The Banking Regulation Review

Fifth Edition

Editor
Jan Putnis

Law Business Research

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EDITOR'S PREFACE

The past year has seen a number of critically important bank regulatory initiatives reach interim conclusions.

In the European Union we have seen the finalisation and coming into force of the primary measures that are required to implement Basel III, as well as – at long last – political agreement on the Recovery and Resolution Directive and the principal elements of the banking union proposals. We have also seen the first foray of the European Commission into bank structural reform, with its controversial proposal for EU legislation on that subject, after the enactment of detailed domestic bank structural reform measures in a number of member states.

In the United States, the past year has seen the culmination of a number of regulatory initiatives, including the issue of final rules implementing the Volcker Rule and the issue of rules that will require large foreign banking groups to establish intermediate holding companies for their US subsidiaries. Both of these sets of rules stem from the Dodd-Frank Act: predictions that numerous legal careers would be made by that legislation are so far proving to be accurate.

I refer to these developments above as 'interim conclusions' because, of course, even though a period of primary rule-making has reached a conclusion, the full implications are still emerging. That said, there are helpfully more certainties now about the future direction of banking regulation than was the case a year ago. The combination of that fact, generally improving western economies and shareholder pressure has made many banks take the plunge and start to reorganise and restructure.

Recovery and resolution planning work remains a powerful driver of structural reform. It does not, however, require a particularly sophisticated legal and regulatory view to conclude that the world remains far from a position where we can have confidence that a global systemically important bank could be resolved in an orderly manner today without significant disruption and damage to the world economy. The fact that some regulators occasionally argue to the contrary disregards the detailed work that still has to be done so that governments and regulators may have a good chance of attaining that confidence in the next few years. But that work is, in general, progressing and reassuringly shows no real sign of faltering yet as memories begin to fade of just how close the world came to economic calamity during the financial crisis.

Divergent approaches to structural reform in different countries could, however, make group-wide resolution more difficult to achieve. Localism, in the form of requirements that banking subsidiaries hold additional, more loss-absorbent capital and additional pools of liquidity, and have boards of directors with a significant independent membership, all have the potential to threaten the concept of a global banking group unless careful thought is given in such groups to how to address these challenges. The ways in which banking groups can best coordinate their relationships with multiple regulators are high on this agenda.

Perhaps the most difficult challenge facing banks in their relationships with their regulators is that of how to reconcile the need for close and cooperative working relationships with those regulators against the backdrop of seemingly never-ending conduct-related investigations and enforcement action. This difficulty varies according to which regulator is carrying out the investigation and the extent to which the investigation relates to matters that are historic and which the banking group concerned has taken steps to address. The challenge is clearly greatest where a major investigation concerns recent conduct and is led by a regulator with which the relevant bank requires good relations in order to achieve its commercial objectives to the satisfaction of its customers and shareholders.

It will be increasingly important for banks to appreciate the capacity of the more material investigatory and enforcement activity to shape business structures as much as structural reform itself. The changes to the ways in which certain markets and trading operations will be organised in the future in response to enforcement activity will be at least as significant as the changes that are brought to those markets and operations by, for example, resolution planning.

The upheaval that all of this implies for some banks' corporate and business structures, as well as for their staff, is combining with changes to previously held assumptions about the profitability of certain activities as Basel III capital requirements bite. The result is uncertainty, but with some grounds for cautious optimism, at least for those banking groups that are less seriously affected by conduct investigations and are firmly on the road to developing simpler, more capital-efficient structures.

Banks that have adopted a properly integrated and global approach to structural reform will, in my view, reap the benefits. While, in the short term, that is likely to be more expensive from a resourcing perspective, in the long term it should achieve savings. It is all too easy to address each regulatory initiative as it comes along, not recognising that this reactive approach runs the risk of structural muddle and missing out on developing business models that address multiple regulatory concerns at the same time. It is to be hoped that more regulators start to recognise positive proactivity on the part of banks not just as commercial astuteness but as a contribution to the restoration of trust that is required to make bank regulatory reform a success.

One increasingly important aspect of reform in the banking sector concerns the capital structures of banking groups. The requirement for more and higher quality loss-absorbing capital under Basel III, coupled with the introduction of bail-in as a resolution tool in a number of important banking jurisdictions, means that banking groups are having to rethink which company or companies they will use to raise capital and what form that capital will take. Particularly in Europe, the issue of additional Tier I capital and other contingent capital instruments has added complexity to banks' capital structures and a need for banks to engage with current and potential investors to explain those structures.

This fifth edition of *The Banking Regulation Review* contains submissions provided by authors in 56 jurisdictions between late February and mid-April 2014, as well as the chapters on 'International Initiatives' and the European Union. Preparing the chapters has been a particularly onerous task for the authors this year because many of their clients have now moved from observing the regulatory revolution that has taken place in the banking sector to taking tangible steps to reorganise in order to make themselves fit for the new world in which the sector finds itself. My thanks go to all of the authors for their dedication in completing their chapters.

Thank you also to Adam Myers, Shani Bans, Nick Barette and Gideon Roberton at Law Business Research Ltd for their patience, understanding and – above all – great effort in preparing this edition.

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Jan Putnis
Slaughter and May
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Chapter 35

LATVIA

Armands Skudra[1]

I INTRODUCTION

In 2013 Latvia's banking sector showed moderate overall development and improvement of major operational indicators. This was shown by the sustaining of relatively high levels of capitalisation and liquidity in the banking sector, increased profitability and credit portfolio quality, as well as the rapid increase in resident deposits. 2013 was the second consecutive (following three previous loss-bearing years) when the banking sector showed an overall profit reaching in total €246 million (compared with €185 million profit in 2012). Meanwhile, 15 Latvian banks and five branches of foreign banks, whose assets together constitute 95 per cent of the total assets in the banking sector, showed a combined profit of €301 million. The combined gross assets of Latvian banks in 2013 reached €28 billion showing a 1.7 per cent fall from the previous year. The market is still dominated by banks associated with large Scandinavian financial groups, including Swedbank (17.4 per cent of the total gross banking assets), SEB Bank (13 per cent), followed by fast-growing local ABVL Bank (11.9 per cent), which was able to surpass Latvian branch of Nordea (10 per cent) and the local Rietumu Bank (9.5 per cent).

One of the major developments and challenges for banking sector in 2013 was the joining of the eurozone by Latvia; the transition to the euro was in fact managed by the banks rather efficiently and smoothly. The introduction of euro facilitated a steep increase in bank deposits by residents of 13.3 per cent during 2013. The consolidation of the banking sector continued and, despite three banks voluntarily surrendering their banking licences, the largest market players, including several local banks, were able to strengthen their market positions. This was combined with an increase in operational efficiency including the further expansion of electronic services. On average, 98 per cent

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of payment transactions in banks were handled electronically, either by internet banking or payment cards.

As an integral part of the national economic system, the banking sector was generally able to benefit from continuing positive signs of the growth of the Latvian economy in 2013. GDP in Latvia has grown by 4 per cent in 2013 (one of the fastest rates in the EU) showing a consecutive increase for four years after a steep decline of 19 per cent in 2009. The unemployment rate also has fallen slightly to 11.8 per cent in 2013, while still remaining one of the highest in EU. The government, by retaining restrictions on public spending cuts and continuing structural reforms, was able to reduce the excessive budget deficit and ensure compliance with Maastricht criteria, thus paving way for Latvia's entry into the eurozone. One of the remaining 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 6.5 per cent in 2013 (although largely attributable to write-offs of bad debts from the pre-crisis period), thus apparently limiting the supply of the financing so desperately needed for businesses and consumers. While the banks still remain rather cautious and their lending activities limited in scope, there are certain indications that some banks, particularly those that are part of the large Scandinavian banking groups, may be willing and able to gradually increase lending, at least in some sectors of the market. New business and commercial credit in 2013 reached €2.3 billion, an increase of 8.3 per cent from the previous year.

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 2013, there were 17 registered local banks in Latvia and nine branch offices of foreign banks. During 2013, all the banks in Latvia remained solvent, 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 addition 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 on 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 in 2009.

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 four 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 2012 also prompted an overall increase of the compensation for board and council members.

iii Regulatory capital

Maintaining sufficient capital adequacy continued to be one of the major practical concerns for the Latvian banking sector in 2013. While the volume of overdue credit payments remained substantial during the course of the year it showed consecutive decrease, reaching on average 14.6 per cent of the total credit portfolio of the banks. The total amount of non-performing loans decreased by 1,8 per cent compared with 2012. In this situation, the banks were still required to make further capital injections to maintain the required capital adequacy rate. During the course of 2013, six Latvian banks invested total additional capital of around €60 million (€200 million in 2011) and the total paid-up share capital of the banks as of October 2013 was around €2.7 billion. These additional injections helped to maintain average capital adequacy ratio in the Latvian banking sector at around 18.9 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 stricter 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 the Reorganisation 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 filed 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 requests;
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 must 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 euros to banks against securities collateral. Other types of market operations (e.g., long-term refinancing operations, foreign-exchange swap tenders and fixed-term deposit tenders) are also held occasionally by the Bank of Latvia. Additionally, banks can borrow funds in euros from the Bank of Latvia against securities collateral with overnight maturity or deposit funds in euros with the Bank of Latvia with overnight maturity.

For funding of their activities, Latvian banks rely primarily on such sources as capital contributions from shareholders, accumulated deposits and revenues from other traditional banking services. 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 – banking groups previously relied heavily on debt and equity financing from their foreign parents. In 2013, however, the obligations of banks towards monetary financial institutions fell by 25 per cent due to the continual decline in financing that subsidiaries and branches of foreign banks received from their parent companies. This reduction in financing amounted to €1.3 billion, prompted by, *inter alia*, consolidation of the banking sector, an increase of resident deposits and the shrinking of credit portfolios.

Due to the increase of on-demand deposits in the overall bank deposit portfolio, in order to balance term structure of the financing banks are trying more actively raise finances through issue of long-term bonds. Although proportion of such bonds in total financing portfolio remain low, during the last year their amount has increased for 68 per cent reaching in total €333 million.

Local banks that are not part of large international financial groups, historically have relied to significantly 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. Owing to the consolidation of the local banking market resulting from government takeover of Parex Bank, the insolvency of Krajbanka and the voluntary surrender of banking licences by three other banks, the major Latvian banks, ABLV Bank and Rietumu Bank, were also able to significantly strengthen their positions and market shares by accumulating significant non-resident deposits.

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, 33 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 provide 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 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 the banking sector in particular, was able to continue its recovery during 2013. The majority of Latvian banks showed operational profits for the second consecutive year; however, macroeconomic issues still presented substantial challenges, including completion of structural reforms, high unemployment and social welfare problems.

In 2013, the banking sector as a whole showed stability, consolidation and moderate growth. The Commission maintained a proactive role in bank supervision and continued work on further elaboration of the regulatory framework related to, *inter alia*, advance material risk identification procedures; risk, asset and capital adequacy evaluation procedures; corporate governance (e.g., compensation and requirements); maintenance of correspondent accounts; and credit risk management, insolvency and bankruptcy liquidation procedures.

Heated political debate and tensions were caused in 2013 by a legislative initiative to introduce the principle of 'surrendered keys' into insolvency law, which would allow a private individual whose debt was secured by collateral pledge (mortgage), after the foreclosure and sale of the collateral, to be discharged from the residual credit obligation to the lender. This initiative was strongly lobbied by borrowers' associations but as equally strongly opposed by banking sector and as the result these legal amendments are currently put on hold.

Although new licensing requirements, hefty licensing dues and minimum capital requirements were introduced in 2011 for non-banking consumer credit providers, the market of 'express' consumer credits provided by non-banking institutions is still considerable and causing regulatory concern about predatory and reckless lending practices. It is estimated that 22 per cent of the Latvian population have used 'express' credits and 49 per cent of the borrowers have problems with timely repayment of the debt. A legal framework for the regulation of express credits and imposing additional restrictions on, *inter alia*, unfair lending practices, contract terms and penalties was further strengthened during 2013 and it is starting to engender positive effects in the respective market sector.

One of the main practical challenges in the banking sector that the government still faced in 2013 related to Parex Bank, which was rescued and nationalised in 2008. 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 2013 the government was actively trying to find an eventual buyer for the 'good' Citadele Bank, however, in the current global economic environment no suitable buyer for this bank has been found thus far and it remains an important priority.

The state apparently does not want continuous involvement in commercial bank management in the long term. The state's general intention to exit the commercial banking business in 2013 was further demonstrated by the restructuring of the other remaining state-owned bank Latvijas Hipotēku un zemes banka, with the separation of its development bank and commercial bank operations, and the sale of the latter to private investors.

VIII OUTLOOK AND CONCLUSIONS

Developments in the banking sector in Latvia during 2014 will probably be closely related to the level of development and growth of the national economy in general. The outlook for Latvia looks promising, in particular as a result of the expected stabilising and positive effects of joining the eurozone in 2013. This was also acknowledged by Standard & Poor's, which raised Latvia's credit rating from stable to positive in December of 2013. However, contingent risks and vulnerability are still present and are associated with the uncertainty and stagnation in the global and particularly EU markets, since 60 per cent of Latvia's economy is dependent on export. In the near future, banks in Latvia will still be faced with substantial challenges and issues associated with overall residual economic hardships, such as unemployment and demographic decline. Parliamentary elections are also taking place in 2014, which may cause additional political tension and uncertainty. In January 2014 the Latvian parliament ratified the Treaty Establishing the European Stability Mechanism and so Latvia became a full member.

In 2014, work will continue on establishing an EU banking union. Work on the single supervisory mechanism will commence on 4 November 2014. It is planned that the single regulatory mechanism and amendments to the Deposit Guarantee Scheme Directive will become effective in January 2015. Under the new framework the European Central Bank, in cooperation with the Commission, will supervise the three largest Latvian banks (based on asset valuation): Swedbank, SEB Bank and ABLV Bank.

Although, on the whole in the banking sector, the rate of non-performing or overdue loans has been slowing, it still represents a considerable problem for local banks needing to make substantial reserve provisions and limits their opportunities to resume an adequate level of business and consumer credit, which is important for sustained economic growth. Helping the banks resume lending in order to provide proper support for businesses via commercial credit and consumers with housing credit is one of the most important tasks in the short term. An important step towards this goal is the intended state support programme for young families with children, under which the state will guarantee the deposit (up to 20 per cent) for the acquisition of their first properties. This is intended to make residential credit more affordable for young families, who frequently struggle to raise money for the deposit.

Appendix 1

ABOUT THE AUTHORS

ARMANDS SKUDRA

Skudra & Ūdris

Armands Skudra is a partner at Skudra & Ūdris and is currently head of the banking and corporate practice of the firm. With over 18 years of extensive practical experience in a range of areas, including banking, securities, 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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