The Banking Regulation Review

Third Edition

Editor
Jan Putnis

Law Business Research

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Third Edition

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Jan Putnis

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EDITOR'S PREFACE

Jan Putnis

When the first edition of this book was published in mid-2010, banking regulation seemed to be undergoing a transformation driven by a reasonably coherent international agenda. There were questions about how long it would be before nationalist and protectionist tendencies fractured the broad consensus that seemed to have built up on such issues as the need for more and better quality capital resources, liquidity requirements and the strengthening and reform of vital market infrastructure. However, there appeared to be a reasonable degree of certainty about the direction and speed of reform, at least among the G20 countries.

Events, as they always do, have since conspired to make the position considerably more complicated, in two separate ways. First, achieving many of the regulatory reforms agreed in principle at the meeting of G20 leaders in London in 2009 has proved to be a far more complex and difficult task than even those expert in the field of banking regulation had expected. Secondly, as concerns about solvency have spread to governments, sovereign debt has assumed centre stage. The eurozone crisis, as it has come to be known, rumbles on with no obvious short-term solution that would avoid significant economic and social upheaval in parts of the European Union. There is also the potential existential threat that sovereign defaults of eurozone countries would pose to banks that are either established in those countries or have significant exposure to banks or assets in those countries. Events in the eurozone have given the frenetic activity in the area of financial regulatory reform in the European Union a slightly surreal quality against the backdrop of the consequences of potential economic and financial upheaval in one or more eurozone countries. Meanwhile, in the United States, the rule-making process under the Dodd-Frank Act has continued, behind its original schedule, and banks continue to digest the consequences of the Volcker rule.

On both sides of the Atlantic the volume and complexity of new and proposed rules has continued to be a cause of criticism and frustration. A banking sector that was roundly blamed for creating the complexity in products, markets and business structures that exacerbated aspects of the financial crisis is facing the irony of a wall of new regulation of such complexity that the complexity itself might end up being the main reason that the new regulation fails to achieve its objectives.

Separately, in many Asian financial centres reforms are underway but are, in general, far behind those proposed and enacted in the United States and the European Union. Many governments, regulators and bankers in Asia saw (and continue to see) the western financial crisis of 2007–2009 as exactly that, a western financial crisis, and view the gradual liberalisation of the Chinese banking system and greater convertibility of the renminbi as the greater challenge and opportunity.

If we set ourselves the task of summarising the positive things that have emerged for banking regulation from that western financial crisis, what would we say now, three years on? There is little doubt that there is now much greater awareness among policymakers and regulators in all major jurisdictions of two important factors that will probably dominate any future international banking crisis:

a Banks, however well capitalised, risk collapse in sufficiently extreme circumstances and the crisis demonstrated that those circumstances should never be regarded as too extreme to contemplate. Assumptions about the credit quality and liquidity of assets, and about withdrawal of sources of funding (including deposits), may cease to apply in stressed market conditions. That means that the maturity transformation role of banks ('borrowing short term and lending long term', as it is often simplistically described) makes them subject to existential threats that are, by their very nature, difficult to anticipate and address accurately.

b Contagion can spread through financial systems in unexpected ways, or at least in ways that are unexpected by governments and regulators. Studying the potential routes of contagion and considering whether there are ways of closing down those routes without adverse unintended consequences for economies that are recovering from recession is therefore an important aspect of regulatory endeavour.

It might seem incredible now that these points were not appreciated sufficiently by governments and regulators before the financial crisis first erupted in the United States in 2007 and then spread to Europe in the following year. But that was undoubtedly the case.

The past year has seen international banking groups grappling with the practical realities of regulatory reform. Doubts about the ability of some banks to raise the additional capital (particularly Tier I capital) that they will require in order to meet the gradually increasing capital requirements set out in the Basel III agreement are feeding concerns about the long-term viability of some banks' business models and, more generally, about previously long-held expectations as to returns on equity of banking groups. Banks have begun to respond to actual and prospective higher capital requirements, in some cases by raising equity with varying degrees of success (which has been difficult in the market conditions prevailing in most of the world in the past year) and in other cases by selling or preparing to sell assets and business units, or simply by closing down business lines.

Politics have intervened in banking in the past year in ways that have made the debate about the direction of regulatory reform in the banking sector more complicated. In some countries, concern about the remuneration of senior management of banking groups has reached fever pitch in the media while, at the same time, a less emotive and generally more thoughtful debate has continued on the need for more financing for businesses, particularly small and medium-sized enterprises.

The apparent shortage of finance for businesses in many economies, coupled with expected further pressure on the ability of banks to provide that finance as their capital requirements continue to increase, has led to concerns about the development of other sources of finance. Is credit risk, and the contagion to which it can give rise if borrowers default, shifting in dangerous ways out of the banking sector into the so-called 'shadow banking sector'? The European Commission looks set to start investigating this topic in earnest in 2012. The consequences of regulatory intervention in this area are currently very difficult to predict, not least because any attempt to regulate non-bank sources of finance more heavily is bound to attract criticism from those who claim that it will only reduce further the sources of finance available to the 'real' economy.

Another area of regulatory reform that banking groups continue to grapple with in 2012 is transparency with regulators. There are various examples of the ways in which this is starting to affect the sector. The most immediate and relevant example concerns the work that many of the largest banking groups in the United States and Europe are currently involved in to draw up 'recovery plans' and to draw up, or to assist their regulators in drawing up, 'resolution plans', those plans being collectively (and somewhat misleadingly) referred to as 'living wills'. The phrase of the moment is 'barriers to resolution', describing factors that would prevent or inhibit the orderly resolution of a bank at or close to its collapse. Plenty of barriers to resolution are being identified as recovery and resolution plans are prepared. The second half of 2012 and 2013 will likely be an interesting period in which regulators ponder these barriers and deepen their discussions with banking groups as to what might be done about them.

Fears of enforced structural reorganisations and changes to business models have led some banking groups to spend considerable amounts of time and resources developing their own solutions to perceived barriers to resolution. More immediately, the process of preparing recovery and resolution plans has proved difficult, the main challenges including how to reconcile differences between the statutory resolution and insolvency procedures for banks in different jurisdictions and to understand the cross-border elements of those procedures. Fundamental questions about the availability of cross-border services to banking operations in a crisis, the treatment of banks' global hedging arrangements, and ultimately the resolvability of banking groups, are at stake. It seems likely that we are many years away from having recovery and resolution plans that carry the benefit of clarity around how regulators would operate them on a cross-border basis in a crisis. It also remains to be seen whether cross-border cooperation between regulators would work in such circumstances given the significant differences between national resolution and insolvency procedures and the desire in many jurisdictions to protect local depositors. Another major area of uncertainty concerns the proposals by some regulators that debt issued by banking groups be 'bailed in' (i.e., written off or converted into equity) in a crisis and how that could happen without spreading contagion through the banking system and the wider economy via the holders of that debt.

Meanwhile, scrutiny of the structure of banks themselves has continued in some countries. The likely implementation in the United Kingdom of proposals to require the 'ring-fencing' of retail banking activities within banking groups may be the start of a trend that spreads to other countries. Despite the prevalence of 'universal' banks, combining retail and investment banking activities in single legal entities in many of the other Member States of the European Union, the European Commissioner for the Internal Market has commissioned a study into the structure of banks with a remit to consider ring-fencing of retail banking.

Liquidity has remained a central concern for many banking groups in the past year. Short-term liquidity problems at banks (arising, in particular, from concerns about the strength of some banks as counterparties) have resulted in an increase in the range of funding for which banks generally are now expected to provide collateral. This trend is expected to be exacerbated by longer-term developments such as the Basel III requirements on liquidity and the proposed introduction of depositor preference in some countries for the first time. Liquidity pressures have led to many banks engaging in new types of transactions, such as so-called 'liquidity swaps', to increase the amount of high-quality collateral that they have available for their funding operations. This ongoing search for liquidity, and for the collateral required to obtain liquidity, has made some financial regulators concerned about the potential spread of contagion within the banking sector and from the banking sector to other sectors. For example, some liquidity swap transactions have involved banks receiving liquid assets from insurers in return for assets that are less liquid.

This third edition of *The Banking Regulation Review* updates the position on important aspects of banking regulation in the countries covered, in most cases to February 2012. While the book is aimed principally at staff in the legal and compliance departments of banks, it is to be hoped that senior management also find it helpful. The book focuses most closely on the deposit-taking activities of banks. The constraints of space and time mean that it will never be possible to do full justice to all of the subjects covered in each chapter, but readers are of course welcome to contact me if they have any suggestions for future editions.

Preparing successive editions of this book continues to be an onerous task for the busy lawyers who contribute the chapters and who are otherwise much in demand. My thanks go to them for their dedication to the task. Significant changes to a book such as this also mean much more work than would otherwise be the case for the publisher. I am therefore very grateful to the publisher's team for their understanding, hard work and patience with a group of authors who often have many other commitments.

Finally, I would like to thank the partners and staff of the financial regulation group at Slaughter and May for appreciating this book's value and for encouraging our involvement in it for a third successive year.

Jan Putnis
Slaughter and May
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Chapter 31

LATVIA

Armands Skudra[1]

I INTRODUCTION

In 2011 Latvia's banking sector showed signs of recovery from the impact of the global financial crisis and the downturn the Latvian economy suffered in several preceding years. Although the total losses of Latvian banks sustained during 2011 reached €256 million they were 50 per cent less than in 2010. Furthermore those losses were predominantly related to the insolvency of Latvijas Krajbanka (the Savings Bank of Latvia) in autumn 2011 and bad debt write-offs of Parex Bank, which was nationalised in 2008. The total operating profit of Latvian banks in 2011 (before tax and reserve allocation) was around €340 million or 66 per cent higher than the 2010 figures. The majority of banks, notwithstanding the ongoing general economic hardships, were able to ensure profitable business operations and compliance with the banking regulations, including capital adequacy and liquidity requirements. The market was dominated by banks associated with large Scandinavian financial groups, including Swedbank (18.5 per cent of the total gross banking assets), SEB Bank (12.8 per cent), Nordea (10.8 per cent), DnB Bank (8.4 per cent) followed in fifth place by local ABVL Bank (8.1per cent).

The largest casualty in the Latvian banking sector in 2011 was related to the unexpected downfall and insolvency of Latvijas Krajbanka. It was the 10th largest bank in Latvia, holding 2.7 per cent of total gross banking assets. However, its systemic importance was further associated with the fact that it was the oldest commercial bank of Latvia – established 85 years ago – and had the largest individual retail banking network in the country, with a large number of individual depositors. Events leading to the insolvency of Latvijas Krajbanka were initially triggered by nationalisation in autumn 2011 due to the financial hardships of its parent – Lithuanian Snoras Bank – by the government of Lithuania. That prompted the Latvian banking regulator – the Financial and Capital Market Commission of Latvia ('the Commission') to step in and

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carry out an emergency audit of Latvijas Krajbanka that eventually revealed a substantial undocumented shortage of funds in excess of €140 million due to allegedly unreported and illegal transactions prompted by the controlling beneficial owner of Snoras Bank and respectively Latvijas Krājbanka. The Commission ultimately sought insolvency of Latvijas Krajbanka, which was approved by the Riga Regional Court in December 2011.

As an integral part of the national economic system, the banking sector was generally able to benefit from some initial positive signs of the recovery of the Latvian economy in 2011. GDP in Latvia has grown by 5.3 per cent in 2011 (one of the fastest rates in the EU) showing a consecutive increase for two years after a steep decline of 19 per cent in 2009. The unemployment rate also has gone down from 14.5 per cent in 2010 to 11.7 per cent in 2011, while still remaining one of the highest in EU. The government, by retaining restrictions on public spending cuts and commencing structural reforms, was able to reduce the excessive budget deficit and largely prevent further economic decline. One of the significant impediments to swifter economic recovery is the reduced amounts of commercial and consumer credit that Latvian banks are able to provide. The overall credit portfolio of Latvian banks decreased by 8.1 per cent in 2011, thus apparently limiting the supply of the financing so desperately needed for businesses and consumers. While the lending activities of banks still remain rather cautious and limited in scope, there are certain indications that some banks, particularly those that are part of large Scandinavian banking groups may be able and willing to gradually increase lending, at least in some sectors of the market.

II THE REGULATORY REGIME APPLICABLE TO BANKS

Latvian law defines a 'bank' as a credit institution incorporated as a company with limited liability that accepts from the general public deposits and other repayable funds, issues credits in its own name and provides other financial services. A branch of a bank is a structural unit of the bank that does not have the status of being a separate legal entity and is acting in the name of the bank. Public solicitation of the deposits and other repayable funds is permitted only to those registered in Latvia as banks and branches of foreign banks, as well as banks and branches of other EU and EEA Member States.

A bank may commence operations in Latvia only after it has received a licence from the regulator – the Commission – and has undergone the registration process on the Company Register required for conducting business. A bank from another Member State may open a branch in Latvia without receiving a licence from the Commission only after the national banking regulator from the respective Member State has sent the relevant notification to the Commission, and confirmation from the Commission is received indicating that it is ready to commence supervision of the respective branch. Any bank registered in another Member State may start providing financial services in Latvia without opening a branch one month after it has notified its national banking regulator that it intends to commence providing such services in Latvia. As of the end of 2011, there were a total of 21 registered local banks in Latvia and eight branch offices of foreign banks. As mentioned, notwithstanding the continuation of economic hardships, during 2011 only Latvijas Krajbanka went out of business, serving to indicate the general overall strength and stability of the Latvian banking system.

The principal legal framework related to the status, operations and supervision of banks in Latvia is set by the Law on Credit Institutions ('the Banking Law'). Under the Banking Law, in additional to taking deposits and providing credit, banks are permitted to provide other financial services such as processing of payments and money transfers, financial leasing, providing investment services, issuance of bank guarantees, trust operations, trading in its own or on behalf of clients with currency, financial instruments and securities, etc. In its securities activities, banks need to comply with the general requirements set by securities law, as well as the requirements under the Banking Law, in particular relating to risk management, reporting and accounting. Local legislation in the area of securities activities has been substantially approximated with the requirements of the relevant EU directives.

The Commission is the regulator and has supervisory authority in the banking sector. In the aftermath of the financial crisis the practical involvement and role of the Commission inevitably increased and helped to prevent uncontrolled spreading of a systemic banking crisis in the aftermath of Parex Bank takeover.

The Banking Law also stipulates the authority of the central bank – the Bank of Latvia – to issue binding regulations and guidelines for banks within the scope of its statutory duties relating to the implementation of monetary policy and ensuring the functioning of the national payment and settlement system. In particular, the Bank of Latvia sets the amount of mandatory reserves that banks must deposit and maintain with the Bank of Latvia.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The main responsibilities of the Commission in the banking area are related to licensing, setting operational, information disclosure, accounting and reporting requirements, and regulations with the principal motivation of ensuring systemic security, stability and development. The Commission is an independent state institution whose status and competence is defined in the Law on the Financial and Capital Markets. Governing officers of the Commission are directly appointed by Parliament. In addition to banking activities, the Commission also supervises public securities and the capital markets and their participants, as well as insurance business. The activities of the Commission are funded by set mandatory payments from the market participants.

Banks have regular ongoing reporting and disclosure obligations to the Commission, including the provision of financial statements, information about compliance with liquidity and capital adequacy requirements, overall strategy, procedures and actions for the implementation of the regulatory requirements relating in particular to risk management and internal control policies.

In addressing the challenges to the banking sector caused by the financial crisis, the Commission took a proactive role in intensifying bank supervision and developing the legal and regulatory framework. The Commission conducted stress tests on a regular basis in order to better evaluate the risks associated with each specific bank. Additionally, each bank was asked to perform bottom-up stress tests based on the same macroeconomic scenario. The Commission strengthened cooperation and exchange of information with foreign – in particular Scandinavian – banking regulators, and monitored the implementation of international best practice in credit quality evaluation systems and the making of risk provisions. The administrative and supervisory authority of the Commission was also increased by giving it the right to unilaterally impose restrictions on the operations of banks in order to prevent the excessive flow of deposits from them.

ii Management of banks

A bank registered in Latvia operates as a stock company, and has three tiers of organisational and management structure including shareholders, a council and a board. The council is the supervisory body that represents the interests of shareholders between shareholders' meetings and supervises the board. The council appoints the board, which acts as the executive body, managing and representing the respective entity. While executive authority primarily vests in the board, under the corporate charter certain principal decisions or transactions may also require prior council approval. A subsidiary of a foreign bank does not have the status of a separate legal entity and does not have separate supervisory or executive bodies in Latvia, but its representation rights are carried out locally by a duly registered authorised representative.

As a bank's board or council member, the person in charge of material financial decisions, the head of internal audit or the head of a branch office of foreign bank can only be a person that is properly qualified, including competence in financial management, the requisite professional education and work experience, an impeccable reputation and no record of intentional crime or malicious bankruptcy.

The law imposes the general statutory obligation on each council or board member to act as a diligent and upright manager. The responsibilities of the management bodies of a bank include the legal duty to ensure that the bank complies in all relevant aspects with legal and regulatory requirements relating to, for example, risk management, financial reporting, capital adequacy, bank secrecy and anti-money laundering laws, as well as fiduciary duties to the shareholders to achieve efficient, safe and profitable commercial operations of the bank. The financial crisis has apparently put additional stress and burdens on the management of the banks, which had to deal with both the impact of global market turmoil as well as the results of their own previous – and in some instances, rather reckless – credit practices, which have led to overall substantial operational losses and excessive exposure to 'toxic' debt in the Latvian banking sector since the end of 2008. As a result, in the past few years there have been rather extensive changes, particularly at the top management level of several Latvian banks, indicating the dissatisfaction of the shareholders with previous operational policies.

In order to discourage compensation arrangements for bank management that facilitate excessive risk taking and pursuit of quick short-term profits that may jeopardise sound development and operation results of the banks in the long run, the Commission introduced regulations in December 2009, setting principal guidelines for the banks' compensation policies. In particular, the regulations outline the obligations of the council and board in setting a reasonable compensation policy and supervising its implementation, as well as the disclosure requirements related to compensation policy. However, improved operational performance of the banks in 2011 also prompted an overall increase of the compensation for board and council members by 17 per cent in 2011.

iii Regulatory capital

Maintaining sufficient capital adequacy continued to be one of the major practical concerns for the Latvian banking sector in 2011. While the volume of overdue credit payments remained substantial during the course of the year it showed a slight decrease, reaching on average 24 per cent of the total credit portfolio of the banks. The total amount of non-performing loans decreased by €439 million or 8.7 per cent of the total. In this situation, the banks were required to make further capital injections to maintain the required capital adequacy rate. During the course of 2011, 12 Latvian banks have invested total additional capital of around €220 million (€1.3 billion in 2009) and the total paid-up share capital of the banks as of the end of December 2011 was €2.82 billion. These additional injections helped to maintain average capital adequacy ratio in the Latvian banking sector at around 17.4 per cent (the minimum legal requirement being 8 per cent).

Latvian banking regulations have substantially incorporated the requirements of the EU Capital Requirements Directive. Latvia has used optional electives under this directive and imposed more strict requirements relating to risk weighting of credit secured on commercial and residential real estate mortgages. Furthermore, additional restrictions are placed on high-risk transactions or open positions in foreign currencies. The minimum capital base (excluding preferential shares with set dividends) for a bank in Latvia is €5 million, payable in cash. Consequently, the amount of shareholder equity in a bank must not fall below this threshold. The Banking Law provides that a bank must maintain shareholder equity in an amount that is equal to or larger than the aggregate of the following capital adequacy requirements: (1) risk capital requirement for credit and diminishing of recoverable value risks (8 per cent of the weighted average total of the risk transactions); (2) foreign currency and commodities risk capital requirement; (3) securities and trading portfolio risk capital requirement; and (4) operational risk capital requirement. In accordance with the Banking Law, the calculation of shareholder equity is based on the aggregate of share capital, reserves and certain obligatory elements, as reflected in audited financial statements of a bank, that are freely available to the bank for covering possible but as yet unidentified losses related to common operational risks.

iv Recovery and resolution

Insolvency and bankruptcy procedures of banks and other credit institutions in Latvia are regulated by the Banking Law, which also incorporates relevant requirements of the EU Directive on Reorganization and Winding-up of Credit Institutions (2001/24/EC).

Restrictions on the operations of a bank may be imposed under certain conditions even prior to the commencement of a formal insolvency process. Article 113 of the Banking Law provides that where the bank violates applicable banking regulations or its operational safety is endangered the Commission may impose certain restrictions on performance of the bank's obligations (e.g., full or partial suspension of banking services or performance of obligations) and appoint external managers of the Commission.

The duration of such restrictions cannot exceed a 12 month-period and may apply to performance of some or all obligations of the bank.

The insolvency of a credit institution can be commenced upon application of the bank itself, its liquidator, unsecured creditors (such application shall first be filled with the Commission) or the Commission. The official decision on the commencement of the insolvency process is to be approved by the district court, which also appoints an administrator for the insolvent bank proposed by the Commission.

The insolvency process may subsequently involve either (if possible and suggested by the administrator) adoption by the Commission and the creditors' meeting and implementation of the recuperation (rehabilitation) plan intended to restore the bank's solvency and proper resumption of its business activities or, if recuperation is not possible or fails, performing a bankruptcy procedure involving the sale of the bank's assets and liquidation of the bank.

IV CONDUCT OF BUSINESS

The Banking Law and the regulations issued by the Commission set out the principal legal framework and requirements related to the conduct of business by banks. Banks are required to ensure implementation and operation of effective and comprehensive internal control systems corresponding to the nature, scope and complexity of the activities of each respective bank. Credit operations should be conducted in accordance with individual credit policy that sets criteria and guidelines for the issuance and repayment terms of credit (loans), supervision procedures for the issued loans and criteria for the evaluation of the quality of the loans. Banks must comply with legally prescribed capital adequacy and liquidity requirements, as well as with restrictions related to: (1) open positions in foreign currencies; (2) the total amount of high-risk transactions that cannot exceed 25 per cent of the shareholder equity; and (3) the investments in the share capital of other companies (excluding banks, financial institutions or insurance providers), which cannot exceed 60 per cent of the shareholder equity. Banks are prohibited from directly or indirectly issuing credit for the purpose of acquiring shares in the bank itself or related group companies. Banks are required to prepare and make publicly available audited financial statements in accordance with the requirements of Latvian law and international accounting standards, as well as to provide the Commission with other legally prescribed information.

Banks are under the legal obligation to guarantee the confidentiality of the information pertaining to the identity of the clients, their accounts, deposits and transactions. Disclosure of such information by a bank to any third party is legally prohibited, except on grounds expressly set out by the laws for authorised state institutions for the performance of their statutory duties. Such information can be requested from the banks by:

a the Commission for performing its supervisory functions;

b the court in relation to a case under its adjudication;

c law enforcement agencies (prosecutor's office, police, Anti-Corruption Bureau) in performing their investigative and procedural duties in accordance with specific formal information request;

d court marshals for the enforcement of the court judgments;
e the State Revenue Service in relation to performing tax auditing, tax collection enforcement and other statutory functions; and
f the State Treasury, the State Control and the Bank of Latvia within the scope of their functions.

Client information by a bank can also be provided to the courts or law enforcement agencies of other Member States in accordance with the provisions of the respective international treaties. Latvian banks must also comply with the requirements of the Law on Prevention of Legalisation of Finances Acquired through Criminal Activities ('the Anti-Money Laundering Law') and the banks shall provide relevant information to the Anti-Money Laundering Service of Latvia in accordance with the procedures and within the scope of this law. Under the Anti-Money Laundering Law, *inter alia*, banks have to comply with proper 'know your customer' identification procedures and also monitor and report possible fraudulent or illegal client transactions that fall within the scope of the law.

In accordance with consumer protection law, banks need to comply with special regulations related to loans issued to private individuals (consumers). In particular, consumers have the right to early full or partial repayment of loans without any surcharges or penalties. If the loan amount is more than 100 legal minimum salaries (€25,750), the bank must request official information from the State Revenue Service about the amount of reported taxable income of the borrower. The amount of consumer loan secured by real estate mortgage cannot exceed 90 per cent of collateral real estate market value.

The persons that have a statutory duty to preserve confidential bank client or account information (e.g., bank shareholders, council and board members, employees and auditors) can be subject to criminal prosecution for the breach of such duty. Offences related to breaches of the Anti-Money Laundering Law, intentional withholding of information or provision of misleading information to the authorities required under the Banking Law, or intentional malicious bankrupting of a bank can entail administrative or criminal liability. Bank officers, including board and council members, can also be subject to civil liability if they act with intent or gross negligence to breach their fiduciary duties or cause damage to the bank and its shareholders.

V FUNDING

The Bank of Latvia implements monetary policy through such instruments as reserve requirements, market operations and standing facilities of lending and deposit of funds. Reserve requirements imply that banks must hold a certain ratio of the attracted deposits and issued debt securities with the Bank of Latvia. In 2009, the Bank of Latvia decreased the ratio of mandatory reserves thus increasing overall liquidity in the banking sector. The Bank of Latvia also regularly performs market operations, in particular, main refinancing operation tenders, where the Bank of Latvia grants funds in lats to banks against securities collateral. Other types of market operation (e.g., long-term refinancing operations, foreign-exchange swap tenders, fixed-term deposit tenders) are held occasionally by the Bank of Latvia. Additionally, banks can borrow funds in lats from the Bank of Latvia against securities collateral with overnight maturity or deposit funds in lats with the Bank of Latvia with overnight maturity.

For funding of their activities, Latvian banks rely primarily on such sources as capital contributions from the shareholders, accumulated deposits and revenues from other traditional banking services. However, since Latvia joined the European Union, various banks have chosen to or have to rely on different strategies for core funding of their activities. Banks belonging to large international – primarily Scandinavian or US (e.g., General Electric Money) – banking groups have relied heavily on debt and equity financing from their foreign parents. During the previous years of rapid economic growth, these banks poured huge financial resources into the local credit market in pursuit of a larger market share and hefty profits, at the time substantially exceeding the amounts of deposits attracted in Latvia, and thus materially contributing to the overheating of the local economy, excessive inflation and the real estate price bubble. As a result of the recession, these banks took some rather severe financial hits and experienced substantial credit losses; however, they were able to withstand the storm largely due to support and backup from their foreign parents.

The remaining banks are primarily local banks that are not part of any large international financial groups. These banks rely primarily on funding received from accumulated deposits, including deposits from non-residents from countries such as Russia and Ukraine, and borrowings from the international markets through syndicated interbank loans. These banks, having been hit by the global financial crisis, are still facing some challenges relating to remaining at a relative standstill in the international financial markets and the limited possibility of external borrowings and additional accumulation of deposits. However, so far they have generally also been able to withstand the crisis on their own and remain in business, with the exception of Latvijas Krajbanka.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Under the Banking Law 'material participation' in a bank is deemed to be the direct or indirect participation of a person, or a group of persons acting in concert, that represents at least 10 per cent of the share capital or voting rights in the bank or provides the possibility of materially influencing the financial or operational policy of the bank. Material participation in a bank can be acquired by a natural person that has an impeccable reputation and sufficient free capital, or by a legal person (entity) that has been in existence for at least three years (this three-year mandatory period does not apply to licensed entities from other countries participating in the World Trade Organization or any entities whose sole shareholder is another Member State) and whose financial statements are prepared and audited in accordance with international accounting standards, or by the state or municipality. The Commission has the right to verify the identity of a person intending to acquire any material participation in bank. If material participation is acquired by a legal entity, the Commission has the right to verify information about its entire ownership chain until the information about the natural persons who are the ultimate beneficial owners of this entity is ascertained. Any person acquiring material participation must have adequate financial standing to be able, if necessary, to make additional capital contributions in the bank in order to ensure compliance with capital adequacy and other banking regulation requirements.

Any person that intends to acquire material participation or increase its material participation to in excess of 20 per cent, 33 per cent or 50 per cent of the share capital or voting rights in a bank must provide advance notification to the Commission. Within 60 days of receipt of such notification, the Commission evaluates the identity of the applicant, the adequacy of its available financial resources and financial standing, and takes the decision whether to allow the proposed acquisition.

Latvian banks are subject to the general restriction on self-financing applicable to joint-stock companies, which provides that a company cannot directly or indirectly finance acquisition of its own shares.

ii Transfers of banking business

A bank may transfer all or part of its business (comprising deposits, other assets, standard client agreements and obligations) to the ownership or use of another entity ('transfer of undertaking') subject to consent from the Commission. A transfer of undertaking that involves a transfer of financial services agreements of a bank is not subject to the general provisions of commercial law of Latvia that prescribes joint liability of a transferee and transferor of the undertaking. Upon approval from the Commission, the transfer of undertaking does not require the consent of the creditors of the bank involved in the transfer or any other persons, including, *inter alia*, consent for the validity and effectiveness of the transferred obligations between those persons and the transferee under the transfer of undertaking, except where the transfer proposal approved by the Commission provides otherwise. The transfer of undertaking with respect to assets located in another country is legally effective and binding notwithstanding any legal provisions of this other country applicable to such assets or any part thereof.

The respective provisions of the Banking Law relating to the transfer of undertaking were enacted in 2009, and apparently – at least to some extent – their enactment was triggered by the government takeover of Parex Bank and the need to implement further restructuring of the bank's business in order to make its eventual sale more practical and possible.

VII THE YEAR IN REVIEW

The Latvian economy in general and its banking sector in particular showed some signs of recovery during 2011, after several consecutive years of recession. In 2011 more than half of Latvian banks showed operational profit in comparison with predominantly losses sustained during 2010. However, macroeconomic issues still presented substantial challenges, including cuts in the government fiscal spending, large unemployment, stagnating real estate market and overall uncertainty and hardships in global economy. This situation required decisive efforts on the part of the government, the Commission and the Bank of Latvia to further develop bank regulation and supervision.

The largest systemic shock sustained by the Latvian banking sector in 2011 was the insolvency and eventual bankruptcy liquidation of Latvijas Krajbanka. The downfall of Latvijas Krajbanka was triggered not solely by general economic hardship but allegedly fraudulent actions. The decision of the Commission to revoke its banking licence and seek the insolvency of Latvijas Krajbanka was finally triggered when it was discovered that substantial amounts of monies – approximately €140 million – held in the correspondent accounts with several foreign banks had been actually pledged (although no such pledges were officially recorded in the books of the bank) to secure allegedly shareholder-related and undocumented loans and the ability to recover such funds by Latvijas Krajbanka appeared to be highly problematic.

The insolvency of Latvijas Krajbanka triggered for the first time huge payouts from the Deposit Guarantee Fund to pay state-guaranteed reimbursement to the depositors of the bank in the amount of up to €100,000 each. In total the amount of paid guaranteed deposit reimbursement reached €437 million and since this payout exceeded the currently available funding in the Deposit Guarantee Fund the necessary funding had to be borrowed from the State Treasury. This had put an additional financial burden on the banking sector in general since in order to ensure more expedient accumulation of the depleted funds in the Deposit Guarantee Fund the amount of mandatory financial stability payments by the banks has been increased.

The insolvency of Latvijas Krajbanka also created increased public criticism of the Commission for not timely detecting potential problems in the bank, particularly in the aftermath of the Parex Bank failure and that eventually lead to the resignation of the chairwoman of the Commission and her deputy directly responsible for the bank supervision.

The Commission under its new leadership promised to take a more proactive role in bank supervision and to work on further elaboration of the regulatory framework related to, *inter alia*, advance material risk identification procedures; risk, asset and capital adequacy evaluation procedures; preparation of quarterly public financial statements; maintenance of correspondent accounts; credit risk management, insolvency and bankruptcy liquidation procedures, etc.

An important new development was the introduction of new licensing requirements and licensing dues in 2011 for non-banking consumer credit providers. Previously, such non-banking consumer credit providers were not subject to any special supervision or licensing and their activities caused numerous complaints about alleged misleading advertising, unfair contract terms and dubious debt collection procedures.

From 1 January 2011, for the first time Latvia introduced capital gains tax with respect to interest and dividend income for private individuals at 10 per cent. This new tax was a part of extensive tax reforms triggered by the urgent need to tackle the budget deficit facing Latvia in 2011.

One of the main practical challenges the government faced in 2011 related to Parex Bank, which was rescued and nationalised in 2009. In 2010 the split-up of Parex Bank and the transfer of its good assets to newly formed Citadele Bank was implemented, with the intention of facilitating the eventual sale of Citadele Bank to private investors and thus increasing the possibility of a swift recovery of at least some of the funds used by the government for the bailout of Parex Bank. In 2011 the government was actively trying to find an eventual buyer both for the 'good' Citadele Bank and the potentially 'toxic' remaining Parex Bank, however, in the current global economic environment no suitable buyer has been found thus far and it remains an important priority.

The state is apparently not willing to be involved in commercial bank management in the long term. Although Citadele Bank has so far worked profitably, Parex Bank was still generating losses in 2011, and the decision was taken to surrender the banking licence for Parex Bank so that in the future it shall operate as a general corporation not subject to banking regulation. The state's decision to generally exit commercial business in 2011 was further manifested by the commencement of restructuring of the other remaining state-owned bank Latvijas Hipotēku un Zemes Banka (the Latvian Mortgage and Land Bank), with the intention to split its development bank operations and commercial bank operations with the aim of eventually selling the latter to private investors.

VIII OUTLOOK AND CONCLUSIONS

Developments in the banking sector in Latvia during 2012 will probably be closely related to the level of recovery in the national economy in general. Active work by the government on fiscal consolidation of the state budget continues. Commenced structural and tax reforms and commitments for a further financial stimulus package for the core sectors of the economy, and small and start-up businesses, give some preliminary hope and indication of positive developments. However, in the near future, the banks will still be faced with substantial challenges and issues to be resolved. Although in total in the banking sector the rate of non-performing or overdue loans has been slowing down, it still represents a considerable problem for local banks needing to make substantial reserve provisions; this contributes to the banks' overall losses and limits their opportunities to resume an adequate level of business and consumer credit, which is important for economic recovery. Helping the banks resume lending in order to provide proper support for businesses via commercial credit and consumers with residential and consumer credit is one of the most important tasks in the short term, which will require a combined effort from the government, banks and the borrowers. Nevertheless it appears that the deepest point of economic recession in Latvia is already in the past and there are grounds for hope of a gradual albeit rather cautious recovery. But this process will likely be closely interlinked with further global economic developments, in particular in the EU and the eurozone.

Appendix 1

ABOUT THE AUTHORS

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Skudra & Udris

Armands Skudra is a partner at Skudra & Udris and is currently head of the banking and corporate practice of the firm. With over 15 years' extensive practical experience in a range of areas, including banking, securities market, government contracts, corporate law and others, Mr Skudra has an extensive domestic and international client base. He has advised some of the major international banks and financial institutions in Latvia on a wide range of matters covering such areas as syndicated loans, acquisition and project finance, banking regulation, capital markets and complex financial instruments such as derivatives. He has also been involved in work related to the development of a regulatory framework for interbank payment and settlement systems and has lectured at the University of Latvia.

Mr Skudra obtained law degrees from the University of Latvia (BA, *cum laude*) and the New York University School of Law (LLM in International Law) and is admitted to practise in Latvia and New York. Mr Skudra is fluent in Latvian, English and Russian.

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