152.8% {134.2%} at the end of 2003, as some banks financed part of the loans granted to

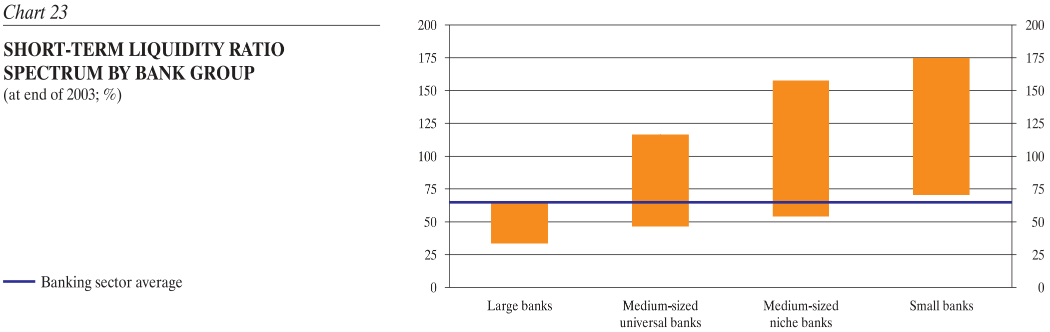
[1] In accordance with the "Regulation on the Compliance of Credit Institutions with Liquidity Requirements" of the Financial and Capital Market Commission.
[2] Short-term liquidity ratio = liquid assets/demand liabilities (to banks and non-banks) x 100.
[3] Liquid assets = vault cash + claims on central banks and other credit institutions + central government fixed income debt securities.

domestic non-banks from the funds of their parent companies and international development banks (EBRD, NIB, EIB). Loans granted to non-residents accounted for only 17.5% {14.1%} of the total non-resident deposits. Several medium-sized niche banks also granted part of their loans to domestic non-banks using the deposits of non-resident non-banks. Lending expansion was additionally fuelled by the banks' growing capital. In 2003, banks' capital and reserves increased by 25.6%.

Looking at the short-term liquidity spectrum of the banks (see Chart 23), it is evident that large banks and part of medium-sized universal banks have larger liquidity risk exposures. These banks mainly grant loans to resident non-banks. The liquidity of the majority of medium-sized banks (especially medium-sized niche banks) and all small banks is much higher than the banking sector average and their liquidity risk is minimum.

Chart 23

SHORT-TERM LIQUIDITY RATIO SPECTRUM BY BANK GROUP
(at end of 2003; %)



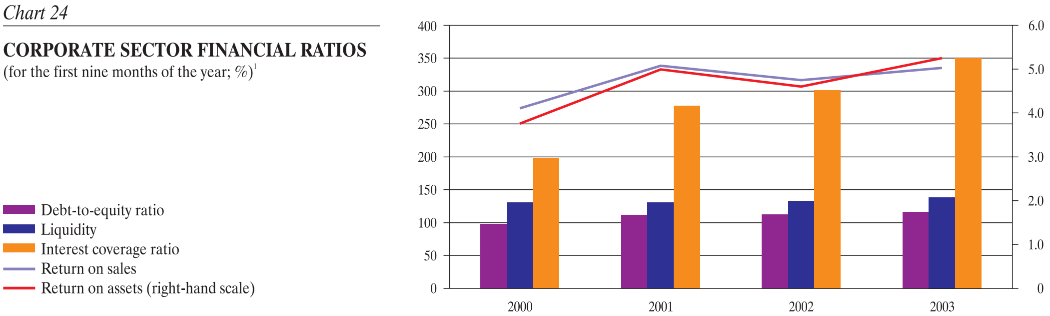
9. FINANCIAL VULNERABILITY

Profitability and liquidity of the corporate sector continued to improve, while the debt-to-equity ratio in some less indebted sectors of economy slightly deteriorated.

The successful development of manufacturing and trade, which are the economic sectors dominating the banks' loan portfolio, continued in the third quarter of 2003. Both in the third quarter and in the first nine months of 2003, pre-tax earnings of the corporate sector soared, increasing by more than one fifth year-on-year. Return on sales picked up, return on assets and average liquidity continued to grow, but the average indebtedness also increased slightly (see Chart 24).

Chart 24

CORPORATE SECTOR FINANCIAL RATIOS
(for the first nine months of the year; %)[1]



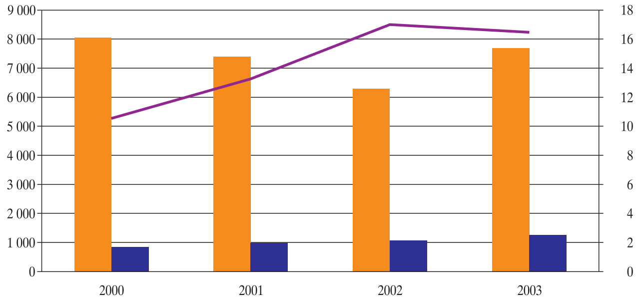
A robust economic growth and favourable business environment were also reflected in the increase in the number of business start-ups (22.3%), which according to

[1] Debt-to-equity ratio is the ratio of debt to equity; liquidity: current assets to short-term liabilities; interest coverage ratio: profit to interest expense; return on sales: pre-tax profit to sales; return on assets: pre-tax profit to assets.

the data of the Register of Enterprises of the Republic of Latvia (Commercial Register) reached a three-year high in 2003 (see Chart 25).

Chart 25

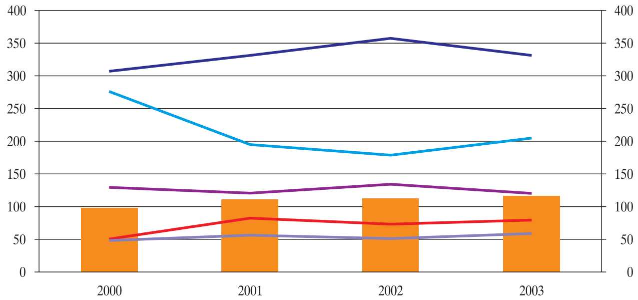
BUSINESS START-UPS AND INSOLVENCY



The rise in corporate profits in the third quarter and in the first nine months of 2003 pushed up the growth of equity, which exceeded borrowing; nevertheless, the average debt-to-equity ratio reached 116.1% at the end of the third quarter (an increase of 3.8 percentage points year-on-year; see Chart 26). With enterprises exceedingly relying on long-term financing in manufacturing, trade and real estate, renting and other business activities, total short-term liabilities even registered a slight decline in the third quarter, while average liquidity improved significantly.

Chart 26

CORPORATE SECTOR'S AND ITS MAJOR BRANCHES' DEBT-TO-EQUITY RATIO
(for the first nine months of the year; %)



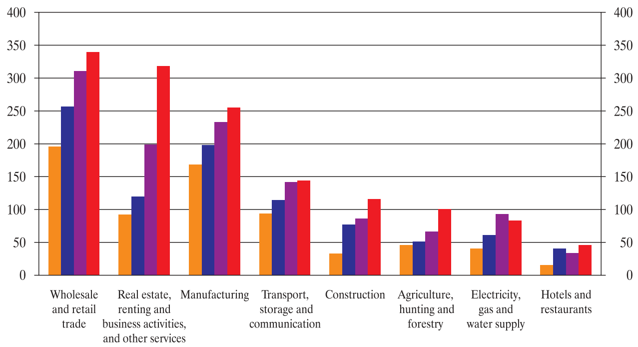
The rapid growth of profits and lower interest rates had a significant impact on the growth of interest coverage ratio as well. In the third quarter, interest payments were lower quarter-on-quarter, but slightly higher year-on-year.

With the cost of sales and operating costs growing at a slower pace than the revenue, increased business efficiency underlay a surge in profits and corporate profitability. However, strengthening of the competition on the domestic market resulted in accelerating distribution costs.

In the third quarter, more than a half of the increase in lending consisted of bank loans to real estate, renting and other business activities, and other small services

Chart 27

BANK LOANS TO DOMESTIC NON-FINANCIAL ENTERPRISES BY SECTOR
(amounts outstanding at end of period; in millions of lats)



sectors as well as to finance activities related to those sectors (see Chart 27). The level of these loans outstanding approached that of loans granted to trade sector. The growth of lending to trade decelerated significantly, whereas the second highest rise was recorded in lending to agriculture, hunting and forestry.

In the third quarter, the wholesale and retail trade equity continued to grow. Asset growth remained modest and was mainly financed by equity; therefore, the debt-to-equity ratio of the trade sector improved. Attracting mainly long-term financing, the liquidity of the sector improved as well. Profits and profitability of the sector continued to grow, while the balance sheet risks diminished. Trade results improved both quarter-on-quarter as well as year-on-year. Profitability increased, pushing the costs of sales (procurement) down, while operating costs and distribution costs continued to rise.

Manufacturing continued to develop buoyantly in the third quarter, and the key risk indicators also improved. High profits earned by manufacturers in 2002 enabled them to significantly increase their equity, and the share of borrowed capital shrank. The debt-to-equity ratio of the sector improved notably year-on-year. Manufacturing profits, which had doubled in 2002 still continued to grow rapidly. The results of the sector were primarily determined by successful development of the manufacture of wood and products of wood. In 2002, it held almost one third of the bank loans attracted by the manufacturing sector. The majority of smaller manufacturing sub-sectors also continued to develop rapidly. Most of the bank loans and the largest share of total loans were recorded in manufacture of food products and beverages sub-sector where profits declined and the growth of equity was insignificant.

The rise in bank loans was still dominated by lending to real estate, renting and business activities. The major share of long-term and bank lending to the sector were concentrated in real estate transactions, and it continued to grow rapidly in the third quarter and the first nine months of 2003, financing investments in fixed assets (land plots, houses, constructions etc.). That contributed to significant deterioration of the sub-sector's average debt-to-equity ratio (to 122%) and bank risks related to changes in real estate prices increased.

In the third quarter, enterprises of real estate, renting and business activities sector continued to earn high profits. With revenue remaining broadly unchanged, the significant decline in distribution costs and other costs during the first nine months of 2003 determined a surge in profitability. Although the JSC *Latvijas Kuģniecība* suffered minor losses in the third quarter, they were lower than in 2002, and noteworthy profits were accumulated during the first three quarters. In the third quarter and the first nine months of 2003, profits before taxes in real estate, renting and business activities more than doubled year-on-year.

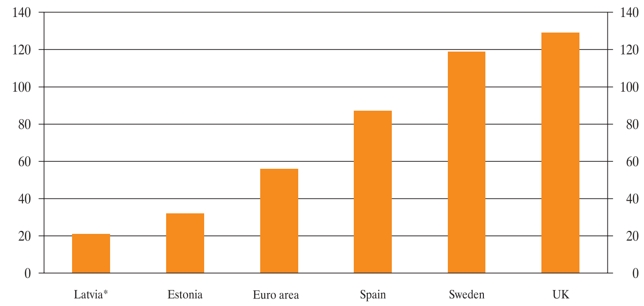
With dynamic economic development continuing, construction expanded increasingly rapidly. In the third quarter, the construction sector revenue grew by one fourth year-on-year. The share of loans granted for construction purposes in the banks' loan portfolio increased by more than one third. A boost in construction activity caused deterioration of the debt-to-equity ratio of the sector as significant lending was attracted, while profits and equity grew at a slower pace. With fixed asset acquisition and renting costs increasing, the costs of sales of construction enterprises were high in the third quarter; therefore, profits shrank and were considerably lower year-on-year. Hence, interest payment coverage ratio shrank significantly, but, taking into account the results of the first nine months of 2003, the drop in interest payment coverage was not that sharp and was close to the 2002 figure.

Household debt still accounted for a fairly small share of their disposable income; however, the debt grew rapidly.

The household debt consisting of liabilities to banks, leasing companies and savings companies reached 21.4% {15.4%} of the households' disposable income in 2003 (see Chart 28). In comparison with both the developed countries and other transition economies, the level of household debt has remained low, although its developments point to growing risks.

Chart 28

HOUSEHOLD DEBT-TO-INCOME RATIO
(in 2003; %)



* Bank of Latvia estimate.

In 2003, with the growth rate of lending remaining high and that of deposits decelerating, net financial position of households decreased, albeit remaining positive (see Chart 29). Should these trends hold in 2004, however, households are more likely to become debtors.

Chart 29

FINANCIAL ASSETS AND LIABILITIES OF HOUSEHOLDS TO BANKS, LEASING COMPANIES AND CREDIT UNIONS
(at end of period; in millions of lats)

The household debt to banks consisted primarily of loans for house purchase and consumer credit, accounting for 64.2% and 18.0% of total loans granted to households at the end of 2003, respectively. Household interest payments to banks increased at a much slower pace than their debts and totalled 44.2 million lats in 2003, which is 33.4% higher than in 2002.

According to the data on lending to households released by three biggest leasing companies, household loans amounted to 94.1 million lats at the end of 2003[1], recording a 6.3% increase year-on-year. Data on households' interest payments to leasing companies are not available, but, judging by the level of indebtedness, they are considerably lower than those paid to banks.

The share of loans granted in foreign currencies continued to follow an upward trend and stood at 58.5% {54.4%} of total household debt to banks at the end of 2003 (see Chart 30). The interest rates on long-term loans to households in the OECD currencies were much lower, and in December 2003 the spread between the interest rates on long-term loans in lats and in the OECD currencies was 3.6

[1] Data provided by the Latvian Leasing Association. The lease portfolio profile by the lessee's sector of the economy: other sectors, including households.

{2.3} percentage points. This trend was driven also by the US dollar depreciation in the second half of 2003. At the same time, the share of household deposits in foreign currencies diminished (see Chart 31). The fall was primarily influenced by the low interest rates on foreign currency deposits and the opportunities to make foreign currency investments in real estate.

Chart 30

LOANS GRANTED TO HOUSEHOLDS BY CURRENCY

(at end of period; in millions of lats; left-hand scale)
In lats
In the OECD currencies

(annual growth; %; right-hand scale)
In lats
In the OECD currencies

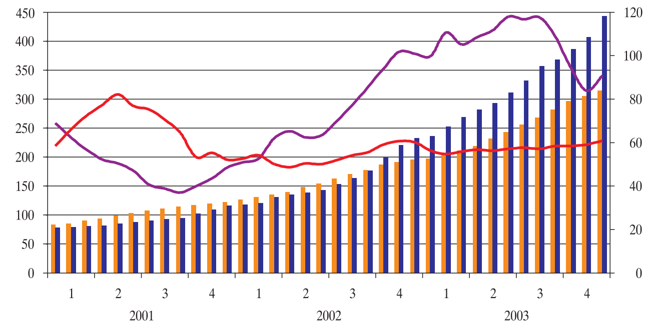
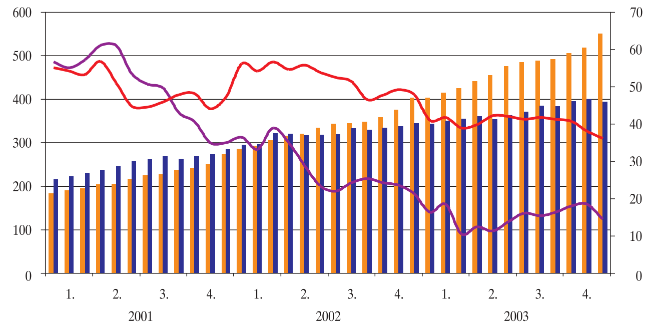


Chart 31

HOUSEHOLD DEPOSITS BY CURRENCY

(at end of period; in millions of lats; left-hand scale)
In lats
In the OECD currencies

(annual growth; %; right-hand scale)
In lats
In the OECD currencies



The rise in foreign currency lending means increased currency risks for those households earning income in lats. Along with the floating interest loans, those households also subscribe to the interest rate risk. Taking into account the expected rise in interest rates as the US economy continues to grow, those risks may increase in 2005. The potential scale of the interest rate rise can be derived from the following data: at the end of 2003, the 6-month money market interest rate index LIBOR for the US dollars was 1.2%, whereas in 2000, during the economic upturn in the US it was 6–7%.

10. LEASING COMPANIES

The share of shorter-term leasing increased.

Leasing and factoring portfolio of three biggest leasing companies (limited liability company *Hanza Līzings*, limited liability company *Unilīzings*, limited liability company *Nordea Finance Latvia*) totalled 321.1 million lats at the end of 2003 (12.1% more year-on-year). The leasing and factoring portfolio was dominated by financial lease; however, the growth rate of operating lease portfolio in 2003 was considerably higher than that of the overall loan portfolio. The factoring portfolio shrank. The services of the leasing companies were mostly used for purchasing vehicles, manufacturing equipment and real estate (see Chart 32).

Looking at the profile of the leasing portfolio of legal entities by economic sector, the major lessees were manufacturing companies, trade companies and companies of transport, storage and communication sector (see Chart 33). Household lease

Chart 32

LEASING AND FACTORING PORTFOLIO OF LEASING COMPANIES BY TYPE OF ASSETS
(at end of period; in millions of lats)

2000
2001
2002
2003

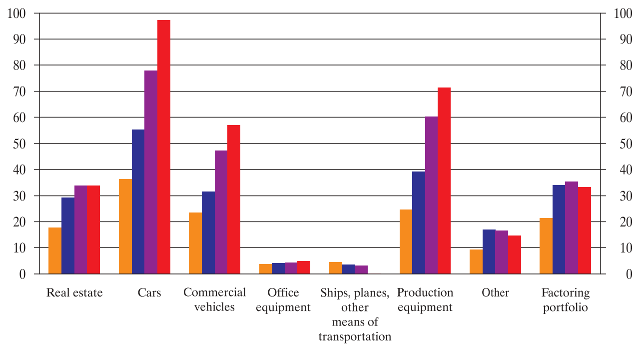
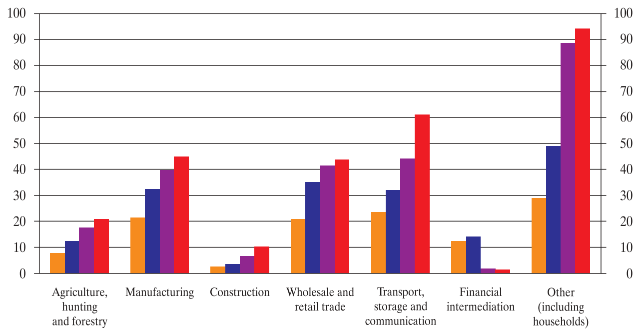


Chart 33

LEASING PORTFOLIO OF LEASING COMPANIES BY ECONOMIC SECTOR
(at end of period; in millions of lats)

2000
2001
2002
2003



transactions accounted for the largest share in the total leasing portfolio, but it diminished slightly in 2003, with leasing in transport, storage and communication, manufacturing and construction expanding at a quicker pace.

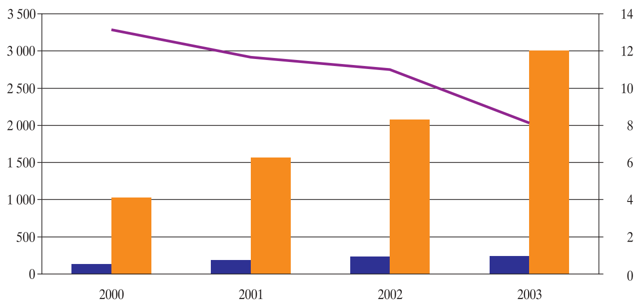
In 2003, the share of shorter-term lease in the maturity profile of the leasing portfolio of leasing companies increased notably, while the share of longer-term transactions (over 3 years) declined. These changes in the maturity profile of the leasing portfolio suggested that the leasing companies market their services as a convenient means for obtaining short-term loans. As it is easier and quicker to get a lease loan than a bank loan, leases are exceedingly more often favoured as a means of receiving a short-term loan. When taking a longer-term loan, the price of the borrowing matters more and bank loans are usually more attractive under such circumstances than lease loans.

The ratio of leasing and factoring portfolio to bank loans decreased in 2003 (see Chart 34). This was promoted by the activities undertaken by banks to attract clients, especially in mortgage lending, confirmed also by the changes in maturity profile of leases and deceleration of the growth rate for leasing in real estate.

Chart 34

LEASING AND FACTORING PORTFOLIO OF LEASING COMPANIES AND BANKS' LOAN PORTFOLIO
(at end of period; in millions of lats)

Leasing and factoring portfolio of leasing companies
Banks' loan portfolio
Leasing and factoring portfolio of leasing companies to banks' loan portfolio (%; right-hand scale)



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