

# Principal Causes of Financial Frises in Latvia for Last 20 Years

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## Abstract

In the article the author analyses activity of the Latvian banks with the purpose of search of ways from a crisis situation. In the middle of 2000th rapid development of crediting resulted in negative tendencies. It was assisted by not only superfluous liberalization of crediting but also decline of quality of supervision. Successful development of economy of Latvia in a great deal depends on stability of commercial banks that accumulated money resources. Besides the commission of market of finances and capital, successful development of the banking system in a great deal depends on activity of central bank and government. Therefore an exit from a financial crisis depends on Latvian commercial banks will be able to tide over financial difficulties and pick up thread crediting of enterprises. Secondly, on the basis of the analysis of events development in the banking area the Author discloses the true reasons which brought the Latvian economy to the deepest financial crisis among the countries of the European Union. The period from 1995 till 2014 is being investigated. The author uses a wide range of research methods, such as: grouping method, method of comparison of financial ratios, etc.

**Keywords** Central bank; Commercial banks; Financial market; Bank lending; Real estate market.

## 1 Introduction

After Latvia had regained its independence the central bank began to reform the credit system. We can note both positive and negative moments of its activity. Undoubtedly, one of the reasons of banking crises in 1995 and 1998 were the shortcomings of activity of the Bank of Latvia[1]. The fast price liberalization, cancellation of subsidies, manipulation with funds of the enterprises at exchange of old money to new one also contributed to the creation of certain problems.

At the same time the essential changes in relation to streamlining of requirements for credit institutions occurred in the field of regulation of all banking system in Latvia. This has allowed the strengthening of the position of the whole credit system of the country, increasing confidence in the banks and improving of their financial performance.

Prior to 1995 the number of failures did not exceed two or three cases per year. In a result of crisis, the number of licenses revoked by the Bank of Latvia reached 15: Tautas banka, Latgales komercbanka, Latintrdes banka, Depozitu banka,

Centra banka, Alejas komercbanka, Polarzvaigzne, Liepajas komercbanka, Kredo banka, Olimpija, OLTiIbanka, Talsu komercbanka, Lettika, Rigas Starptautiska banka and Banka Baltija. In 1996, more seven banks have lost their licence: Tukuma banka, Daugavas banka, Bauskas banka, AKO banka, Dinastija, Jelgava, Atmoda.

Despite the fact that the number of closed banks has been high, the total bank capital had resumed quickly. A considerable reduction of banks and the fact that the top ten banks were in this list, including the country's largest bank - Banka Baltija, significantly affected the main indicators of the industry, what gave a reason to speak about the banking crisis in Latvia in 1995.

## **2 Bank Crisis in 1995**

One of the main reasons of the banking crisis of 1995 was the fact that banks did not manage the risks in due manner. Banks have been working in markets which had not been enough good explored. The recession, slow rate of reforms and the imperfection of legislation kept the already high degree of risk in bank activity.

Many of them enjoyed the demand for bank loans. They provided loans and attracted deposits at high rates, which had fallen harshly subsequently. A tough position of the Bank of Latvia in relation to the supervision over commercial banks had a considerable importance for stabilizing the banking system. Only a year after the crisis, the Bank of Latvia issued a dozen of rules, guidelines and regulations.

The most important of them included the toughening of regulatory requirements for commercial banks, providing the Bank of Latvia with information about shareholders, restrictions on attracting by banks of deposits from individuals, which had limitations in financial activities, mandatory annual audits by international audit companies, coordination with the Bank of Latvia of any changes in the capital, in management, etc. Though all these measures have complicated the activity of commercial banks, streamlining of their activity was justifiable because of positive efficiency in development of banking system.

Some banks have had incompetent managers who failed to forecast the development of financial and currency markets. Notwithstanding to the valid legislation the Bank of Latvia was approving people without economic education, or even without experience of work in the banking system, for the positions of Chairmen of the Board and their deputies. There was a shortage of qualified specialists in the field of lending, foreign exchange and bank marketing. As a result, the mistakes in lending and evaluating business plans were quite often. The banking regulatory authorities did not carry out a due control.

### 3 Bank Crisis in 1998

According to the law “On Credit Institutions”, which came into force in October, 1995, the Bank of Latvia got new supervising powers in relation to both licensing of banks and essential changes in structure of shareholders[2]. Bank of Latvia considerably strengthened this control, especially with acceptance of new rules of licensing in the beginning of 1996. The Bank of Latvia regularly checked banks records and events connected with the change of shareholders, and if the rules weren't observed in full completeness, it applied the financial sanctions.

The Bank of Latvia established a wide set of standards and regulations for credit institutions. Developing them, it proceeded from principles and the standards valid in banking systems of the developed countries, considering EU regulations in the bank sphere and principles of Basel Committee of Bank Supervision. Some of them were even stricter, for example, the requirement to the capital sufficiency (10%) to cover the defined risks. Basel Committee set a sufficiency of the capital at a level of 8%. It is necessary to notice that this standard had no big importance at that time since the capital sufficiency of bank industry at that time was more than 17%.

At that time the Bank of Latvia has played an important role in the regulation of bank liquidity in order to limit the fluctuations in interest rates. As a matter of fact the value of interest rate is defined by the cash flows and the value of supply and demand in the financial market. The Bank of Latvia set a refinancing rate, which served as the initial point for the whole banking system. The short-term loans have been provided to the commercial banks under this rate.

One of the most popular instruments of the Bank of Latvia was the credit refinancing which using began in 1993 by issuing the short-term loans to ensure the liquidity. In the late 1990-s there was a tendency in Latvia of lowering of the refinancing rate. The interest rate of refinancing established in 1993 at level of 120% per annum, decreased to 4% by 1997. Such policy made it possible to create more favorable conditions for banks lending, what made it possible to carry out a policy of credit expansion. The commercial banks lowered the interest rates, making their loans more available for economy development. The increased demand for loans thus caused the increasing of investments.

Initially, the loans were given to each bank within specific maximum limits which depended on the fulfillment of regulatory requirements stipulated by the Bank of Latvia. Such order was necessary because the loans were given without any collateral. The amounts of the refinancing were relatively limited, as most of them have been used for foreign currency converting. Though the loans were small, nevertheless they allowed banks keeping the liquidity in cases when those couldn't get them at the interbank market which was poorly developed at that time.

The development of securities market has reduced the necessity to cover the domestic debt by the loans of the Bank of Latvia. As a result, there appeared a possibility to limit the additional emission and to reduce inflation. The internal state bonds were the main source of the budget deficit financing. In 1996, the demand was much higher than supply.

The amount of reserve requirement established by the Bank of Latvia on July 15, 1993 was 8% of the balances involved in all types and terms of money. This meant that each bank having a license was obliged to reserve the average daily funds appropriate to the amount mentioned in the requirements in the period from 16th day of previous month until the 15th day of the reporting month. Therefore, the amount of funds in different days could differ considerably. At the same time, 50% of the required reserves could be the average cash balances, while the rest part should be reserved on the correspondent account with the Bank of Latvia.

As of December 1998, the volume of bank reserves amounted to 129.9 million Lats, including 34.3 million in cash balances. Cash balances in foreign currency were not taken into account in meeting the reserve requirements. Assessment of standards of execution of reserve requirements under average value gave the banks chance to handle their funds more freely and to provide liquidity in settlements. In order to consider the reserve requirements as monetary instrument to control the money supply, in April 1, 1997 the Bank of Latvia gave the banks the right not to include the obligations related to the transactions with foreign central banks, local and foreign credit institutions into the calculation of reserve requirements.

As a result, banks got an opportunity to increase the money supply in the frameworks of this conservative monetary policy instrument. After a year since the introduction of these changes, the volume of liabilities to foreign central banks and credit institutions increased by more than three times. This gave a chance to attract additional loan resources for a longer period of time. At the end of April 1997 they amounted to 57.1 million and increased to 183.5 million to the end of April 1998.

In 1997, the lowering of credit rates promoted the lowering of discount rates for liabilities. In the beginning of 1997, they were 8-10.5 %, and decreased up to 3.5-5.5 % by the end of the year. The total amount of the state securities in 1998 fell to 18.4 %, and amounted to 127.0 million in the end of the year. Respectively, the share of all term liabilities available in circulation decreased in comparison with the previous year, i.e. 12 month liabilities-36.5 %, 6 month-8.0 %, 3 month - 1.7 %, 1 month-0.2 %, and the share of 2 year bonds was 53.6 %[1].

However, the sustainability of financial market at that time was achieved mainly due to foreign currency interventions. It was possible to reduce loans interest

rates owing to the operations of buying and selling of foreign currency, what favorably affected the formation of the business environment. A tough position in establishment of the rate of Lat allowed limiting the inflation, increasing the fiscal discipline, creating the conditions for sustainability of business and the confidence of foreign investors.

It is worth regretting about poor coordination between the government and the Bank of Latvia. Should the national currency be supported timely by reasonable tax policy stimulating, it could be possible to cause a domestic investment demand, which would enable a more efficient structural change in the economy. In process of its development the monetary market and securities market would have a stimulating effect on production development, creating the conditions for linkage in a trade turnover of considerable monetary funds.

Since July 1, 1997 the "Terms and conditions of trade (currency swap transactions) on the purchase with subsequent sale and sale with subsequent Lats repurchase" came into force. The Bank of Latvia has developed them with the aim to introduce a new financial instrument. The terms of such transactions does not exceed three months. Since May 12, 1998 the Bank of Latvia began organizing auctions of currency reverse transactions quarterly. The volume of currency "swap" transactions in December 1998 amounted to 23.1 million Lats, including 7.5 million Lats with 7 day period (average interest rate - 6.8%), 6.9 million Lats with 28 day period (average interest rate - 7.5%), 8.7 million Lats with 91 day maturity (average interest rate - 8.6%).

Regarding the involved deposits the demand deposits dominated in the banking structure. In April 1998, their share in total deposits was 73.4%[1].

Lets note, that the currency market traditionally has been one of the most developed and liquid sector of financial market in Latvia. Its average turnover per day amounted to 279.9 million Lats as of April 1998. In contrast, the average daily turnover of interbank market was almost four times less (76.3 million Lats) during this period.

Prior to 1994 it was impossible to carry out the operations on open market, as government securities werent available. After their issuance the volume of state bonds grew relatively slowly, and their liquidity was not enough high, because the secondary market of liabilities was inactive and poorly developed. Such operations gained their significance after 1997. The volume of state securities in the secondary market amounted to 704.5 million Lats in 1998. The share of transactions with residents has increased from 46.4% (in 1997) to 78.0% (in 1998), and non-residents transactions decreased from 18.0% to 2.3%.

By carrying out the operations in the open market the regulation of the reserves has been made providing the fixed level of interest rate, defined by a tactical task in spite of the eventual changes of interest rates specified by impact of market

processes.

The Bank of Latvia carried out the open-market purchases of securities as a stabilizing measure, thereby extending bank reserves and increasing the money supply to the extent that was sufficient to keep interest rates on the same level. This increase in money demand put pressure on the interest rate.

As the interest rate exceeded the target level, the Bank of Latvia started buying the securities from commercial banks. The process of using the excessive loan resources increased the money supply in circulation. Open-market purchases continued until the moment when sufficient amount of new money has been formed ensuring the compliance with the demand and supply at a fixed interest rate. Thus, the Latvian market has been achieving a certain balance.

When the Bank of Latvia was selling the securities to the banks, sterilizing the money supply, the interest rates were increasing. The volume of transactions on purchase and sale of securities amounted to 109.5 million Lats in 1998 (in previous year - 89.7 million Lats). The most volume of transactions was in August (purchase - 30.2 million Lats) and September (sale - 11.5 million Lats). The Bank of Latvia was buying mainly the government bonds, increasing its securities portfolio and replenishing the amount of active money by such operations. The securities portfolio of the Bank of Latvia in the middle of 1998 was 40.6 million Lats (at par).

Since October, 1995 the Bank of Latvia began actively using "repo" auctions. The interest rates on "repo" auctions fixed by the Bank of Latvia were differentiated on terms and could be both above and below the level of a rate of refinancing.

The Bank of Latvia carried out "repo" auctions daily, offering the credits for term of 7, 28 and 91 days. The interest rate at auctions exceeded a refinancing rate a bit. In 1997, the volume of the credits of the "repo" auctions with validity period of 7 days amounted to 55,7 million Lats, for 28 days-33,1 million Lats, for 91 days-5,7 million Lats. In 1997, the Bank of Latvia credited the commercial banks in amount of 112.6 million Lats that was more on 3.5 % than in 1996. Their structure looked as follows: repo auctions-83.9 %, auto pawn-14.8 %, a pawn on demand-1.3 %[1].

The volumes of lending have been increasing every year. For example, in 1998, the loans to commercial banks reached 458.0 million Lats, which was 4.1 times more than in 1997. From them: 58.8% was issued in repo auctions, 33.1% of pawn demand, 4.2% - auto pawn and 3.9% - loans in emergency situations. In 1998, repo loans for 194.4 million Lats were issued with 7 day term, 40.6 million Lats- 28 day term and 34.5 million Lats - with 91 day maturity. Therefore, the commercial banks could solve the problem of short-term liquidity, and the Bank of Latvia knowing the maturity of loans, could make short-term forecasts of amendments in the liquidity of all banking sector.

While and today, one of the problems slowing down the development of a national economy of Latvia[3, 4], was a deficit of balance of payments. Foreign trade still remained a weakest point of national economy. In 1997, there was a growth of both in export and import. And the gap between them increased by high rates, creating a considerable deficit in the countrys trade balance. The volume of foreign trade in 1997 amounted to 2554.1 million Lats that more on 23.2 % than in previous year. The deficit reached 610.7 million Lats at export amounting to 971.7 million Lats in1997. The payment of the international services already couldn't compensate the missing foreign currency to pay the imported goods. The missing currency could be received generally by the means of loans. Therefore, the trade surplus of the balance of payments at that time depended on capital flow more and more. It was clear, that since the producers of the goods don't find the new markets and new buyers, the country will import on credit, live in the account of converting the foreign loans. The only one solution of successful development of economy was to search ways of increase the inflow of foreign investments into manufacture and infrastructure.

The current account deficit of balance of payments could be financed either by foreign funds coming to the country or by using of foreign exchange reserves. The balance of payments summarizes the flows of goods, services, capital and related income - interest payments, dividends of Latvian residents and foreign countries. Considering the limitation of the state budgetary funds and caution of commercial banks at crediting of the long-term projects, only the foreign investments could be the main source of long-term capital.

However, the inefficient economic management, when the ministers of economic departments have been changed several times a year, volatile fiscal policy, the absence of free land market, the disorder in legislation and other factors prevented the attraction of foreign investments. Since 1996, the government tried to limit the growth of external debt. The main reason lied in inefficient use of earlier received credits.

In relation to state debt and the budget deficit, Latvia focused on the implementation of the Maastricht requirements. The external debt included loans from international financial organizations and the private sector. A number of loans was provided to Latvia for a considerable period and under very favorable terms, i.e. the loan of the International Bank for Reconstruction and Development-for 17 years (under 7.6% per annum), Exim Bank of Japan - for 16.5 years (4.7%), the European Bank for Reconstruction and Development - for 15 years, the credit of the American "Commodity Credit Corporation" - 30 years (terms of initial payments were extended to 5 years).

The balance of state debt at the end of 1998 amounted to 231.5 million Lats (6.1% of GDP) , and the government has issued guarantees in amount of 42.9

million Lats in order the enterprises could get the foreign loans. In 1998, the government has spent 37.0 million Lats to administrate the external debt. The amount spent for servicing the external government debt equaled to 3,5% of annual export amount. The domestic debt included the Government borrowings in the local market. It grew every year. For example, it increased by 5.4% and amounted to 8.3 million Lats during 1997[1].

Contrary to the previous crisis, the bank crisis of 1998 was caused not only by internal shortcomings of activity of Latvian banks, but also by many external factors. The financial crisis in Russia burst in August, 1998 was the main reason. Respectively, the Russian crisis negatively affected the development of the banking sector of Latvia in the second half of 1998, as the majority of banks formed the considerable part of their assets by investments to CIS countries.

The main aspect was that considerable monetary resources left Latvia in the form of investments into foreign securities because the Latvian banks had actively operated on securities markets of other countries. It is known that the commercial banks way out from a crisis situation in 1995 was reached for the account of increase of the operations with investments and converting of currencies in Russia and CIS countries. The Bank of Latvia didn't see it. In November, 1996, the investment into foreign securities reached 121.5 million Lats and amounted to 171 million Lats in August, 1998.

Such migration of capital was stipulated by high interest rates on the Russian government securities and securities of the entities what created a possibility to receive profit by the Latvian banks. The interest rates nearly three times lagged behind their counterparts in the CIS at that time in Latvia. Unfortunately, the Bank of Latvia didn't take the timely actions to protect a national banking system from possible financial crashes in the monetary markets of CIS countries.

The financial crisis of 1998 brought serious changes to the development of bank sphere of Latvia. It negatively affected the activity of all banks. The total losses of credit institutions according to financial reports of auditors for 1998 amounted to 56.6 million Lats (only 8 banks got profit in amount of 3.5 million Lats). Two banks got bankrupt (Latvijas Kapitalbanka and Komerbanka Viktorija), and Rigas Komerbanka was in a state of insolvency with losses amounting to 9 million Lats in the beginning of 1999. Parekss banka had the greatest profit-1.21 million Lats (the total declared profit before audit - 5.6 million Lats). The losses of Latvijas Unibanka were 15.1 million Lats[1].

In spite of the fact that the Bank of Latvia revoked licenses of two banks during 1998: Latvijas Zemes banka (in connection with the merger with Hansabank-Latvija) and Doma banka (due to insufficiency of the equity), we can state that the whole banking system has successfully overcome the negative consequences of crisis. The positive changes in key indicators of the banking industry were the



evidence as well as the fact that 19 banks from 24 finished the year of 1999 with a profit.

The process of enhancement of the legislation continued. In 1998, two new laws came into force: “On the Prevention of Laundering of Proceeds Derived from Criminal Activity ” and “On guarantees of deposits of individuals”. The adoption of the Law ”On the Financial and Capital Market Commission” was an important event in the process of improving the legislation base[5].

The introduction of unified supervision on the market of finance and capital in Latvia became a significant event. As a result, Agency on Supervision of Credit Institutions of the Bank of Latvia, State Inspection for Supervision of the Insurance Market and the Commission of the Securities Market were united into the Financial and Capital Market Commission. The number of banks in Latvia

**Table 1** Bank and branches in latvia from 2005 to 2014

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total number of the banks	22	21	21	21	21	21	20	20	19	17
Branches of foreign banks	1	3	4	6	8	10	9	9	9	10
Number of branches	215	224	235	247	231	223	-	406	342	313
Average number of employees	10,520	11,611	13,334	14,381	12,628	11,616	-	10,256	9,845	9,362
Customers current accounts, thousands	2,912	3,316	4,341	4,545	4,462	4,525	4,539	4,568	4,581	3,078
Customer accounts available via Internet, thousands	-	-	2,538	2,859	3,015	3,163	3,230	3,444	3,643	2,618
Payment cards, thousands	1,711	2,107	2,389	2,518	2,478	2,424	2,325	2,381	2,369	2,305
Number of ATMs	878	957	1,143	1,274	1,320	1,359	1,207	1,270	1,154	1,068
POS terminals accepting payment cards	18,495	17,571	20,367	23,350	24,381	24,366	25,430	26,259	29,066	31,121

has considerably reduced in a period from 1992 to 2005. Thus, if there were 61 commercial banks in 1993, in 2005 the number of commercial banks reduced to 22 banks (in 2014 -17 banks). The licenses of commercial banks have been issued by the Bank of Latvia which carried out the supervision over banks activities. Since 2001, the Bank of Latvia handed over these responsibilities to the Financial and Capital Market Commission.

#### 4 Financial Crisis of 2008

The volume of loans increased up to 1,086.7 million Lats at the end of 2000, 3.8 times more than in 1996. The year of 2001 has been the most successful for

the banking sector of Latvia. The best indicator of the annual profit in amount of 46.7 million Lats has been achieved this year. The indicators of all banking industry have been growing rapidly, i.e. the assets grew by 28.2%, deposits - by 24.6% and shareholders' equity - 35.4%, and the volume of loans increased by 50.5%[1].

By this time, the main role in development to a bank system was played by three largest Latvian banks. Parekss banka was the leader of banking system in the beginning of 2000. It was the largest bank in Latvia by size of total assets, equity and the attracted funds of the clients. From the beginning of 2000 to 2003 the assets of Parekss banka increased by 74 % and reached 954 million Lats. Speaking about the dynamics of development among the largest banks, the leader was Hansabanka which assets have been doubled for the similar period. Latvijas Unibanka, the second-top assets bank of Latvia showed less aggressive dynamics at that period. Its assets increased only by 57 %.

At the same time, Latvijas Unibanka had the greatest amount of the loans among the largest banks of Latvia - 543 million Lats. It was the largest lender among the largest Latvian banks, the share of its credit portfolio in assets composed 74.5 %. This indicator clearly reflected the credit specialization of Latvijas Unibanka. It should be noted that credit-oriented Latvijas Unibanka had 135 ratio as regards of the issued loans and clients funds. It means that the bank allocated not only all client funds for loans, but also 35 % of other involved funds and own resources. Accounting the supervision by the Scandinavian bank group (SEB), most likely the loans were financed from parent bank as well.

Hansabanka had the second rank by amount of the issued loans amounted to 497 million Lats. Hansabanka had essentially increased the credit portfolio for the last two years and bypassed of Parekss banka under this indicator. Hansabanka share of the issued loans in assets had been also high-70.5 %.

Parekss banka had relatively small credit portfolio among three largest banks of Latvia (381 million Lats), and its dynamics lagged behind the growth of credit portfolios of other banks in that triplet. In whole, the structure of assets of Parekss was oriented on the investments into securities and interbank operations. After all, the credit portfolio even in structure of assets of Parekss Banka composed approximately 40 %.

So, the triplet of system banks approached to today's crisis with such indicators. Regarding the prospects of development of the largest commercial banks of Latvia it was possible to notice the following aspect: the affiliated structures of foreign banks (Latvijas Unibanka and Hansabanka) still continued the dynamic development, using the resources of parent structures and favorable position on the market. These two banks were targeted to the increase of amounts of loans.

Parekss Banka has been managed by major shareholders and constantly was

in process of search of the strategic investor. The Parex financial group enlarged what fostered to attract the additional capital. With time, it was extended by Parex Bankas (Lithuania); insurance companies Parekss apdrošināšanas kompanija (Latvia) and Baltic Polis (Lithuania); leasing companies Parekss Lizings (Latvia) and Parex Lizingas (Lithuania). The activities of broker company Parekss Brokeru Sistēma and the pension fund Parekss Atklatais Pensiju Fonds effectively supported the activity of Parex business group.

The volumes of mortgage loans have formed a significant part of all loans issued in Latvia. Within 2007, the total amount of mortgage loans increased by 40.6% and their share in total loans was 52.9% that was 1.1% more than at the end of the previous year. In comparison with the end of 2006, the total loans to businesses for current assets increase, has grown by 24.4%, and its share in total loan portfolio of commercial banks amounted to 20.3%.

The aggregate loan portfolio of commercial banks at the end of 2007 was divided between residents and non-residents of Latvia as follows: residents-87.9 %, non-residents-12.1 %. Similarly, the loan portfolio of borrowers-residents was divided as follows: private non-financial companies-49.8 %, households-41.2 %, financial institutions-6.7 % [1].

On the end of 2006, the Latvian banks issued 916.5 thousand loans. In 2007, the number of the issued loans increased on 211.4 thousand (30 %). The number of the loans issued to private residents for acquisition, reconstruction or repair of housing has increased by 28.5 thousand (27.6 %) and reached 131.7 thousand loans; the consumer loans increased on 43.5 thousand (38.3 %) and reached 157 thousand loans. The number of the loans on individuals payments cards and accounts reached 583.9 thousand and increased on 131.9 thousand (29.2 %) in comparison with previous year [1].

The real estate in Latvia was one of the basic instruments of savings. Throughout more than ten last years it has been bringing high profits not only to businesses but also to individuals. A rare company did not invest their money into real estate transactions. These years were marked by prices explosion for all types of apartments throughout Latvia. For example, there was 100% growth of prices in Riga and its vicinity only in 2006. We can assume that the main reasons for such prices increases were the insufficient amount of new housing, the increase in solvent demand of people and growth of speculative transactions. The real estate in Latvia was one of the basic instruments of savings. Throughout more than ten last years it has been bringing high profits not only to businesses but also to individuals. A rare company did not invest their money into real estate transactions. These years were marked by prices explosion for all types of apartments throughout Latvia. For example, there was 100% growth of prices in Riga and its vicinity only in 2006. We can assume that the main reasons for

such prices increases were the insufficient amount of new housing, the increase in solvent demand of people and growth of speculative transactions.

In a result of housing crediting the number of real estate transactions in the mortgage market increased considerably. If in 2000 there were registered 22,689 transactions of real estate sale and purchase, by the beginning of 2007 their number was doubled, and 65 % of them were financed by the bank loans[6].

The basic reasons of crediting growth were: first, availability of bank loan upon housing purchase, secondly, a rise in prices for real estate. The commercial banks themselves played a considerable role in real estate prices rise while demanding a security at crediting. Therefore, even the inexpensive apartments were accepted as a security by the prices which was seemed unrealistic to the appraising firms even a year before.

As well, the decrease in interest rates for long-term loans played its role on the Latvian real estate market. At the end of 2004 the price explosion was observed on the market, the price grew even several times on specific segments. The greatest growth was observed on a segment of apartment houses, i.e. in Riga they increased more than 7 times in average in comparison with 2000.

Such growth had forced Bank of Latvia to undertake the urgent measures on restriction of amounts of crediting, including increase in interest rates for long-term loans. As a result, if in 2004 the average interest rate in Latvia decreased by 2.5 percent points compared to 2001, for the next 4 years it increased again by 6.9 percent points, and made 14.6 % per annum in 2007[1].

It is necessary to notice that the consumer loans have been issued not only by banks, but also by other companies having no relation to bank activity and not supervised by the Financial and Capital Market Commission. According to the research of DnB NOR banka, the Latvian real estate market was saturated by 1.8 billion Lats of free money along with the bank mortgage loans since the beginning of 2007, i.e. about 150 million Lats per month (5).

The calculations were made on the basis of data of the real estate companies stating that a half of transactions on housing acquisitions for the last year were financed by such loans. In April, 2007, the government developed the program to fight against inflation. The most efficient of this 30-points program for chilling the market were the following points: the developer must brought to bank his/her own funds in amount of 10 % of a project cost prior to the beginning of construction as well as must submit the reference about the amount of the received income.

As a result, the performance indicators of Latvian real estate market changed extremely negative. The volumes of mortgage lending began to fall quickly even before world financial crisis. The prices for new housing gradually decreased as well as on secondary housing market. Thus, according to the real-estate compa-

nies, the prices for serial housing in Riga have decreased on 8-10 % in a year. The real estate agents weren't able to find buyers for three thousand apartments in newly built houses.

The number of real estate transactions fell considerably, the income of realtors and developers respectively fell. Increasingly, they have started offering discounts on real estate aiming to attract new customers. The construction boom went on recession. The bankruptcies of construction campaigns began. The developers and other builders could hardly to obtain mortgage loans in banks. There passed the first auctions on sale of real estate which was mortgaged earlier in banks.

The developers and real estate companies were not in a hurry to reduce the prices hoping that the situation in the market would change and demand for real estate will go up again. The potential buyers, in their turn, didn't hurry to conclude the real estate transaction, assuming the prices for property to become even lower.

Such situation has coincided with world financial crisis which much more aggravated a situation in the Latvian market. The hopes of developers, realtors and buyers of real estate couldn't come true, and the fast development of a crisis situation equalized all sides regarding the responsibility for the situation occurred in the market.

The predicted trend has been implemented into the actual figures. Despite the Bank of Latvia in 2005 has been repeatedly raising the reserve rate and brought it to 8%, the banks continued to increase the lending capacities. According to the information of the Financial and Capital Market Commission, the loan portfolio of Latvian commercial banks amounted to 4,380.6 million Lats in December 31, 2004, and at the end of 2006-10,872.9 million Lats[2]. The most significant increase in the volume of loans amounting to 16,588.9 million Lats was in 2008 (see Table 2).

As the table shows, the growth of credit portfolio of the commercial banks was especially high when the financial crisis had begun. Its share in total assets was 71.4% in the end of 2008. In comparison with 2008 the assets of banks have decreased by 2,775.2 million Lats or 11.9 % in 2013. Thus, the share of credit portfolio in total assets of commercial banks in comparison with 2008 decreased by 13.7 percent points and made 57,7 %. Equities in capital of enterprises increased (29.6 %) for the same period. The due from other financial institutions increased on 738.2 million Lats (29.6 %).

Analyzing the changes in total liabilities of commercial banks for the similar period, we can conclude that the balance of deposit accounts had a reverse tendency compared to the amounts of credit debt. Thus, in 2013 the deposits amounted to 11,071,5 million Lats and increased on 1207 million Lats or by 12.5 %, in comparison with 2008, and their share in total liabilities of commercial banks reached

51.4 % [1].

**Table 2** Structure of asset of latvian commercial banks from 2008 to 2013 (the end of the year, in million Lats)

	2008	2013	Share of items in total assets		Changes in interest points	Changes in 2013 compared to 2008	
			2008	2013		mln.	%
Cash and balances with the Bank of Latvia	1,325.20	2,008.60	5.7	9.8	1.2	683.4	51.6
Due from other financial institutions	2,496.90	3,235.10	10.7	15.8	6.3	738.2	29.6
Loans	16,588.90	11,820.30	71.4	57.7	-13.7	-4,768.60	-28.7
Bonds and other securities with fixed income	2,015.70	2,104.30	8.7	10.3	1.3	-88.6	4.4
Shares and other securities with non-fixed income	51.9	210.6	0.2	1	0.8	158.7	305.8
Equities in capital of enterprises	130.7	324.5	0.6	1.6	1	193.8	148.3
Fixed assets and intangible assets	234.8	115.8	1	0.6	-0.4	-119	-50.7
Other assets	275.9	490.7	1.2	2.4	1.2	214.8	77.9
Prepaid expenses and accrued income	123.5	158.2	0.5	0.8	0.3	34.7	28.1
<b>Total assets</b>	<b>23,243.30</b>	<b>20,468.10</b>	<b>100</b>	<b>100</b>	<b>-</b>	<b>-2,775.20</b>	<b>-11.9</b>

## 5 Conclusion

An effective banking system is one of the most important conditions of economic development of Latvia. It is assumed that Latvian economy will be able to implement positively the experience of monetary and credit regulation accumulated in the worlds practice.

For the past years the modern two-level banking system was established and developed in the country. Gradually, the competitive credit and financial infrastructure was formed, basic elements of which were the commercial banks. Some of them have already received a high international rating. The Association of the Latvian Banks turned into the National Bank Association.

At the end of 2014, 27 commercial banks, including ten branches of foreign credit institutions were registered in the Republic of Latvia (see Table 1). JSC GE Money Bank wound up its business in 2013. Moreover, based on the applications submitted by the particular commercial banks, as of 1 January 2014 commercial banks licences were cancelled for JSC UniCredit Bank which left the Baltic market due to changes in the group strategy and SJSC Latvijas Hipotku un zemes banka which was transformed into SJSC Latvijas Attistibas finansu institucija Altum [1].

The Latvian banks slowed the lending down and tried to reduce the credit risks, what had a negatively effect on national economy. The banks tried to increase the liquidity by transferring the bad credits to the structures specially

established for this purpose.

At the same time, there is the unpredictability of actions of the Latvian administrative bodies. A main goal of the Bank of Latvia and the Financial and Capital Market Commission is the ensuring of the general sustainability in the monetary and credit markets. Thus, exercising all rights defined by the law, the Bank of Latvia should provide stability of the prices, and the Financial and Capital Market Commission should treat everyone who forms the instability in finances and capital market in whole or in its separate sectors by their activity or non-activity.

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