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LATVIA'S BANKING SECTOR IN THE CHANGING ENVIRONMENT

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Abstract

There is little disagreement these days that globalisation is changing the world, rapidly, radically, and in ways that may be profoundly disequilibrating. But beyond this already trite cliché, almost everything else concerning the phenomenon is subject to intense debate – in the context of an explosion of interest in and research on the subject.

The **object** of this paper is Latvia's banking sector.

The **purpose** of this research is to analyse how to maintain the benefits brought by globalisation at the same time as we are avoiding from the crisis as a last one.

To achieve the purpose the following **tasks** were conducted:

1. Identifying the main benefits and challenges of banking sector development in the changing environment;
2. Analysing Latvia's banking sector as a part of global financial system;
3. Analysing the main preconditions of sector financial stability;
4. On the basis of the author's findings to put forward offers, how Latvia's banking sector can to benefit in the changing environment.

Chapter 1 explores the key benefits of banking sector globalisation. Chapter 2 analyses the main challenges of banking sector development in the changing environment. Finally, in Chapter 3 the author looks for solutions how Latvia's banking sector can to benefit from changes brought by globalisation at the same time avoiding from the crises as the last one, by analysing capital and regulation as a most important components of financial stability.

The results underline the need to recognise that markets need rules, constraints and careful monitoring so that banking failures are less frequent and less costly. And that the rules, constraints and monitoring exercises need a macroprudential approach.

During development of the paper the generally accepted qualitative and quantitative **methods of economic research** were used.

1. Main Aspects of Banking Sector Globalisation

For the first time since the October 2008 Global Financial Stability Report, risks to global financial stability have increased, signalling a partial reversal in progress made over the past three years. The pace of the economic recovery has slowed, stalling progress in balance sheet repair in many advanced economies. Sovereign stress in the euro area has spilled over to banking systems, pushing up credit and market risks. Low interest rates could lead to excesses as the "search for yield" exacerbates the turn in the credit cycle, especially in emerging markets. Recent market turmoil suggests that investors are losing patience with the lack of momentum on financial repair and reform. Policymakers need to accelerate actions to address longstanding financial weaknesses to ensure stability. [11]

The banking sector has a great importance in our modern service-oriented economies, as the present euro zone debt crisis and the last global financial market crisis and the subsequent severe economic recession have pointed out. According to present dominant approaches to economics, the financial structure of the economy may influence aggregate economic activity and amplify business cycles. However, modern economies are viewed as essentially stable and tending towards steady growth; and the investment-finance linkage is considered as an amplifying mechanism of shocks exogenous to the economy. A complementary strand of research emphasizes the role of the investment-finance link not just as a propagator of exogenous shocks but as the main source of financial instability and business cycles, i.e., during good times economic agents take excessive risks and lend and borrow too much, generating endogenous ruinous boom-and-bust cycles. Besides, recent developments in statistical equilibrium approaches to economics, alongside with the emergence of behavioural and agent-based models, have indicated the way to overcome the limitation of traditional equilibrium-based analytical models characterized by fully rational representative agents.

The key characteristics of banking sector and financial market globalisation may be summarised as follows:

- Borrowers, lenders and investors increasingly have global options with respect to the source of funding and the allocation of funds and savings.
- As a result, the geographical domain of financial intermediation has widened and has become increasingly global. In its extreme form (not yet achieved), the global financial system can be viewed as a set of financial markets, exchanges and institutions which trade in financial instruments and channel world savings (wherever they are located) to investment wherever the risk-adjusted rate of return is considered to be greatest. In this way, financial institutions and markets intermediate in business between agents irrespective of their location or that of the institution or market. While the bulk of financial intermediation is still conducted within the domain of national financial systems, this proportion is decreasing and, at the margin and especially for the corporate sector, global options have become increasingly available. In principle, this should raise efficiency in the allocation of financial resources in the global economy to the extent that savers, borrowers and institutions have wider options and are not restricted to domestic options.
- Financial firms also locate outside their own country and conduct intermediation business for foreign local, domestic and international customers.

- Financial innovation (the creation of new financial instruments, markets and facilities) spreads quickly on a global basis.
- Shareholdings of both financial and industrial or commercial companies are becoming increasingly international in that, over time, the proportion of shares of major banks and financial enterprises that is owned outside the country has been rising steadily.
- Various forms of arbitrage between financial markets and institutions take place on a global basis.
- Financial markets and institutions are not only in competition with each other, but face increasing competition from outside their domestic countries. This is especially the case in the market for corporate and wholesale business but, to some limited extent, also in retail business.
- Shocks are transmitted internationally.
- Market discipline has been enhanced, and the market in corporate control (the mergers and acquisitions market) has increasingly become international in the financial sector and again relates both to financial institutions and to markets: witness cross-border mergers and acquisitions in the banking sector and also in securities markets. [16]

Globalisation has wider dimensions than those described above. However, the characteristics of globalisation that have been highlighted are those are particularly relevant to the discussion that follows.

2. Globalisation Effect on Banking Sector Development

In this chapter the author summarizes the main benefits brought by globalisation and at the same time analyses the main challenges that banking sector faces under the globalisation process.

Globalisation has created clear efficiency benefits by intensifying competition within the key commercial banking market and increasing financial market completeness. Entry by foreign financial institutions using advanced credit risk assessment and portfolio management tools intensifies price competition and improves credit allocation by better matching price and nonprice terms to the level of credit risk, thereby reducing the role of directed credit. FSFDI (Foreign direct Investment in the financial sector) has increased the completeness of markets as foreign-owned financial institutions have introduced new financial products to emerging financial markets. The development of securities and derivatives markets provides alternatives to bank loans for channelling credit and liquidity in the local economy. Expanded consumer lending markets improve the economic welfare of households.

So far everything looks rather positive, but globalisation also implied changes, increased cross-border competition and pressure to adjust have provoked resistance and calls for protection, and not only in emerging markets. Throughout the world economy we can observe an increasing aversion to risk and to change.

As current financial crisis is obviously global, would it help to keep own countries in order to minimise impact of financial crisis?

Unfortunately the answer is negative, as we need international coordination. The perimeter of international coordination has widened. Just as risk management at individual firms

does not add up to the stability of the financial markets, so, too, macroeconomic and financial stability at the national level does not necessarily add up to global financial stability.

Home and host country supervisors need to coordinate their supervision of large, multinational institutions. Where foreign-owned institutions make up a large proportion of the financial sector of an emerging market country, the health and wellbeing of the country's financial system may depend greatly on the financial strength and managerial effectiveness of the parent organisation, as well as the local subsidiary or branch.

The author positively values EU countries attempts to enhance cooperation within the 27 EU Member States by signed the Memoranda of Understanding (MoU) in 2008. The fact that representatives from supervisory authorities, central banks and finance ministries across the entire EU have agreed on a common set of principles for crisis management and resolution is an important starting point for more intense cooperation. Furthermore, in September 2010, the Council of Europe approved a legislative package thus creating the legal basis for a new EU financial supervisory framework. This was a follow-up of the recommendations voiced by the EC in September 2009 regarding a radical reform of the so-far mainly national-regulatory-regime-based EU supervisory system. This decision has emerged as a result of serious political discussions lasting for more than 6 months among the European Council, the EC and the EP. [12]

The reform introduces essential changes in the EU framework for supervising banks and securities and insurance market participants. As an outcome of these changes, a new European System of Financial Supervision (ESFS) has emerged to operate as of January 2011. The new two-pillar (macro-prudential and micro-prudential) system will help strengthen the supervision of financial system both as a whole, i.e. at the macro-prudential level, and at the level of individual entities, i.e. at the micro-prudential level. [5]

The ESFS comprises the European Systemic Risk Board (ESRB) responsible for macro-prudential oversight and a network of micro-supervisory institutions. This network is represented by three European supervisory authorities: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA) as well as the Joint Committee of the European Supervisory Authorities and supervisory authorities of the EU Member States. [1]

ESFS Macro-Prudential Supervisory Pillar

The former system of EU financial supervision did not have any mechanism at the macro-prudential level to ensure efficient identification of systemic risks and to support their adequate mitigation.

The most important strategic goal of the ESRB is to mitigate and prevent systemic risks threatening the stability of the EU financial system as a whole. Thus, in contrast to the former European financial supervisory framework, a stronger focus is on the systemic risks jeopardising the whole financial system of the EU vis-á-vis individual risks to certain financial systems of EU Member States. However, the ESRB can issue recommendations and warnings to particular countries if systemic risks jeopardising the stability of the whole EU financial system arise from the developments in them. [14]

The ESRB operation will rely on the synthesis of analytical work carried out by central banks and microsupervisory authorities. Representatives of the Bank of Latvia and FCMC will take an active part in the work of the ESRB and its committees and working groups.

One of the most important ESRB's tasks when elaborating the warning and recommendation issuance procedure is to develop a common set of indicators enabling faster and enhanced public awareness of financial stability risks. This system would enable the assessment of cross-border financial institutions' risk levels according to uniform standards.

The General Board of the ESRB is the main decision-making body of the ESRB. It represents a wide range of experience, expertise and stances. The leading role in the General Board belongs to the ECB and central banks of EU countries duly accounting for their functions in the financial stability domain.

ESFS Micro-Prudential Supervisory Pillar

As a result of the reform, the former banking, pension fund, securities and insurance market supervisory committees, i.e. the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), and the Committee of European Securities Regulators (CESR) before exercising only advisory functions have gained in importance. The new supervisory authorities took over all functions of the given committees, with their tasks and authority expanding substantially. [1]

Representatives of the FCMC will actively participate in the work of the European supervisory institutions. One of the most essential conceptual features of the EU financial supervisory reform consists in its orientation towards developing common regulative and supervisory standards and practices within the single EU market.

The main task of the European supervisory authorities in this context is to develop fully harmonised supervisory regulations.

The European supervisory authorities have the discretion to settle disputes arising among national financial supervisors, and temporarily ban excessively risky financial products or operations. These authorities will assume the leading role also in protecting the consumers' rights, enhancing transparency, simplicity and fair attitudes in the market of financial products and services for consumers across the whole internal market of the EU.

The new Basel III standards have been developed to address the weaknesses of the regulatory framework, particularly revealed by the recent global financial crisis, as the quality of bank capital as well as the levels of capital and liquidity were insufficient to cope with the serious systemic shocks. The gradual phasing-in of the main Basel III requirements is projected to take six years, the period starting with 2013.

One of the most fundamental improvements introduced by the Basel Committee in its reform package is the macroprudential focus to address both system-wide risks and the procyclical amplification of risks over time. [2]

As the global financial system is far more interconnected than was previously recognized and excessive risk taking that threatened the collapse of the world financial system was far more pervasive than almost anyone realized[13], global banks and global markets require global cooperation in regulation, supervision and macroeconomic policy.

3. Latvia’s Banking Sector as a Part of European Market

The Latvian banks play an important role in attracting foreign investment. It is extremely important for Latvia to retain access to international capital markets to offset the external

imbalance caused by the last global financial crisis, and to make efficient use of technological and organisational possibilities related to foreign investment. A successful banking sector is therefore an essential precondition for restriction of instability risks, and its prime responsibility is to set up a favourable investment climate that would attract foreign long-term investment.

In this chapter the author looks for answers to the following questions:

1. Are Latvian banks a part of global financial system?
2. If yes, will it help to achieve financial stability in Latvia?
3. And finally,
   a) Are capital requirements in Latvia necessary and sufficient to achieve financial stability?
   b) Are regulation and supervision of banks sufficient to achieve financial stability?

At the end of 2010 banking services in the Republic of Latvia were offered by twenty-one bank and ten branches of foreign (EU) banks as well as by credit institutions or their subsidiaries registered in the countries of the European Economic Area that have submitted their applications to the Financial and Capital Market Commission (FCMC). Eight electronic money institution and two money market funds have also been registered with the Bank of Latvia. [9]

The market share of 10 foreign branches in total assets was12%, while the market share of 10 subsidiaries of foreign banks was about 55% in total assets, where 5 banks operated as subsidiaries of EU Member State with the market share more than 50% and 5 banks operated as foreign banks (CIS) with the market share smaller than 5% in total assets. [9] In total the market share of foreign branches or subsidiaries in 2010 was almost 67% in total assets.

Latvian banking market is also attractive for other European Economic Area member countries to undertake financial services in Latvia without opening a branch, as a result, during last five years the number of notification increased almost 2.5 times. [6; 10]

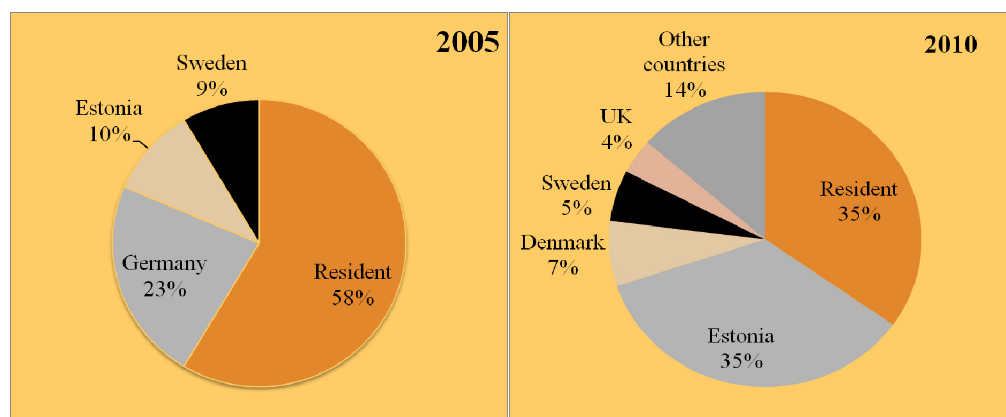

Figure 1. Banking paid-up share capital broken by countries in 2005 and 2010 in Latvia (as a percentage) [6; 7; 8; 9]

The role of banks in the attraction of foreign investment is confirmed by the fact that according to Financial and Capital Market Commission [9] data in Q2 2010 81.5% of institutions' liabilities to monetary financial institutions was comprised of foreign banks'

financing to their Latvian subsidiaries and branches. However the share of foreign' liabilities is smaller than previous years (compared to 85.3% on 31 December 2005), but taking into account repayment of syndicated loans and a decrease of financing from parent foreign banks during last two years, this level is still constituted the major share in total banking liabilities to MFI.

Unfortunately Latvian banks are not so active in foreign markets and the market share of 11 Latvian branches abroad in total assets was 2.6% at the end of 2010 and all foreign activities took place within EU. [9]

According to the Financial and Capital Market Commission data, foreign shareholders owned 65% of the total paid-up share capital in Latvian banks at the end of 2010 (see Figure 1), what is less than previous years, but if compare with 2005 year (42%) (see Figure 1), we could see large increase.

According to Financial and Capital Market Commission data the main investors are from EU countries and the share of non- European countries is insignificant. [10]

Analysis that has been highlighted before indicates that the answer to the first question is more positive than negative. Our banks are part of European banking sector as we are a member of EU. And as a part of big European market we are effected by as positive as negative changes in the USA and Asia, so all over the world. Last global financial crisis affected our banking sector activities very significantly (see Figure 2).

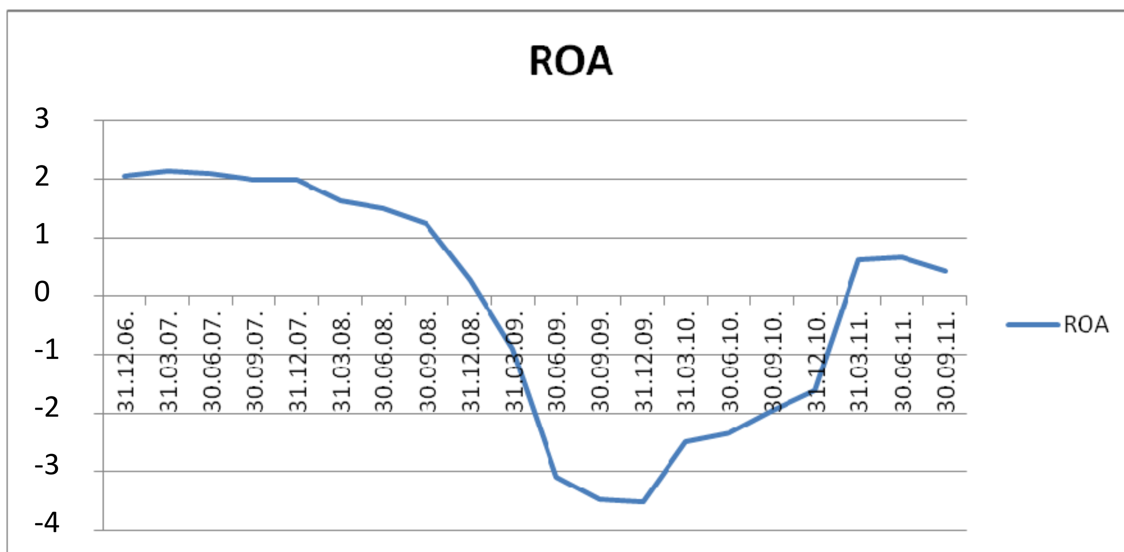

Figure 2. Dynamics of Return on Assets (ROA) for banking sector from 2006 – 2011 in Latvia (as a percentage) [6; 7; 8; 9; 10]

Banks concluded year 2010 with losses, albeit at a considerably smaller scale year-on-year since the need for building provisions moderated. In 2010, total bank losses amounted to 360.7 million lats (773.4 million lats in 2009). Expenditure on provisions for non-performing loans and commitments, the main reason for losses in 2010, shrank considerably (to 727.1 million lats, down from 1 266.1 million lats in 2009). As a result of smaller losses, ROE

(-20.4%; -41.6% in 2009) and ROA (-1.6%; -3.5% in 2009) improved, although still remaining in a negative territory. [1]

Losses of the last two years were almost equal to the overall bank profit since 2000. An increasing number of banks made profit in some months. However, only nine banks earned profit throughout 2010, with their total profit amounting to 8.3 million lats and their assets accounting for 15% of total bank assets. Losses incurred by the three state-owned banks exceeded half of total bank losses whereas their assets were a mere 15% of total bank assets. [1]

As a result Latvian national banking sector is already constituent part of the global financial environment; however with regional aspects- our banks are more Europeanised.

The legislative framework for banking in Latvia meets the EU requirements in full, and in some areas the requirements are even more rigorous. The International Accounting Standards (IAS) has been fully introduced; banks' annual reports are prepared in accordance with IAS and audited by internationally recognised auditing firms. Practical supervision of the banking sector in Latvia is very tight and bank inspections are conducted more frequently than in the EU Member States.

But will it help to achieve financial stability?

To answer this question is a multifaceted task, and a lot of measures are on the table, but in this article the author tries to find answer to one special, as capital is a central part of the financial reform: "Are capital requirements in Latvia necessary and sufficient to achieve financial stability?"

In Latvia regulations on the Calculation of Minimum Capital Requirements took effect on 11 May 2007 (transposing requirements of directives 2006/48/EC and 2006/49/EC pursuant to provisions of the Basel II Accord regarding to minimum capital requirements) considerably affecting risk assessment and risk management in banks. [15] Banks made use of a possibility to apply these Regulations provided for in the Credit Institutions Law as of 1 January 2008 and submitted to the Commission the first reports for the 1st quarter of 2008 in accordance with the new Regulations.

Several new methods for risk measurement and assessment have been introduced along with the new Regulations allowing for more precise measuring of risk. The procedure for the calculation of credit risk capital requirement has been completely changed, namely, in the calculation the banks may choose either Standardised Approach or Internal Ratings Based Approach. Besides, in addition to requirements for credit risk and market risk the banks will have to calculate also capital requirements for operational risk.

During new requirements period (from the 1st quarter of 2008 to the end of 2009), the total amount of banking capital requirements decreased by 22.6 million lats or 2%. In 2009, the total amount of banking capital requirements decreased by 81.6 million lats or 6.8%, i.e. following a decrease in loan portfolio, capital requirements for credit risk shrank the most – by 63.5 million lats or 5.9%. By end-December of 2009 total amount of banking capital requirements made up 1126.9 million lats, of which the greater share or 90.2% were capital requirements for the credit risk inherent in the banking book, 8.1% – capital requirement for operational risk and 1.7% – capital requirements for position, foreign currency and commodity risks. In the following years the decrease of total amount of banking capital requirements continues (see Figure 3) [7; 8; 9; 10]

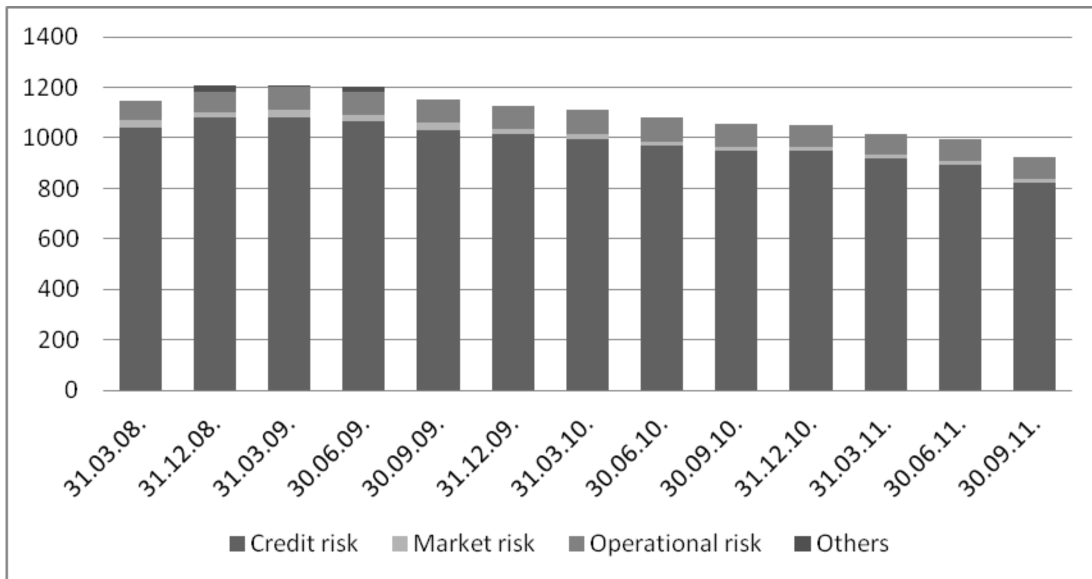

Figure 3. Breakdown of capital adequacy requirements from 2008-2011 in Latvia (millions Ls) [7; 8; 9; 10]

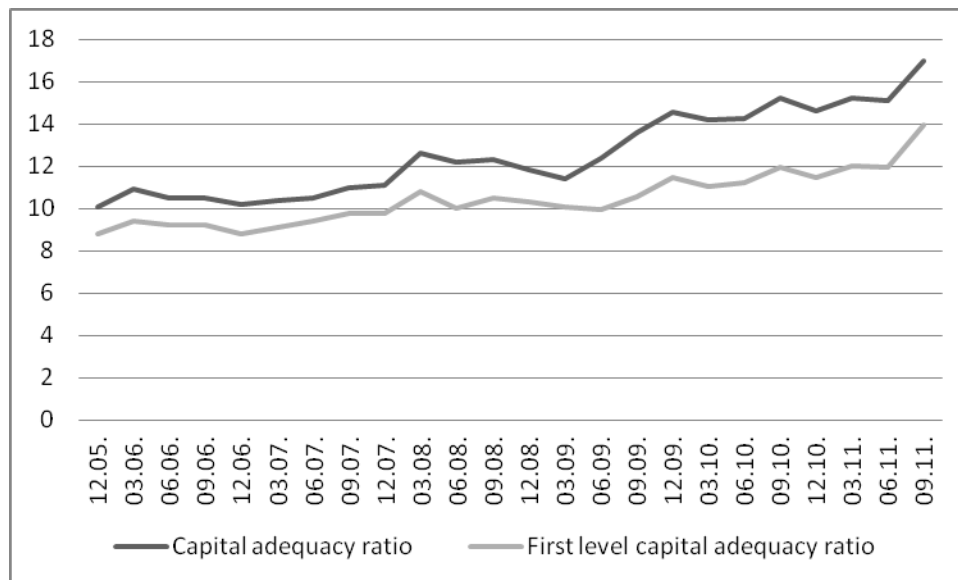

Figure 4. Capital adequacy ratio from 2005-2011 in Latvia (as a percentage) [6; 7; 7 8; 9; 10]

Following the ongoing deterioration in the banking asset quality and considering the necessity for notable additional provisioning for loan impairment, the banks attempted to strengthen their capital base in 2009 year – 13 Latvian banks increased their capital by about

one billion lats in total, of which share capital by 728 million lats, subordinated capital by 222 million lats and reserves capital by 48 million lats. Upon an increase in the banking own equity by 14.7%, and a decrease in the amount of bank risk-weighted assets by 6.8% in 2009, capital adequacy ratio of the banking sector grew and at end-December totalled 14.6% (compared to 10.1% at end-2005) and restarted the growth from this year (see Figure 3.4) [6; 7;7 8; 9; 10]

The capital adequacy ratio of banks was consistent with the regulatory requirements by the FCMC and stood at 17.0% at the end of 09.2011, whereas Tier I capital ratio amounted to 13.95%. Banks continued to boost their capital: 14 banks expanded capital during the 2010, with the overall increase amounting to 324.4 million lats, including a rise of 278.8 million lats, 20.7 million lats and 24.8 million lats in the paid-up share capital, subordinated capital and reserve capital respectively. [9; 10]

At end-2010 capital adequacy ratio below 10% was only for one bank with insignificant banking market share compared to the end-2005, when 7 banks with banking market share over 70% (see Table 1)

Table 1

Bank groups broken down by capital adequacy ratio in 2005 and 2010 in Latvia [6; 9]

Capital adequacy ratio (%)	31.12.2005		31.06.2010	
	Number of banks	Banking market share (% of total banking assets)	Number of banks	Banking market share (% of total banking assets)
below 10	7	74.4	1	-
10-15	7	18.3	11	41.9
15-20	3	5.5	5	41.7
above 20	5	1.9	3	2.6

In common we could see drastic increase of capital adequacy ratio for majority of banks compared to 2005 year.

It may be true that in the period after the restoration of independence, the Latvian economy has not had a chance to experience the full cycle of economic activity, and, as a result, domestic bankers do not have enough experience in this area. Luckily, however, most of the largest banks in Latvia are owned by foreign shareholders that have the requisite expertise and the experience. They are also best positioned to provide the necessary incentives for the domestic management of the commercial banks in Latvia. The foreign shareholders of the largest Latvian or, indeed, pan-Baltic banks must more emphasis on risk management and pay more consideration to sustainability issues in developing the business strategies for their Baltic branches, as opposed to short-term growth issues. For our banking system, which is relatively young, this could be the best way of benefiting from more mature markets where the banking experience and expertise have been accumulated over several hundreds of years.

Nevertheless to global cooperation in banking sector supervision the author offers to use the Nordic-Baltic countries experience to improve countries cooperation and to increase

coordination by creating a permanent structure for regional cooperation. This structure takes the form of a so-called cross-border stability group.

It is important to emphasise that the establishment of a well-functioning cooperation structure is not something that is done overnight. On the contrary, the establishment of the Nordic-Baltic Cross-Border Stability Group has been an ongoing process for quite some time now. It started already in 2007 when Nordic-Baltic countries carried out a Nordic-Baltic crisis management exercise. By trying to manage an imaginary crisis using actual banks and applying the institutional and regulatory structures of the different countries, Scandinavians learnt from one another and realised the importance of working together.

By signing a Memorandum of Understanding (MoU) on financial stability, crisis management and crisis resolution in 2010 the ministries of finance, central banks and financial supervisory authorities in Denmark, Estonia, Finance, Iceland, Latvia, Lithuania, Norway and Sweden concluded the agreement in order to enhance the region’s preparedness to deal with potential risks to cross-border financial stability. [4] This MoU strengthens the preparedness for dealing with cross-border financial stability issues in the Nordic-Baltic region. Signing this agreement means that the authorities in the Nordic and Baltic countries are the first to implement the provisions of the EU-wide agreement on cross-border financial stability established in June 2008. Moreover, the first European cross-border stability group is being appointed.

Capital requirements are necessary, but they are not sufficient. Indeed, the author argues that regulation was only part of the problem and it is only part of the answer. Capital is not enough; regulation is not enough. Capital reserves (buffers) and provisions need to be built up in good times so that they can be used in bad times, thus reducing the risk of spillover from the financial sector to the real economy. Lessons have been drawn by the Basel Committee on Banking Supervision concerning the need to improve the quality of capital, to raise the level of capital and to improve the framework’s capture of risk, especially as regards the trading book. [3]

The author offers to build up capital buffers even higher in good times so that more can be taken from them in bad times.

Conclusions

1. Latvian banks have a significant share of foreign assets and liabilities that indicates that the national banking sector is already constituent part of the global financial environment. At the end of 2010 foreign shareholders owned 65% of the total paid-up share capital in Latvian banks. They held over 50% of paid-up share capital in ten banks.
2. The legislative framework for banking in Latvia meets the EU requirements in full, and in some areas the requirements are even more rigorous. Practical supervision of the banking sector in Latvia is very tight and bank inspections are conducted more frequently than in the EU Member States.
3. Is Latvian banking sector a part of global financial system?
   Latvian banking sector is a part of European banking sector as Latvia is a member of EU since 2004. Latvian national banking sector is already constituent part of the global financial environment; however with regional aspects- our banks are more Europeanised.

4. If Latvian banking sector is a part of global market, will it help to achieve financial stability in Latvia?
   To answer this question is a multifaceted task, and a lot of measures are on the table, but in this article the author concentrates on to very important subjects: capital requirements and supervision.
5. Are regulation and supervision of banks sufficient to achieve financial stability?
   Regulation is not enough, but regulation was only part of the problem and it is only part of the answer. The author positively values a new EU financial supervisory framework and establishment of a new European System of Financial Supervision (ESFS). The new two-pillar (macro-prudential and micro-prudential) system will help strengthen the supervision of financial system both as a whole, i.e. at the macro-prudential level, and at the level of individual entities, i.e. at the micro-prudential level. Nevertheless to global cooperation in banking sector supervision the author offers to use the Nordic-Baltic countries experience to improve countries cooperation and to increase coordination by creating a permanent structure for regional cooperation. This structure takes the form of a so-called cross-border stability group. As financial globalisation in the Baltic States has regional aspect we need stronger and tougher cooperation between national authorities – cooperation at the regional level.
6. Are capital requirements in Latvia necessary and sufficient to achieve financial stability?
   Capital requirements are necessary, but they are not sufficient. Capital reserves (buffers) and provisions need to be built up in good times so that they can be used in bad times, thus reducing the risk of spillover from the financial sector to the real economy, but not the opposite what we have observed in last years as response to crisis.

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