3.1

Financial Sector

Kevin R Smith, AWS Structured Finance Ltd

Introduction

As with any sector in an emerging economy, the financial services sector has undergone massive changes in recent years. However, despite the progress already made, there is still further to go. All three Baltic States countries are small – Latvia has a population of only 2.7 million – and this makes some aspects of change easier but others more difficult.

It remains a common misconception that the Latvian currency (lat) is restricted in some form. This is not the case and the lat is fully convertible.

The Governor of the central bank of Latvia (Latvijas Banka) has recently predicted that Latvia will adopt the euro somewhere between 2006 and 2008, following Latvia's admission into the European Union in 2004.

Banks

There are 23 banks in the Latvian banking sector, although the three largest banks account for approximately 53 per cent of the country's banking assets. At the end of May 2002, total assets in the banking system amounted to LVL3.7 billion and there has been solid growth in recent years. The largest bank is Parex Bank, which represents 19.8 per cent of total banking assets, slightly ahead of Latvijas Unibanka (17.8 per cent). The third largest bank in Latvia is Hansabank (15.5 per cent), and Hansabank also has a very strong presence in Estonia and Lithuania.

As evidenced by the continual growth in banking assets, the number of bank accounts and outstanding loans continues to grow. As of April 2002 there were over 1.7 million bank accounts held with commercial banks in Latvia and the volume of demand deposits in client accounts grew twice as quickly as the number of accounts. Over 77 per cent of the accounts were opened with the top four banks and almost 90 per cent of the accounts belonged to Latvian residents.

The amount of loans issued by banks in 2001 came to LVL1.6 billion and increased 51 per cent between 2000 and 2001. A large percentage of the loans were to private companies (LVL1.23 billion) and individuals (LVL245 million). Over the same period deposits grew by 25 per cent of which LVL697 million came from private companies.

All the main Latvian banks have now been privatized although the state does retain a number of minority stakes.

As in other countries in this region, many of the banks are competing in the same sector and initially focused on foreign companies operating in Latvia and the larger local corporates. Competition has been fierce, and this has resulted in a number of the banks widening their focus and looking at smaller corporates and the retail sector.

Given the close proximity of Scandinavia, it is the Finnish and Swedish banks that have had the greatest influence on the banking sector and which are the biggest outside investors. Their influence is obvious and can be seen in the growth and sophistication of electronic banking, back office systems, customer service and other areas.

Overall, the banking sector is both well developed and sophisticated and offers virtually all the products and services that would be expected in any developed market economy. Telephone banking is widely available and Internet banking is being introduced by many banks.

One part of the banking sector that has yet to make significant progress is the provision of residential mortgages. Without doubt this market will become very important in the future but due to factors such as legislation that makes it difficult for the lender to repossess the property in need, and the lack of long term loans it will be some time before major developments are seen. However, most of the bigger commercial banks are now running programmes to promote residential mortgages and are experiencing very rapid growth (albeit from a low starting point) in the size of their mortgage portfolios. This competition is leading to the availability of longer term loans and lower interest rates and this in turn increases demand still further.

One other part of the banking sector that has been relatively slow but is now beginning to take off is the debit and credit card market. The majority of visa and mastercards are actually debit cards rather than credit cards, as in the UK, but the number of transactions using these cards each year doubled to 5.3 million between the end of 1999 and the end of 2001 and continues to grow. At present, only about one in six retail outlets accepts cards but as this increases so too will the level of use.

Financing trade and projects

Approximately 90 per cent of all trade in the European Union is conducted on an open account basis although many companies have some form of credit insurance. Trade with Latvia has not as yet reached the EU level but some 70 per cent of trade is conducted on this basis.

Over the years there have been many successful projects financed on a non-recourse project finance basis. These have been structured both with and without assistance from the British Export Credit Guarantee Department (ECGD) and other export credit agencies. In recent times ECGD has changed its policy on financing projects in the region in order to secure more business and this means that projects that were previously unable to obtain cover may now do so. Perhaps the most important change is that ECGD no longer needs a government guarantee in many cases but will look at municipality or large local corporate risk. In addition, the private insurance market has an increasing appetite for risk in the Baltic States.

The trend towards financing major projects by way of partnerships established between central and/or local government and private companies has not gone unnoticed in Latvia. Whilst progress was being made under the previous government, the new government elected in the autumn of 2002 appears to be even more in favour of public-private partnerships as there is ever growing recognition of the impact that PPPs can have in developing infrastructure such as roads, rail, water treatment plants and many other large projects. Actual progress on this front has been slower than in other EU accession countries but it is hoped that momentum will start to build shortly and if the new government demonstrates its commitment to PPP, Latvia has the potential to overtake a number of other countries in the region.

In order to make these projects happen, laws need to change and attitudes and ideas need to become more flexible. However PPPs offer the most realistic way to finance many of the projects required and as this becomes more widely understood the number of PPP projects in the country will increase dramatically. As Britain and British based firms are world leaders in this type of finance, the development of this sector in Latvia offers many opportunities in the future.

Investment funds

A small number of investment funds and providers of private equity have been active in Latvia for many years, although their role is continuing to expand as the country's economic growth continues. In an effort to promote the sector, the EBRD has invested in a number of funds although the majority of the equity funds have their roots in either Scandinavia or the USA. In very simple terms the preferred scenario for a fund is to invest between US$1 million and US$5 million in a joint venture company with a local partner and a foreign strategic investor. Clearly this is over-simplified and for the right project both smaller and much larger funds can be found and any commercially sound project can, in theory, attract funds.

A number of locally based funds are effectively subsidiaries of global funds or are linked to banks. As the market continues to mature and stabilize the growing demand for this type of funding is being met by the creation of new funds and the expansion of existing ones. The sector remains difficult given the constraints in which it operates but steady growth is expected to continue.

Insurance

Life insurance, as in all the emerging markets, is very under-developed in comparison with western Europe or the USA, as is the private pensions industry. The level of gross premiums increased by 27 per cent in 2002 and totalled some 5.76 million lats but this was still not sufficient to offset the falls in premiums paid in 2000 and 2001 and in 2002 premiums paid were only about half of the 1999 figure. This pattern is unusual, as the level of life insurance premiums is growing quite strongly in the other EU accession countries. At the end of 2002 six life insurance companies operated in Latvia.

The development of private pensions is also now taking hesitant steps forward. As with every country there is an urgent need to move away from the provision of pure state systems and legislation has been changed to allow the implementation of the second and third pillars (mandatory and voluntary contributions to a private pension fund).

The non-life and general insurance sector is, in general, reasonably well developed but the sector has been hampered by the number of fraudulent claims and the low level of payouts made in the past – especially in the motor sector. There are now 15 non life insurance companies and four pension funds in Latvia.

Legal

Section Two of this book is dedicated to legal issues, but given the impact of legislation on doing business in the financial services sector it is appropriate to include a very brief outline here.

The legal sector, or more correctly the law, has undergone more change than perhaps any other sector. A number of international law firms are present and many have been instrumental in adapting old legislation and writing new laws. As the Latvian economy moves ever closer to a market driven economy, the need for legislation to change to allow the economy to expand and foreign companies to invest and trade in a safe environment becomes ever greater. The scope and depth of these changes has increased significantly as EU membership beckons.

It is true that many of the laws are not directly comparable with UK or EU legislation but much progress has been made. However, implementing new legislation is only one aspect of changing laws. It is widely recognized that the interpretation of new laws can on occasion be questionable and it is also generally recognized that there remains an element of corruption that in some cases can undermine the system as a whole. In addition, the judicial system is lacking in experience although this will of course improve over time.

Accountancy

One of the requirements for any company wishing to raise debt or equity funding, trade finance, or establish any form of partnership with a foreign party is the need to produce accounts to international accounting standards. Latvian accounts are often not very transparent, rather brief and open to interpretation and so not very reliable.

All the large foreign accountancy firms are present and the trend towards international accounts is trickling down to the smaller companies.

Chapter 3.2 considers these issues in more detail.

Stock exchange

As is common with most of the stock markets in the emerging markets the stock exchange is not very liquid with only a limited number of companies listed and this can impact on many other aspects of the financial services sector. For example, the limited market restricts the activities of insurance and pension fund asset managers, does not encourage long term savings which in turn reduces the possibilities of the provision of long term loans and does not enable it to act as a provider of fresh capital to fund the growth of local companies.

Market capitalization at the end of September 2002 was LVL422 million and whilst the number of listed shares remained fairly constant at 62, the number of large companies on the official list dropped from six to only three.

There is a co-operation agreement in place with the London Stock Exchange and one Latvian company (Latvijas Unibanka) is listed in London.

Corporate governance

The way in which business is conducted, the transparency of transactions and relationships, minority shareholder rights and general financial management are some of the main concerns behind corporate governance. As with many aspects of the financial services sector in Latvia much has been done but more needs to be done.

Much effort is now being put into addressing many aspects of corporate governance, and indeed the new government that came into power in autumn 2002 did so largely on the back of reducing corruption and increasing transparency.

Regulation

In July 2001 the Financial and Capital Markets Commission officially took over responsibility for the regulation of the financial sector in much the same way as the FSA does in the UK. This includes banks, insurance companies, pension funds, investment funds and the capital markets.

Regulation and supervision of the various parts of the financial services sector were generally regarded as being relatively good prior to this change to one supervisor and the new body continues to improve the situation, although it is recognized that the lack of experienced professionals is a limiting factor.

Summary

The financial services sector has been totally transformed over the last 10 years and while mistakes have been made and there is still more to be done, the progress made has been remarkable and many of the past mistakes have already been recognized and rectified.