**Exchange of Views on the prospects of euro adoption by Latvia**

**ECON Committee, 26 February 2013**

**Questions provided in writing and responses by Latvian Authorities**

**Questions by Greens**

**Question: Latvia has experienced during the last year a profound correction of its relative price level towards the Eurozone. How does the Latvian government want to control the Samuelson effect which previews a higher inflation rate in countries with lower GDP/capita than in those with a higher GDP/capita?**

**Response:** According to the Eurostat data, average price level as measured by GDP deflator in Latvia in 2011 reached 63.3% of the euro zone average. Preliminary estimates show that the GDP deflator in 2012 has increased by 1.3% in the euro zone, and by 2.5% in Latvia. As a result, price level in Latvia might have reached 64% of the euro zone in 2012. The price level in Latvia has thus converged with the euro zone by approx. 0.7% points in 2012. This is not a profound correction by any means.

Moreover, this is consistent with our estimates of the Balassa-Samuelson effect so far (roughly 0.7% points per annum). Thus, the impact is rather moderate and does not pose significant risks to price stability in Latvia, going forward. On the contrary, moderately higher inflation in Latvia relative to the euro zone as income levels in Latvia converge towards the levels observed in other euro zone member countries, is a necessary precondition for real convergence in Latvia. Due to its modest impact and the small share of Latvia's contribution to the EU total inflation, we do not expect the B-S effect in Latvia to have a statistically meaningful impact on the overall inflation figures in the euro zone in the future.

In addition, the risks of unsustainable inflationary pressures have been significantly reduced by the recent policy steps aimed at safeguarding macroeconomic stability. In particular:

* Fiscal policy has been put into the counter-cyclical framework;
* Personal income tax imposed on capital gains, including from real estate, and real estate tax extended to housing. Further tax reforms mainly focus on sustainable economic development, improvements in competitiveness as well as combating grey economy;
* Credit register has been set up, thus allowing for a better risk assessment of potential borrowers;
* Overall banking regulation has been tightened;
* Labour market reforms have been conducted with a view to reducing potential skills mismatches and thus alleviating potential wage pressures in the medium term.

**Question: Latvia has been criticized for its lack of effective information exchange and a lack of transparency of the beneficial ownership of capital. Accordingly, Latvia was criticized by the FATF as well as the “Financial secrecy index” of the Tax Justice Network.  Two related questions:**

**a) Which measures will Latvia undertake to ensure full compliance with FATF recommendations as well as a financial secrecy score at least of Eurozone average?**

**b) Will Latvia change its banking secrecy provisions?**

**Response:** Firstly, the statement included in the preamble to the question is obviously not based on the latest information and refers to somewhat outmoded data.Indeed, Latvia has been criticized for a lack of transparency of the beneficial owners of capital **in 2006** – when assessment of the anti-money laundering (AML) and combating the financing of terrorism (CFT) regime of Latvia was conducted by the IMF. This assessment, however, did not reveal serious shortcomings with respect to information exchange.

As regards **compliance with the FATF 40 Recommendations** it is important to take into account the results of the **latest** assessment of the AML and CFT regime of Latvia done by the Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL) in 2011 (assessment report discussed at the MONEYVAL plenary on July 5, 2012 and **published on November 23, 2012**). Moreover, as regards Financial Secrecy Index, the Tax Justice Network has prepared the results of its evaluation in 2011, i.e., before the latest assessment of AML/CFT regime (results **published in November 2012**).

The MONEYVAL report recognises substantial progress made by Latvia when compared to the situation in 2006. Namely, **there are no non-compliant ratings anymore;** the previously stated problem of a lack of transparency of the beneficial ownership of capital has been eliminated (legislation and practices implementing Recommendation 33 previously rated as non-compliant are now assessed as fully compliant with FATF requirements). The compliance with 70% of all FATF recommendations is rated either "Compliant" or "Largely Compliant", including all three recommendations for legal systems, as well as recommendations on correspondent banking, record keeping, regulation and supervision of financial sector, national and international cooperation.

Latvia's legal provisions ensure that **financial institution secrecy laws** do not inhibit implementation of the respective FATF Recommendations. Hence we have not considered changing our banking secrecy provisions. Latvia was rated as fully compliant with the FATF standard in this regard, both when the compliance with the requirements of Recommendation 4 (Financial institution secrecy or confidentiality) was assessed by the IMF in 2006, and also in 2011 by MONEYVAL.

**Question: According to the IMF’s Macrobond Financial soundness Indicator the share of bad loans in Latvia has grown from 2,1% in 2008 to 13,9% in 2011 and 11,0% in 2012. Which measures does the Latvian government plan to restore the health of its banking industry?**

**Response:** In line with the continuously improving domestic macrofinancial conditions and gradually recovering creditworthiness of the borrowers, as well as with the clean-up of banks' balance sheets, the absolute amount and the share of bad loans (defined as loans past due more than 90 days) in the total banks' loan portfolio has decreased notably – from its mid-2010 peak of about 19.5% to 11.1% in December 2012.

It is expected that the steady improvement in the quality of the banks' credit portfolio, particularly in the segment of corporate loans, will continue along with the positive developments in real economy and diminishing solvency risks of borrowers.

Already in 2009-2010 shareholders of banks made considerable capital injections and raised provisions for bad loans notably. Hence the the capital base of banking sector has already been significantly strengthened. The overall capitalisation of the banking sector exceeds minimum regulatory requirements more than twice – in December 2012 the system-wide capital adequacy ratio stood at 17.6% while core Tier 1 ratio was at its record high level of 15.2%.

Moreover, a series of regulatory measures were taken, to deal with loan quality issues and related risks:

Regulations on assessment of quality of assets and provisioning were revised to highlight specific requirements on provisioning where impairment recognized according to IAS 39 is not prudent enough from supervisory perspective. Positive difference between supervisory provisions and accounting provisions is deducted from own funds in calculation of capital adequacy. (March 2009)

Regulations on Credit Risk Management were enhanced, specifying requirements to develop and conform to the credit granting criteria that are appropriate for reasonable decision-making on credit granting. Criteria shall be adjusted to every credit target market, where the bank issues credits, types of loans, types of borrowers, assessment of borrowers’ creditworthiness, including the borrower's ability to meet credit liabilities in case of the credit currency and borrower's income currency mismatch, if there are significant adverse movements in currency rates and credit interest rates for the borrower and the borrower has not acquired any financial instrument to hedge such risk. For management of credit risk banks shall develop stress testing methodology, scenarios and parameters and perform credit risk stress testing, analyze the result of stress testing, assess its capability of withstanding stressful situations and establish contingency plan (2009, up-dated in 2012).

Regulations on the internal capital adequacy assessment process incorporate requirements to assess the concentration risk and determine capital requirement to cover indirect FX risk inherent in loans granted to households – residents whose income currency is different than the currency of the loan.

Scope of information available in Credit Register was broadened to include positive information on borrowers and their current liabilities, which helps banks in assessment of creditworthiness of clients and credit risk management. Quality of loans and adequacy of provisioning is monitored on an on-going basis. Coverage of NPLs (overdue more than 90 days) by provisions is as follows:

2009 - 52.47%; 2010 - 59.68%; 2011 - 67.02%; 2012 - 71.83%

**Question: What are the main objectives of Latvian financial supervision: prudential control or sales practices and protection of clients?**

**Response:** The main objective of Latvian financial supervision (performed by the Financial and Capital Market Commission (FCMC) – Latvian financial supervisory authority) is to promote the development and stability of the financial and capital market in order to protect the interests of investors, depositors and the insured. The Latvian financial supervision is legally not responsible for the protection of interests of every consumer individually and does not control sales practices, but should promote development and the stability of the financial and capital market in order to protect the interests of investors, depositors and the insured in general.

For example, if an individual submits a complaint about bank's action to the FCMC, the FCMC requires the explanation from the bank in order to establish whether the bank has breached laws and regulations for banking activities, but if the complaint is related to the consumer rights, it either recommends the submitter to refer to the Consumer Rights Protection Centre (responsible for protection of consumer rights and interests in Latvia) or sends the complaint to it.

**Question: Is (are) the Latvian financial supervisor(s) required by Law to look after the protection of the interests of clients?**

**Response:** The Financial and capital market Commission (FCMC) is an autonomous public institution, which carries out the supervision of Latvian credit institutions, insurance companies, reinsurers and insurance brokerage companies, participants of financial instruments market, investment management companies, credit unions, electronic money institutions, payment institutions as well as private pension funds.

Article 5 of the Law on the Financial and Capital Market Commission states that the goal of the Commission’s activities shall be to protect the interests of investors, depositors and the insured, and to promote the development and stability of the financial and capital market. It means that the Commission is not responsible for the protection of interests of every consumer individually, but it has to promote the stability of the financial and capital market in order to protect the interests of investors, depositors and the insured in general.

In addition to the FCMC functions set by the Law, the FCMC in its supervisory practice pays particular attention also to consumer protection issues. Inter alia, the FCMC has issued several regulations, and it participates in consumer education regarding financial services (e.g. the FCMC “Clients’ School” (www.klientuskola.lv), provides information on financial services available in Latvia and prepares the “Banking Compass” thus providing information on banking activities on a quarterly basis as well as interpretation of the data.

**Question: The shadow economy is estimated to be particularly large in comparison to GDP in Latvia? Which measures does the Latvian government undertake or foresee to bring its size to at least Eurozone average?**

**Response:** According to Dr. F.Schneider, the levels of shadow economy in Latvia in the context of Baltic region are relatively modest 26.5% of GDP, in comparison to Lithuania (29.0%), Estonia (28.6%) and Poland (25.0%). The government recognises the challenge to bring more economic activities out of shadows into registered economy, and results are expected to continue improving in medium term.

During the crisis, in the context of decrease in employment opportunities and tax increase in line with budget consolidation, policy response to decrease shadow economy in Europe was not overly successful and incentives for individuals to get involved in shadow economy activities increased. Fast and flexible policy response “The Action Plan to Reduce Shadow Economy and Promote Fair Competition 2010-2013” was introduced, and it contributed to reaching the lowest level of shadow economy in Baltics in the medium term. The main directions to combat the shadow economy are set – reducing the administrative burden, ensuring efficient operation of controlling authorities, imposing sanctions, supporting honest businesses, promoting transfer of businesses from non-registered economy to the registered economy.

From January 1, 2013 new policy measures have been implemented to enhance the fight against shadow economy – limitations on cash transactions, simplified accounting requirements for micro enterprises, improved regulation for company advance payments to owners, restrictions to recognize artificial transactions, when their legal form does not meet their economic nature, for the tax purposes. New measures are under discussion including a possibility to link tax payments to conditions for receipt of public services with an aim to motivate persons to pay taxes.

Over performance of tax revenue in 2012 can be partially attributed to the efforts of tax administration and economic, but some tax revenues are above the levels which could be explained by the increase in economic growth. While difficult to estimate, we consider this additional revenue as coming from the previous shadow economy, which has legalised itself. Latest studies and good revenue performance also suggest that first successes in this field have been reached. (Eurostat, data for 2010; The Shadow Economy in Europe, 2011, A.T. Kearney, 2012.).

**Question: In its report on the 28th of January 2013 the IMF commented critically on the high level of inequality and poverty in Latvia. It recommended further to correct the cut in social benefits from 40 lats to 35 lats. Will Latvia implement this recommendation?**

**Response:** The Latvian Government puts a strong emphasis on efforts to return working age population back to the social insurance system. So far processes display a positive response – namely, the number of persons covered by social insurance (employed or self-employed) increased from 789.8 thousand in December 2011 to 817.4 thousand in September 2012 and the number of receivers of GMI decreased from 63 thousand (3% from the total population) in January 2012 to 41 thousand (2% from the total population) in December 2012.

The statement that a robust social security system – social assistance – is essential to prevent and minimize extreme poverty, is does not capture the whole context. The main causes of poverty in Latvia are low income and income inequality that does not exclude one another. Basically this problem cannot be solved by a social assistance system. Moreover, it is not the objective of this system because social assistance is not targeted towards compensation of deficiencies existing in other sectors – this is inefficient from the point of view of both the rational use of financial resources and policy making, and the individual since receiving social assistance in particular for a long-term gradually reduces the value of human capital, which in the context of an ageing society is unacceptable.

Within the National Development Plan and the new EU development strategy and National Reform Program, the strong direction towards reduction of poverty and social exclusion has been defined, i.e. rise in income, especially for employed with low income, reduction of unemployment, improvement of skills and reduction of discrimination. To fight poverty and social exclusion, the Latvian Government focuses on supporting employment, more effective matching and increased employability and, accordingly, on increasing the number of persons covered by social insurance.

Since local municipality is the closest public administration to the individuals and households and has all the resources and capacities to analyse the household situation, the provision of social assistance is the responsibility of local municipalities. Thus administration and financing of social assistance in Latvia has been decentralized since the very beginning of the system, not changing this provision also as a result of socioeconomic crisis – the state defined a co-funding of municipal expenditures but the system is still being implemented and financed applying the principle of decentralization. In the framework of social security system the social assistance system is organized to provide targeted support, i.e., to the most needy people by assessing their material resources – income and properties that is the basic principle in provision of social assistance.

The amendments to the legal framework of social assistance have been made – GMI level is reduced to 35 lats from 2013 and local governments finance the GMI benefit from municipal resources in a full amount.

To ensure that local municipalities can cope with their functions, the Government has taken a decision to provide additional (along with the equalization fund) financial assistance to the municipalities. In 2013 the municipalities with the most limited financial resources will receive subsidy from the budget.

As before, local municipalities have an option to define higher GMI level but not exceeding the level of a needy person. Since 2013 there are no restrictions concerning the population groups for which the higher GMI level can be defined (until 2013 it was allowed to define higher GMI level only for recipients of disability and old age pensions).

In total, the right to set up higher GMI level in 2013 has been used by 25 municipalities, i.e., 21% from all 119, compared to 13% 2012. Higher GMI levels have been defined to different target groups, but most of all for people with disabilities, children and retired people.

Well targeted and developed social security system is one of the main priorities of the Government of Latvia. It should be mentioned that the Government has decided to establish a working group on social exclusion and poverty reduction issues. It is planned that the Government, until August 1, 2013, will collect and discuss proposals made by the Ministry of Welfare and other partner institutions for further development of social assistance system. It is worth mentioning that tackling in-work poverty is also on the policy agenda.

**Question: In its report on the 28th of January 2013 the IMF projects HIPC inflation at 2,4% in 2012 and 2,2% in 2013 which are both above the Eurozone’s below-but-close-to 2% objective? How does the Latvian government assess this projection in the light of the criteria to join the Euro?**

**Response:** These projections are in line with the macroeconomic projections by the Latvian government and the Bank of Latvia, which put annual inflation at around 2% both in 2013 and 2014. We believe that annual inflation in Latvia within the range of 2-2.5% is fully consistent with the euro zone's price stability objective. This is further confirmed, among others, by the fact that Maastricht price stability criterion necessary for joining the euro zone in December 2012 hovered at 2.8-3.2% (depending on the countries that are included in the criterion).

**Question by ECR**

*Worrying trends regarding NRDs*

**Question, part I: Non-resident deposits (NRDs) in Latvian banks are constantly rising. According to the last available data, NRDs have risen by nearly 17 per cent in one year and now constitute almost one half (48.9 per cent) of the total deposits in Latvia’s banks. NRDs now reach over 6 billion lats, thus surpassing the level of Latvia’s annual budget. What is more, over 80 per cent of the NRD money is deposited on demand deposit accounts which means that the country is vulnerable to sudden outflow of funds, as was experienced on the eve of the recent economic crisis when 30 per cent of non-resident money left the country in one year from August 2008.**

**It should also be added that NRDs, given the origin of the capital, can pose geopolitical risks to the country. Although officially only about 12 per cent of the NRDs come from CIS countries, it is estimated that in reality as much as 80-90 per cent of the money, mostly indirectly via offshore companies from jurisdictions such as Belize as well as from the EU countries (Cyprus and the UK), come from the CIS.**

**Response, part I:** The growth of non-resident deposits in Latvia is not a recent phenomenon; non-resident deposits have always formed around half of the total deposit base of Latvia's banking sector.

Serving non-resident clients (largely corporate depositors from CIS countries) has been part of Latvia's banking sector business since early 1990s due to underlying geographical, historical and cultural reasons, which form comparative advantages for the presence of non-resident business in Latvia. Among them, the primary reasons are geographical proximity – Russia is a large neighbouring country and trading partner and investments from Russia and other CIS countries are present in many industries like transport, storage and communication, energy, financial intermediation and manufacturing; there is also a notable share of Russian-speaking population and, consequently, a possibility for clients from CIS countries to receive banking services in their native language. For those depositors the Latvian banking sector is safer compared with their own countries’ banks, as economic reforms and adjustments have been more profound in Latvia. Furthermore, it is also the high quality, as well as competitive prices of banking services offered by Latvian banks, which determine steady confidence in the Latvian banking sector.

The size (in terms of the total assets) of the Latvian banking sector *per se* is relatively moderate – 129% to GDP (on the background of 369% to GDP on average in the EU) and the amount of non-resident deposits is slightly above a third of the GDP.

Although non-resident deposits surpass the level of Latvia's annual budget, it should be noted, that notwithstanding the fact that the risk based contributions to the Deposit Guarantee Fund (hereinafter – the DGF) for non-resident deposits exceed those for resident deposits, the share of non-resident deposits in total potential liabilities of the DGF forms about one forth (or approximately 7% of GDP) of the total potential liabilities of DGF. This reflects the composition of non-resident deposits as their size usually exceeds the guaranteed amount of the DGF per person. Hence, the effective premium charged on non-resident deposits in contributions to the DGF is about three times higher than on resident deposits and any potential effect of non-resident deposits on the public debt stemming from DGFs liabilities is limited.

Given the larger average deposit amount and shorter maturity, non-resident deposits tend to exhibit more volatility than the resident deposits; however, they are not prone to sudden, large and correlated outflows. The maximum aggregate monthly outflow during the peak of the crisis in 2008-2009 was below 10%. The maximum cumulative decrease of roughly one fourth of non-resident deposits was observed at the peak of the crisis over one year (October 2008 – September 2009) and was mainly caused by one large market participant – *Parex* *bank*, which had to be taken over by government due to the fact that its business model involved servicing both non-residents and residents without adequate level of liquid foreign assets to account for all potential liquidity risks related to this business model.

It is important to note, that at present the banks that are focused on serving non-resident customers[[1]](#footnote-1) (hereinafter - NR banks) have no close links with the domestic economy and are only marginally involved in domestic activities, i.e. domestic lending and even less so in attracting domestic deposits[[2]](#footnote-2). Foreign assets and liabilities of NR banks are broadly balanced as non-resident deposits are invested in a diversified portfolio of mostly liquid foreign assets. These banks have high liquidity buffers – their average liquidity ratio (which is a ratio of the total stock of liquid assets to the total stock of all liabilities with maturities up to 30 days, including all overnight and demand deposits and other funds) was 70.1% in December 2012 (minimum regulatory requirement is 30%). Liquidity stress test results show that each Latvian bank would be able to withstand an outflow of up to a half of its non-resident deposits without recourse to other sources of financing to replenish the outflows.

Moreover, to ensure that banks continue to hold sufficient liquidity buffers that are appropriate for their business models, tighter liquidity requirements are going to be introduced next month for banks with the share of non-resident deposits exceeding 20% in their total assets. Within Pillar 2 framework an individual minimum regulatory liquidity ratio for these banks is to be set depending on the share of non-resident deposits in their balance-sheets, implying that it can be raised up to 60% (from the current minimum 30% regulatory requirement).

NR banks are also well capitalised – the capital adequacy ratio of these banks exceed the minimum regulatory requirement on average about two times. It is also important to note that NR banks are already subject to additional, much stricter, prudential capital requirements (in some cases up to 20%) within Pillar 2 (introduced as of 1 July 2011). These requirements are based on the pre-defined quantitative criteria taking into account both the share of non-resident deposits and loans to non-residents in bank's balance sheet as well as their growth rate. They are imposed on banks that fund more than 20% of their total assets by deposits from non-residents and/or where loans to non-residents exceed 5% of the total assets. The Financial and Capital Market Commission (hereinafter – the FCMC) reviews the additional capital requirements on an annual basis in order to ensure that any increase in risks is adequately reflected in capital add-on.

The risks inherent in the business model focused on servicing non-resident clients are recognized, including also geopolitical risk. In order to mitigate the possible AML risk, Latvia has created internationally recognised legal basis, strong supervision and regulation of the financial sector.

The Financial and Capital market Commission closely monitors developments in this segment on the basis of off-site analysis. Effectiveness and adequacy of internal control systems and quality of risk management of banks actively involved in servicing non-residents (NRBs) is assessed during on-site inspections bearing in mind specifics of risks stemming from this business model. Stress testing is conducted periodically according to banks’ own and supervisory scenarios. Contingency plans have to be revised and up-graded taking into account outcomes of stress-testing exercises.

**Question, part II: Warnings about the worrying NRD trends have repeatedly been voiced by the IMF and lately by the European Commission, as well as the financial press. Despite that, Latvia is still maintaining a favourable environment to non-residents and their money by offering residency permits in exchange for capital investments in the country. Latvia’s accession to the eurozone will only increase the trend, as evidenced in Cyprus. Acknowledging that this is a problem that needs to be addressed before it is too late, what measures is the Latvian government and the Bank of Latvia going to take?**

**Response, part II**: It should be noted that majority of the EU countries issue residence permits to third-country citizens who have invested financial means in those countries under similar provisions. Latvia does not see any inconsistency with the EU law and the good practices of other Member States in this regard.

Since 1st July 2010 Immigration Law of Latvia provides a possibility to issue temporary residence permits to third-country citizens who have invested certain amount of financial means in economy of Latvia. Applicants can choose one of the three forms of investment – in a statutory capital of enterprise, in a credit institution or by purchasing a real property.

Within this period 2366 investors have applied for residence permits (total number of applicants, including family members of investors – 5594 persons) of whom 1899 investors related to purchasing real property (including family members of investors – 4500 persons), 249 related to investments in credit institution (including family members of investors – 637 persons), 218 related to investments in statutory capital of enterprise (including family members of investors – 457 persons).

According to the statistics of the balance of payments, the global financial downturn left negative impact on inflow of foreign capital into the economy of Latvia and intensity of foreign direct investment (FDI) decreased.

As the result of renewed economic growth, FDI flows increased. In general, investments made by applicants for residence permits have little effect on the FDI, which since July 1, 2010 is only 3.6%.

This means that not all third-country nationals who are investing in the Latvian economy, perform this activity just to acquire a residence permit.

After a third-country citizen applies for a residence permit, checks on the risk of illegal immigration, money laundering, threat to public order and state security are carried out. Before taking a decision on issuance of the residence permit, the competent national security authorities are consulted with.

Notwithstanding the above said, we recognise the risks inherent in the business model focused on servicing non-resident clients, including also geopolitical risk. In order to mitigate the possible AML risk Latvia has created internationally recognised legal basis, strong supervision and regulation of the financial sector.

The FCMC closely monitors developments in this segment on the basis of off-site analysis. Effectiveness and adequacy of internal control systems and quality of risk management of banks actively involved in servicing non-residents (NRBs) is assessed during on-site inspections bearing in mind specifics of risks stemming from this business model. Stress testing is conducted periodically according to banks’ own and supervisory scenarios. Contingency plans have to be revised and up-graded taking into account outcomes of stress-testing exercises.

The FCMC has also taken pro-active regulatory measures to address the risks specific to NRBs:

Pillar 2 capital add-on was introduced in 2011. The amount of the capital add-on is calculated taking into account the share of assets funded by non-resident deposits, share of loans to non-residents and growth rate of these indicators. Liquidity requirements above the minimum ratio of 30%, depending on the scale of involvement in non-resident business, have been introduced.

1. Banks with share of non-resident deposits more than 20% of banks assets - excluding state-owned banks and one medium size bank with most of its non-resident deposits stemming from its Baltic branches). [↑](#footnote-ref-1)
2. At the end of 2012, their shares in the domestic loan and deposit market were 11.2% and 10.3%, respectively. [↑](#footnote-ref-2)