ABBREVIATIONS

CAR – capital adequacy ratio
CIS – Commonwealth of Independent States
ECB – European Central Bank
EKS – Electronic Clearing System
ERM II – Exchange Rate Mechanism II
EU – European Union
EU10 – countries that joined the EU on May 1, 2004
EU15 – EU countries before May 1, 2004
FCMC – Financial and Capital Market Commission
FRS – US Federal Reserve System
GAP – repricing gap or difference between interest rate sensitive assets and interest rate sensitive liabilities
GDP – gross domestic product
LLA – Latvian Leasing Association
MFI – monetary financial institution
NPLs – non-performing loans
OPEC – Organization of the Petroleum Exporting Countries
RIGIBID – Riga Interbank Bid Rate
RIGIBOR – Riga Interbank Offered Rate
ROA – return on assets
ROE – return on equity
RSA – interest rate sensitive assets
RSL – interest rate sensitive liabilities
SAMS – Interbank Automated Payment System
SDR – Special Drawing Rights
US – the United States of America
VaR – the maximum expected losses over a certain period of time and with a given probability (Value-at-Risk)

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 Reuters (Charts 1, 2 and 28), the Bank of Latvia (Charts 3, 5–9, 11, 13–17, 19–21, 26, 27 and 30–37), the Central Statistical Bureau of Latvia (Charts 3 and 37), the Financial and Capital Market Commission (Charts 4, 10, 12–18, 22–27, 29–31 and 38) and the Latvian Leasing Association (Charts 36, 37, 39 and 40). Tables have been compiled on the basis of data provided by the Bank of Latvia (Tables 1–4 and 6) and the Financial and Capital Market Commission (Tables 4 and 6).

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## CONTENTS

Executive Summary 4  
1. External Economic Environment and Economic Developments in Latvia 5  
2. Bank Credit Risk 7  
3. Bank Profitability 13  
4. Bank Capital Adequacy 16  
5. Interest Rate Risk of Banks 16  
6. Foreign Exchange Risk of Banks 18  
7. Bank Liquidity 20  
8. Financial Vulnerability 22  
9. Leasing Companies 23
EXECUTIVE SUMMARY

In the first half of 2005, Latvia's economy continued to develop buoyantly, scaling down unemployment and pushing up wages and salaries. Trade, transport, storage and communication and construction contributed significantly to the economic growth. At the same time, inflation remained high as a result of rising prices on fuel, food and services and changes in administered prices and tax rates. Expanding external demand promoted export growth, which exceeded that of imports. Nevertheless, a high current account deficit persisted. Swiftly growing tax collections and EU co-financing underpinned the formation of a financial surplus in the general government consolidated budget (overall, the year is expected to end in a deficit in the general government consolidated budget). A high current account deficit and rapid lending expansion, rising consumer prices against the background of growing dependence on external financing pose risks to sustainable economic development. In order to facilitate macroeconomic stability, which is a pre-requisite to further economic growth, the Bank of Latvia's Council resolved to raise the reserve ratio requirement for banks and branches of foreign banks from 4% to 6% on July 14, 2005 (resolution took effect on August 24, 2005).

Overall, taking into account rapid economic growth, low interest rates and high quality of loans to major sectors, the corporate sector displays no aggravation of credit risk. The quality of loans to those sectors of the economy where banks have higher exposure (real estate, construction, wholesale and commission trade, agriculture, hunting and related service activities) remained high, whereas that of loans granted to manufacture of wood and products of wood was lower as a result of the damage caused by the January 9 storm. Somewhat lower quality of loans to retail trade, manufacture of food and beverages and tobacco sectors with a relatively high exposure to NPLs can be explained by problems relating to certain small enterprises failing to cope with competition and meet the EU market quality requirements. The financial indicators of non-financial corporations point to improved profitability due to higher profits; nevertheless, certain large sectors (in particular, real estate) also show growing debt. Considering the problems relating to the quality of some new construction projects and the lack of experience of certain market participants in both construction and real estate business, the development of real estate debt, bank exposure to this segment and changes in the quality of the respective loans are in need of further careful monitoring.

After repegging the lats from the SDR currency basket to the euro in January 2005, fluctuations of the lats against the US dollar increased; as a result, the share of the US-dollar-denominated loans granted to residents shrank significantly, as borrowers with earnings in currencies other than the US dollar wanted to limit their foreign exchange risk.

Credit risk related to household lending continued to rise on account of the rapid expansion of the household debt and increasingly growing share of residents holding loans. The shrinking of US-dollar-denominated household loans is a positive sign from the perspective of foreign exchange risk and interest rates, as the interest rates on loans granted in euro and lats, in contrast to those in US dollars, tend to decline. Growing competition notwithstanding, the loan-to-value ratio remained conservative (up to 70%).

The rapid rise in lending resulted in a new all-time high for the banks' profit with dividends received from subsidiaries as significant contributors to the growth.

Although the loans outstanding expanded fast, the quality of banks' assets was high, and NPLs to total loans granted to non-banks decreased. Nevertheless, the structure of NPLs changed during the year, with the share of lost loans increasing slightly.
The banks' capacity to absorb credit risk increase deteriorated primarily on account of a decrease in their capitalisation level. This, in turn, was affected by reducing the minimum capital requirement from 10% to 8% in November 2004. With banks gradually adjusting to a lower minimum capital requirement, no significant improvement in stress test results can be expected in the near future; nevertheless, the current shock absorption capacity of banks is high.

The banks' exposure to interest rate risk remains modest. Repegging of the lats to the euro and subsequent measures taken by banks in adjusting the structure of their open currency positions to the new circumstances supported a significant decrease of the banks' foreign exchange risk in the first half of 2005.

Lending expansion underlay a slight deterioration of the high liquidity ratios. An insignificant decrease in non-resident deposits in the second quarter had almost no impact on the overall liquidity ratios of the banking sector. Dependence on foreign bank financing continued to grow.

1. EXTERNAL ECONOMIC ENVIRONMENT AND ECONOMIC DEVELOPMENTS IN LATVIA

External economic environment remained favourable, and Latvia's economic growth accelerated.

In the first half of 2005, the global economy continued to develop buoyantly. Nevertheless, the rise of economic activity decelerated slightly as a result of the climbing oil prices. The economic activity in several countries continued to grow significantly. The EU10 countries displayed a robust economic growth rate, whereas that of the euro area countries decelerated. In the first half of the year, Japanese economy developed rather rapidly, in line with the forecasts. With the US economic growth rate remaining high and employment improving, the FRS continued to tighten its monetary policy. Thus, the FRS raised the target for the federal funds rate by 25 basis points on four occasions in the first half of 2005 to stand at 3.25% at the end of the first half of the year (see Chart 1). Other major central banks did not alter their key rates. Hence, at the end of the first half of the year, the ECB key rate remained at its historical low (2.00%), whereas the base rates of the Bank of England and the Bank of Japan were 4.75% and 0.10%, respectively.

Chart 1

<table>
<thead>
<tr>
<th>BASE RATES OF THE MAJOR CENTRAL BANKS (%)</th>
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<tbody>
<tr>
<td>ECB</td>
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</table>

Oil prices resumed an upward trend in the first half of 2005. This was facilitated by the growing global demand for oil products, particularly in Asian countries, and by concerns that the oil extraction and processing reserve capacity would fail to satisfy the rising demand. At the end of the first half of 2005, the prices of crude oil on the US market rose to 60 US dollars per barrel, whereas the European Brent crude oil prices exceeded 55 US dollars per barrel.
In the first half of 2005, the US dollar appreciated against other major currencies on the global foreign exchange markets. This was mainly facilitated by data releases confirming stable US economic growth rates and by raising the US dollar base rate. Against the background of the failure to ratify the European Constitution in France and the Netherlands, the US dollar appreciated significantly against the euro (by 12%). The exchange rate of the US dollar against the Japanese yen and the British pound sterling increased by 8% and 7%, respectively.

The development of the global stock markets decelerated in the first half of 2005 (see Chart 2). Stock prices developments were primarily affected by the high oil prices and uneven development of the major global economies. The US stock market development was additionally hampered by the gradual raising of the US dollar base rate. Therefore, the first half of 2005 was quite unsuccessful for the US stock markets compared with the second half of 2004. In the first half of 2005, the US stock market index S&P 500 and the technology-dominated NASDAQ Composite decreased by 1% and 8%, respectively. The European and Asian stock markets, on the contrary, continued to expand. The European stock market index Dow Jones EURO STOXX 50 improved by 8% in the first half of 2005. This was facilitated by sound corporate financial results, low lending interest rates in the euro area and the euro depreciation. Partly, the rise of the stock market indices in the euro area was determined also by the increasing energy sector prices, especially in the oil subsector. The development of the Japanese stock market was sluggish and unconvincing. Nikkei 225 for Japan's stock market grew by a mere 1%. Russian stock market experienced buoyant growth as a result of rising energy prices on the global markets. In the first half of 2005, the Russian stock market RTS index improved by 15%.

Latvia's economy continued to develop rapidly in the first half of 2005, with the GDP growth reaching 9.5%. Trade, transport, storage and communication and construction were the main contributors to the GDP growth. Inflation remained high (an average of 6.6% in the first half of 2005). This was determined by mounting prices on fuel, food and services and changes in administered prices and tax rates. Owing to favourable economic conditions, unemployment decreased to 7.9% and wages and salaries grew. Due to the rising external demand, export growth exceeded that of the imports (36.4% and 22.7%, respectively). The current account deficit remained high (10.8% of GDP). A significant increase in tax collections and EU co-financing underpinned the formation of a financial surplus in the general government consolidated budget (2.6% of GDP; overall, the year is expected to end in a deficit in the general government consolidated budget in the amount of 1.7% of GDP). A high current account deficit, rapid lending expansion, climbing consumer prices and growing dependence on external financing pose risks to sustainable economic development. In order to facilitate macroeconomic stability which is a pre-requisite to further economic growth, the Bank of Latvia’s Council resolved to raise the reserve ratio requirement for banks and branches of foreign banks from 4% to 6% on July 14, 2005 (resolution took effect as of August 24, 2005).
2. BANK CREDIT RISK

Rapid lending expansion notwithstanding, the quality of loans granted to major sectors remained very high. Loan-to-value ratio for loans for house purchase mostly did not exceed 70%, pointing to conservative lending standards.

At the end of June, loans to residents amounted to 4 785.6 million lats or 60.2% (46.4%) of GDP, including loans to non-financial corporations 2 415.1 million lats, loans to households (private persons and non-profit institutions serving households) 1 783.9 million lats, non-bank financial institutions 435.6 million lats. The banks' exposure to household loans (particularly, loans for house purchase) increased year-on-year, and for five banks it exceeded 20% of their assets (see Table 1). Considering the growth rate of loans to households, they could catch up with loans to non-financial corporations in one year (see Chart 3).

At the end of June 2005, loans to resident non-financial corporations stood at 30.4% (26.1%) of GDP. In comparison with the respective period of 2004, loans to non-financial corporations increased by 37.9%. Analysis of loans granted to non-financial corporations by sector suggests that the quality of loans to the major sectors of economy (real estate, construction, wholesale and commission trade, agriculture, hunting and related service activities) is one of the best (see Chart 4). For some smaller sectors the loan quality is lower. For manufacture of wood and products of wood, e.g., it was related to the damage caused by the January 9 storm, whereas for retail trade, manufacture of food products, beverages and tobacco with problems faced by some small enterprises failing to cope with competition and meet the EU market quality requirements. The share of NPLs for non-financial corporations is quite low (1.4% of total loans granted to non-financial corporations).

With the foreign exchange risk diminishing after the lats was repegged to the euro on January 1, 2005 and Latvia joined the ERM II on May 2, 2005, interest rates on loans granted in euro to resident non-financial corporations declined significantly. This facilitated expansion of euro loans and an increase in the share of those 1 (1) – indicator of the corresponding period of the previous year.
loans in total portfolio (to 47.9%). At the same time, the share of loans granted in lats and US dollar continued to shrink (see Charts 5 and 6). Overall, due to the rapid economic growth and high quality of loans, the corporate sector displays no aggravation of credit risk. Nevertheless, growing banks’ exposure to the real estate and rapid expansion of loans for house purchase suggests that one of the biggest risks in the banking sector relates to further development of the real estate market.

At the end of June, loans to resident households stood at 22.4% (14.8%) of GDP. In comparison with the respective period of 2004, they increased by 79.4%. Lending to households was dominated by loans for house purchase (68.3%), and the share of those loans increased during the year (66.0%). As far as credit risk is concerned, this is a positive sign, as these loans, in contrast to payment card and overdraft credit and, in part, consumer credit, are secured by mortgage collateral. The quality of loans granted to households remained high, as NPLs accounted for a mere 0.6% of the total loan portfolio, including 0.4% of NPLs were loans for house purchase.

Similarly to the structure of loans granted to non-financial corporations, the share of the euro in total household loans increased notably in the first half of 2005,
amounting to 45.1% of outstanding loans at the end of June. Since the end of June 2004, the share of the US dollar declined by 24.3 percentage points (to 25.0%), and was below 10% in the new loans (see Charts 7 and 8). These changes were even more significant in loans for house purchase, where the share of the US dollar declined from 52.7% at the end of June 2004 to 26.2% at the end of June 2005 (see Chart 9). Overall, the households' foreign exchange risk decreased after repegging the lats to the euro.

Growing competition notwithstanding, the loan-to-value ratio remained generally conservative (up to 70%). This suggests that in the event of a real estate price adjustment the quality of loans with a low loan-to-value ratio, which constitute the largest share of the loan portfolio, will not deteriorate, and in case of forced sale it will be possible to sell at a price which is not lower than the outstanding loan (see Chart 10).

At the end of June, loans to financial institutions amounted to 510.7 million lats or 6.4% (4.6%) of GDP, which is 65.8% higher year-on-year. Since most of these loans were granted to leasing companies, an analysis of the performance of leasing companies has been provided in a separate Section of this Report. Loans granted to insurance corporations and pension funds totalled only 0.5 million lats at the end of June.
At the end of June, loans to non-resident non-banks amounted to 717.7 million lats or 9.0% {7.1%} of GDP, which is 50.0% higher year-on-year. The increase was primarily driven by a rise in loans to residents of the EU10 countries (see Chart 11). Banks’ exposure to non-resident loans was low (see Table 2). Overall, the banks credit risk relating to non-resident lending was low, as the banks’ exposure to those loans was insignificant (7.9% of total assets), due to the regional diversification of those loans and also their high quality (see Chart 12).
Box 1. Stress tests of the banks’ loan portfolio

Stress test results provide an indication of the scale of losses resulting from growing credit risk that banks are able to absorb before their CAR falls below the minimum capital requirement. In the first half of 2005, capacity of Latvian banks to absorb a general credit risk rise diminished (see Chart 13).

At the end of 2004, with the share of NPLs in the total loan portfolio increasing by 1 percentage point, none of the Latvian banks would have had any problems in meeting the minimum capital requirement. At the end of June 2005, however, such a rise in credit risk would have pushed the CAR of one Latvian bank below 8%. The share of this bank in total banking sector assets is below 3%, and it is systemically unimportant. Thus, at the end of June 2005 Latvian banks overall would have had no problems in absorbing a credit risk increase resulting in the share of the NPLs growing by 3 percentage points.

As the NPLs amounted to 1.0% of the total loans of banks at the end of June 2005, one may conclude that overall the Latvian banks would have had no significant problems in absorbing a potential credit risk increase resulting in an expansion of the NPLs by 4 times.

The stress test results for specific or sectoral credit risk shocks (see Table 3) also slightly deteriorated in the first half of 2005.

Table 3
SECTORAL CREDIT RISK SHOCKS USED IN STRESS TESTS AND PARAMETERS THEREOF

<table>
<thead>
<tr>
<th>Types of shock</th>
<th>Shock parameters</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic shock</td>
<td>20% of loans to the major domestic market oriented sectors (construction, trade, real estate, renting and other business activity) become NPLs.</td>
</tr>
<tr>
<td>External shock</td>
<td>20% of loans to the major foreign markets oriented sectors (manufacturing and transport, storage and communication) become NPLs.</td>
</tr>
<tr>
<td>Real estate shock</td>
<td>20% of loans to real estate, renting and other business activity become NPLs.</td>
</tr>
<tr>
<td>Real estate shock affecting households</td>
<td>20% of loans to real estate, renting and other business activity and household loans for house purchase become NPLs.</td>
</tr>
</tbody>
</table>

1 This and the other shock parameters are based on an assumption that the rise in the share of NPLs by 20 percentage points consists of a proportionally equal increase in all three categories of NPLs (substandard, doubtful and lost loans).

Rapid growth of mortgage lending to households significantly increased the Latvian banks’ vulnerability to real estate shock which would simultaneously affect also the quality of household loans. Vulnerability of banks to the domestic shock or a credit risk rise in the most important sectors servicing the domestic market

1 Stress tests reflect banks’ losses as the need to make additional provisions for the NPLs whose amount and share in total loans grows as a result of increasing credit risk. The banks’ capital and risk-weighted assets are reduced by the amount of additional provisions to be made. Calculations assume that with the NPLs increasing, the share of the three NPL categories (substandard, doubtful and lost loans) in NPLs of each bank does not change, i.e. the substandard, doubtful and lost loans (the total of which comprises the NPLs) of each bank grow in proportion to the growth of NPLs simulated in the stress test.
also increased (see Charts 14 and 15). Nevertheless, none of the analysed sectoral credit risk shocks would have caused the CAR of any of the banks to fall below 4%.

Moreover, total losses incurred by the sectoral credit risk shocks to the banks would not exceed 2.5% of the total banks’ assets (see Chart 16). The amount of additionally required capital to meet the minimum capital requirement, however, increased considerably in comparison with the end of 2004 (see Chart 17).

Deterioration of the stress test results was primarily determined by a drop in the banks’ capitalisation level, which relates to reduction of the minimum capital requirement from 10% to 8% in November 2004 (at the end of 2004, the change in this requirement increased the banks’ capacity to absorb a credit risk rise). With
banks gradually adjusting to a lower minimum capital requirement, no significant improvement in stress test results can be expected in the nearest future; nevertheless, the current shock absorption capacity of banks still remains high.

3. BANK PROFITABILITY

Bank profitability ratios continued to improve.

With the rapid lending development, banks gained record-high profit. In the first half of 2005, the banking sector profit went up 89.1% year-on-year and amounted to 93.7 million lats after taxes. The rise of profit was largely affected by dividends received from subsidiaries totalling 14.4 million lats in the first six months of the year (no such dividends were received in the corresponding period of the previous year). The banks’ ROE improved, reaching 28.1% (19.7%) at the end of June, as the growth of the banks’ capital (an increase in the amount of 33.1%) was slower than that of the profit. The banks’ ROA increased to 2.2% (1.6%) (see Chart 18).

In the first half of 2005, the amount of written-off loans totalled 3.8 million lats or 33.8% more year-on-year, whereas the ratio of written-off loans to capital and reserves remained unchanged (0.5%).

Almost all banks improved their ROE year-on-year. For 10 banks the ROE was above 20% and their market share was 55.3% of the total banking sector assets (see Table 4).

Table 4

<table>
<thead>
<tr>
<th>ROE (%)</th>
<th>In the first half of 2005</th>
<th>In the first half of 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Market share of banks (% of total banks’ assets)</td>
<td>Number of banks</td>
</tr>
<tr>
<td>&lt;5</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>≥5–10</td>
<td>4.7</td>
<td>2</td>
</tr>
<tr>
<td>≥10–15</td>
<td>1.8</td>
<td>3</td>
</tr>
<tr>
<td>≥15–20</td>
<td>35.0</td>
<td>7</td>
</tr>
<tr>
<td>≥20</td>
<td>58.5</td>
<td>10</td>
</tr>
</tbody>
</table>

In comparison with the first half of 2004, total income from interest displayed the highest increase in the structure of income (47.8%), primarily on account of the expansion of loans granted to non-MFIs. Interest income from claims on MFIs rose dramatically (2.5 times) as a result of climbing US dollar interbank market interest rates. Interest expenditure grew by 54.8%, mainly due to a rise in interest expenditure

1 Unaudited data.
on liabilities to MFIs and on non-MFI deposits. Net interest income increased by 43.9% and accounted for 37.2% {37.4%} of total income (see Chart 19).

A sharper increase of interest expenditure in comparison with interest income was caused by the overall margin developments: in the first half of 2005, the overall margin\(^1\) narrowed (see Chart 20) and was 2.7 percentage points on average {3.5 percentage points}. The overall margin declined in lending to non-financial corporations and households as well as in attracting deposits. This was primarily affected by tightening bank competition, repegging of the lats to the euro on January 1, 2005 and joining the ERM II on May 2, 2005, which reduced the foreign exchange risk for euro borrowings. Nevertheless, interest rate margins remained rather high. Considering the lending growth rates, this is important as an indication of high lending standards, and it enables the banks maintain sound profitability ratios.

Net commissions and fees grew by 14.3% and amounted to 16.5% {20.8%} of total income. A rise in income from commissions and fees was promoted by an increase in the number of clients and value of transactions. Income from trading with financial instruments slightly declined.

With banks continuing to develop, operating costs of the banking sector increased (by 22.3%, including a rise of 23.6% in personnel wages and salaries). Nevertheless, the share of operating costs and amortisation of intangible assets to total income decreased slightly and amounted to 33.8% {41.0%}.

With the banking sector income growing faster than expenditure (by 44.4% and 31.4%, respectively), the cost efficiency of banks improved and cost-to-income ratio\(^2\) declined to 49.5% {58.5%} (see Chart 21). Cost efficiency improved in almost all banks.

\(^1\) All margins are calculated on new business. Overall margin has been calculated by subtracting the average deposit rate from the lending rate with a fixed maturity. The margin on total loans, loans granted to households and non-financial corporations has been calculated by subtracting the reference rate: the value of average 6-month money market index (RIGIBOR 6M, EURIBOR 6M or LIBOR 6M) for the given period from the relevant lending rate. Margin on deposit rates has been calculated by subtracting the average deposit rate from the reference rate: the value of average 6-month money market index (RIGIBOR 6M, EURIBOR 6M or LIBOR 6M) for the given period.
Specific provisions covered over 90% of the NPLs.

With lending expanding rapidly in the last years, the quality of the banks' assets remains good. Non-MFI NPLs increased by 13.1% year-on-year; nevertheless, their share in total loans to non-MFIs shrank and constituted 1.0% at the end of June 2005 (1.4%). The number and market share of banks where NPLs exceeded 1% of the bank's loan portfolio contracted (see Table 5).

Table 5

<table>
<thead>
<tr>
<th>NPLs (%)</th>
<th>In the first half of 2005</th>
<th>In the first half of 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Market share of banks (% of the banking sector assets)</td>
<td>Number of banks</td>
</tr>
<tr>
<td></td>
<td>Market share of banks (% of the banking sector assets)</td>
<td>Number of banks</td>
</tr>
<tr>
<td>&lt;1</td>
<td>45.2</td>
<td>12</td>
</tr>
<tr>
<td>≥1–2</td>
<td>29.1</td>
<td>5</td>
</tr>
<tr>
<td>≥2–3</td>
<td>22.9</td>
<td>3</td>
</tr>
<tr>
<td>≥3</td>
<td>2.7</td>
<td>3</td>
</tr>
</tbody>
</table>

The structure of NPLs changed during the year. The share of substandard and doubtful loans in the NPLs shrank, but the share of lost loans expanded year-on-year (see Chart 22).

The ratio of provisions to total loans to non-MFIs diminished slightly (0.9% (1.2%); see Chart 23). Specific provisions covered 92.3% of the NPLs at the end of the first half of 2005.

*The cost-to-income ratio has been calculated based on the ECB methodology: (operating costs + intangible 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.
4. BANK CAPITAL ADEQUACY

The level of bank capitalisation declined slightly.

CAR stood at 10.7% at the end of June 2005. The CAR declined by 1.4 percentage points in comparison with the end of the first half of 2004 (see Chart 24).

Four banks took advantage of the fact that from November 2004 the minimum requirement for the banks’ capital adequacy was reduced to 8% (previously 10%). The capital adequacy of those banks was close to 10% (see Table 6).

5. INTEREST RATE RISK OF BANKS

The banks’ exposure to interest rate risk remained limited.

In the reporting period, short-term liabilities of banks increased quite rapidly. Therefore, the ratio of interest rate sensitive assets (RSA) to interest rate sensitive liabilities (RSL) overall decreased (see Chart 25).

The cumulative 1 year RSA to RSL, which is the most meaningful RSA to RSL ratio for interest rate risk management, declined from 1.06 to 1.01 in the reporting period. Thus, in the time-band of up to 1 year the RSA are almost fully in balance.
with the RSL, suggesting that overall banks’ exposure to repricing risk, which is the most significant source of the banks’ interest rate risk, is very limited.

Looking at the difference between RSA and RSL or repricing gap (GAP) in various time-bands, it is obvious that the negative GAP in the time-band of up to 1 month has grown significantly (from 6.9% to 12.0% of total banks’ assets; see Chart 26).

This indicates that, in the event of an increase in interest rates, the banks would incur greater losses in the nearest month. Nevertheless, positive GAPs in the following time-bands would still offset the losses incurred by the potential interest rate rise in the first month.

The results of sensitivity analysis show that the magnitude of impact of interest rate changes on annual profit of Latvian banks remains broadly unchanged. However, the impact of the interest rate changes has reversed, and an interest rate increase would have an adverse effect on the annual interest income of banks, whereas an interest rate fall a favourable one. If at the end of 2004 with the interest rates increasing by one percentage point the banking sector’s profit would have increased by 0.3% of the banks’ total capital and reserves, at the end of June 2005,

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1 Repricing risk is the probability of suffering losses due to interest rate movements and mismatching residual maturities of assets and liabilities. Losses are incurred when the interest expenditure growth exceeds that of the interest income or the interest income falls quicker than interest expenditure. When estimating the bank’s exposure to repricing risk, only RSA and RSL are examined, and they are distributed into several time-bands depending on the time remaining to repricing, which is the residual maturity for fixed rate instruments and the time remaining to reviewing the interest rates for variable rate instruments.

2 The GAP of a pre-defined time-band is the difference between the RSA and RSL value within the specific time-band. The larger a particular bank’s GAP, the higher its interest rate risk exposure. In the event of a positive GAP, the bank will incur losses from an interest rate decline, as the RSA exceed the RSL and, therefore, the banks’ interest income will shrink more notably than the expenditure. In the event of a negative GAP, the bank will incur losses from a rise in interest rates, as the liabilities exceed the assets and, therefore, the banks’ interest expenditure will grow more than the income.

3 Effect on annual interest income within each time-band is calculated by multiplying the time-band’s GAP with the interest rate change and the ratio of this time-band characterising the part of the year when the GAP of this time-band will be active. The calculation of the ratio assumes that repricing will be done in the middle of the time-band. For example, 3–6 months time-band ratio is calculated as follows: \((12 – 0.5 \times (3 + 6))/12 = 0.625\). The total effect on the annual profit is the sum of effects of the first four time-bands of the year.
in the event of a similar scenario the annual interest rate income of banks' would have declined by 0.3% of the total capital and reserves (see Chart 27).\(^1\)

This result of the sensitivity analysis is predetermined by the fact that the first month's negative GAP has a larger impact on the annual income than the positive GAPs of the following time-bands: the sooner the repricing, the bigger its impact on the annual income.

A well-balanced RSA and RSL structure and, consequently, low banks' sensitivity towards interest rate changes, points to an overall limited exposure of Latvia's banks to the interest rate risk.

6. FOREIGN EXCHANGE RISK OF BANKS

The repegging of the lats to the euro reduced the banks' foreign exchange risk considerably.

After the sharp depreciation of the US dollar towards the end of 2004, the US dollar resumed an upward trend in the first half of 2005. Following repegging of the lats to the euro, at the beginning of 2005 the US dollar appreciated against the lats in line with the US dollar appreciation against the euro and exceeded the 58 santims border at the end of June (see Chart 28).

Banks preserved the US dollar open positions (reduced already in December 2004) low through all the reporting period, as after repegging of the lats the lats exchange rate fluctuations against the US dollar increased. The banks' open positions in euro, in turn, increased significantly since the beginning of the year (see Chart 29). Moreover, the rise of the open currency positions in euro was no longer contained by the banks' regulatory requirements. Since the repegging of the lats, the restrictions of the open currency positions no longer apply to the open currency

\(^1\) As the calculations are based on the GAP method, they do not take into account the interest rate impact on the economic value of the banks and are based on the structure of the banks' aggregate balance sheet as at the end of June 2005.
VAR reflects the maximum expected losses over a certain period of time with a given probability. 1% 10 day VAR from exchange rate fluctuations means that within the next 10 days there is only a 1% probability that losses from exchange rate fluctuations will exceed the VAR. In this report, VAR was obtained based on open currency positions of individual banks at the end of each month. Calculations use the historical daily exchange rate changes within one year prior to VaR evaluation date (last day of the relevant month). Since repegging the lats to the euro, VAR calculations no longer include the euro component.

Overall, these developments should be considered positive as the foreign exchange risk associated with the open positions in euro after the repegging of the lats is restricted within the permissible fluctuation band of the lats against the euro. The US dollar as well as the total open currency positions, in turn, were considerably lower in the first half of 2005 than in 2004.

Value-at-Risk (VAR)\(^1\) results also suggest that in the first half of 2005 the foreign exchange risk of the banks was considerably lower than in 2004 (see Chart 30).

Repegging of the lats to the euro and subsequent measures taken by the banks in adjusting the structure of their open currency positions to the new circumstances supported a significant decrease of the banks’ foreign exchange risk in the first half of 2005.

\(^{1}\)VAR reflects the maximum expected losses over a certain period of time with a given probability. 1% 10 day VAR from exchange rate fluctuations means that within the next 10 days there is only a 1% probability that losses from exchange rate fluctuations will exceed the VAR. In this report, VAR was obtained based on open currency positions of individual banks at the end of each month. Calculations use the historical daily exchange rate changes within one year prior to VaR evaluation date (last day of the relevant month). Since repegging the lats to the euro, VAR calculations no longer include the euro component.
7. BANK LIQUIDITY

An insignificant decrease in non-resident deposits in the second quarter had almost no impact on the total liquidity ratios of the banking sector.

The banks' liquidity ratios still exceeded the minimum level set by the FCMC considerably (30%\(^1\)): At the end of June, the banks' liquidity ratio amounted to 51.8% (54.0%). Banking sector's short-term liquidity ratio\(^2\) posted a slight decrease and stood at 61.2% (62.3%) (see Chart 32) at the end of June. Liquid assets\(^3\) amounted to 29.0% (32.6%) of the total banking sector's assets (see Chart 33), mainly driven by a pickup in loans granted to non-MFIs. Shrinking of the liquid assets in the first half of 2005 was facilitated by a decline in the central government fixed income securities and claims on MFIs (other than associated and related). The drop in claims on MFIs in the first half of 2005 was caused by the US Treasury's April announcement on placing two Latvian banks under certain restrictions due to suspicion of money laundering. Anti-money laundering measures were implemented in those two banks as well as other banks, including a review of the customer base, resulting in a decline in the number of non-resident customers and a slight decrease in non-resident deposits.

With the development of lending, the non-MFI loan-to-deposit ratio reached 97.8% (82.9%) at the end of June. For resident transactions, this ratio was 173.5% (148.8%) at the end of the June. Banks financed part of the lending from loans granted by foreign banks and, in a smaller amount, from non-resident non-MFI deposits. Lending expansion was partly also fuelled by the banks' growing capital; with the banks' shareholders investing funds in further development of the banks, the banks' paid-up capital increased by 17.0% within a year.

Analysing net positions of assets and liabilities by sector and currency, it can be

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\(^1\) The total assets with less than 30 days to maturity may not be less than 30% of the total liabilities with 30 days to maturity.

\(^2\) Short-term liquidity ratio = liquid assets/demand liabilities (to banks and non-MFIs) x 100.

\(^3\) Liquid assets = vault cash + claims on MFIs + central government fixed income securities.
concluded that banks servicing residents\(^1\) (see Chart 34) attract funds available on the interbank market abroad and use them mostly for granting loans to resident non-MFIs. A large part of the attracted interbank funds (70.4\%) is received from parent banks. Long-term syndicated loans from foreign banks and loans from the West European investment banks are also being attracted. In comparison with 2004, resident non-MFI net position in euro assets continued to grow, determined by expansion of euro loans. Dependence on foreign bank financing increased slightly.

Banks servicing non-residents mostly attract funds from non-resident non-MFIs in US dollars, and place the majority of them in foreign banks or invest in securities (see Chart 35). A minor part of the non-resident deposits was also used for granting loans to residents in US dollars and in euro. Nevertheless, the liquidity risk relating to non-resident deposits is low, as the major share of those assets is placed on correspondent accounts in foreign banks and invested in securities. In the second quarter of 2005, non-resident non-MFI deposits contracted slightly (by 3.7 million lats). At the end of June, non-resident non-MFI deposits amounted to 2 870.2 million lats (27.8\% higher than at the end of June 2004). Analysing non-resident deposits by country, it becomes evident that the decrease was the most pronounced for the US resident deposits, whereas the deposits of the residents of the EU countries grew.

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\(^1\) Banks are grouped by the share of non-resident non-MFI deposits in the banking sector liabilities: if it exceeds 20\%, a bank is regarded as a bank servicing non-residents; if it is below 20\%, a bank is regarded as a bank servicing residents.
8. FINANCIAL VULNERABILITY

With the sales increasing rapidly, the profitability of non-financial corporations improved.

In the first half of 2005, the non-financial corporation sector continued to develop, earning high profits. The number of registered insolvency applications declined, whereas the number of new businesses continued to grow year-on-year.

In the first half of 2005, the profitability before taxes of the non-financial corporations grew significantly year-on-year. According to preliminary data, there was an improvement in all major sector. With the sales expanding rapidly, the financial information of major sectors pointed to improved business efficiency, with the ratio of production and operating costs to sales decreasing, underpinning higher profitability. An increase of production costs ratio to sales was observed only in agriculture, hunting and forestry (as a result of the impact of damage caused by the January 9 storm) and in wholesale and retail trade, repairs of motor vehicles, motorcycles and personal and household goods, due to increased purchase and transportation costs.

Although the equity of non-financial corporations continued to grow rapidly, increasing investment needs and favourable lending conditions fuelled a rapid growth of liabilities. As a result, the aggregate leverage increased in the first half of 2005, mainly driven by a rise in manufacturing, real estate, transport, storage and communication, construction and energy, gas and water supply.

With the share of the US dollar in household debt shrinking, the foreign exchange risk of households diminished; nevertheless, a rapid debt expansion pointed to risk aggravation in this segment.

In the first half of 2005, the negative net financial position of households continued to grow and amounted to 4.1% of GDP, i.e. household liabilities exceeded deposits (see Chart 36). At the end of June, the household debt consisting of liabilities to banks, leasing companies and credit unions stood 76.8% higher year-on-year and totalled 23.4% (15.7%) of GDP (see Chart 37). Interest payments, on the other hand, remained very low and did not exceed 1.1% of GDP (71.9% more than in the first half of 2004). Although the volume of debt and interest payments was low, its increase pointed to growing risks in this segment. The share of the US dollar in the currency composition of the household debt contracted notably, whereas that of the euro expanded. Therefore, the foreign exchange risk for households diminished and the banks’ credit risk declined accordingly. As the majority of loans have been granted at floating interest rates, households are exposed to quite significant interest rate risk. Nevertheless, no rise in the base interest rates on loans granted in euro is expected in the nearest future and, according to information provided by banks, the high income of the majority of borrowers will enable absorption of the potential interest rate increase.
At the end of June, the number of banks’ loans for house purchase amounted to 88.8 thousand. The average outstanding loan was 13.7 thousand lats; moreover, the average outstanding loan in lats was significantly smaller than that in euro and US dollars (see Chart 38). It may be that loans in lats are granted primarily for housing repairs rather than purchase, since compared with other currency loans the maturity of loans for house purchase granted in lats exceeds five years less often. 51.9% of the total number of loans for house purchase was granted in lats. Of 9.8% households having taken loans for house purchase, only 4.7% had undertaken foreign exchange risk. As the lats is pegged to the euro, only 2.3% of households are exposed to a high foreign exchange risk due to holding loans in other foreign currencies, mainly in US dollars.

9. LEASING COMPANIES

Transport vehicle leasing posts an expansion, whereas that of real estate and consumer goods is declining with the development of the respective banking services.

According to the LLA data on developments in the leasing and factoring portfolio of six companies in the first half of 2005, operating leasing services recorded the highest growth (the annual rise totalled 79.6%, about two times more than the increase of financial lease at 44.3%). Leasing portfolio grew to 475.6 million lats and together with factoring portfolio, which increased by 72.6% during the year, totalled 544.9 million lats. The overall leasing portfolio was favourably affected by a new leasing company joining the LLA.

Leasing portfolio by customer type in Latvia is quite similar to the average leasing portfolio of leasing companies of the European countries (according to the data of the European Federation of Leasing Company Associations). The most notable expansion of the leasing portfolio (over 60%) was recorded in agriculture, hunting and forestry, and fishing. Leasing expanded significantly (by more than 50%) also
in construction and services, 49.2% of the leasing portfolio was attributable to the services sector (see Chart 39). The share of leasing services delivered to households in the leasing portfolio decreased slightly year-on-year (to 14.9%).

Transport vehicle (commercial vehicles and passenger cars) leasing reached 64.7% of the total leasing portfolio (see Chart 40). The share of transport vehicles was significant also in new business; passenger car leasing and commercial vehicles leasing totalled 68.3%. As opposed to the banks’ mortgage lending dynamics, the share of real estate in the leasing portfolio continued to shrink. The share of consumer goods in the leasing portfolio also continued to decline.