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Financing of the Economy

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Summary

A robust financial sector that ensures stable access to financing for companies and households is crucial for fostering healthy economic growth. This report delves into the factors constraining access to financing in Latvia while providing solutions to improve the situation.

Lending in Latvia remains sluggish, with loans to non-financial corporations and households accounting for only 27.5% of gross domestic product (GDP) in the first quarter of 2024. Beyond the cyclical factors and monetary policy tightening that hinder lending across the euro area, structural issues, such as limited competition in the lending market, further constrain lending in Latvia. These issues are reflected in high lending rates and stringent collateral requirements.

Lending rates in Latvia and the Baltic States overall remain among the highest in the euro area. This is particularly evident in the housing loan segment. In the first quarter of 2024, interest rates on housing loans in the Baltic States were 2 percentage points higher than the euro area average and well above the nearest followers. This is partly due to the high share of loans with variable interest rates in the Baltic States. Elsewhere in the euro area, fixed interest rates – that remain unchanged for the term of the loan agreement or adjust less frequently, thereby protecting borrowers from fluctuations in short-term interest rates – are far more common. Latvia should also seek solutions to broaden the range of interest rate fixation options and make them more attractive for borrowers. This would expand the range of loan options and allow borrowers to shield themselves from frequent changes in interest rates.

At the same time, the housing loan segment has seen some positive developments – while interest rate markups remain high, they have decreased. For instance, in 2018, households aiming to receive a loan for house purchase or construction were subject to a markup of roughly 2.4%, but in early 2024, the average markup stood at 1.6%. The lower markups benefit not only those seeking a new loan, but also those who have already been granted loans, as they now have the opportunity to refinance their loans under more favourable conditions. This is particularly relevant in light of the regulatory amendments introduced at the beginning of 2024, which have substantially reduced the costs associated with refinancing housing loans.

Meanwhile, the corporate lending segment shows little sign of positive change. Interest rate markups have remained high and, combined with a large share of variable interest rate loans, have resulted in very high lending rates. To improve the lending conditions, competition in corporate lending must also be intensified, with one option being a reduction in loan refinancing costs. For companies, loan refinancing costs include not only the fee for the new loan agreement (around 1% of the loan amount), but also a fee for early repayment (around 2% of the outstanding loan amount), and represent a significant burden, reducing the likelihood of refinancing. Therefore, Latvijas Banka proposes to prohibit the fees for the early repayment of loans or for their refinancing with another lender.

The high interest rates on loans in Latvia cannot be attributed to poorer credit quality. In fact, Latvian credit institutions impose very stringent collateral requirements to mitigate the risk of losses. For approximately 75% of loans to non-financial corporations, the value of collateral exceeds the loan amount by one and a half times, and in half of the cases, it is even double the loan amount. Nearly 90% of loans to non-financial corporations are secured by two or more collaterals, and about a half of the loans are backed by four or more. Compared to other euro area countries, Latvia, and the Baltic States as a whole, generally have the most rigorous collateral requirements.

While the activity in the Latvian capital markets remains very sluggish, the non-bank sector has become increasingly important in financing the economy. This is especially true for non-bank lenders which have increased their financing to both households and non-financial corporations. Notably, the demand for these relatively costly loans has risen despite sustained improvements in the financial health of Latvian households and companies, therefore indirectly pointing to an insufficient supply of bank loans.

Generally, the economic shocks experienced over the past couple of years have thus far failed to leave a lasting impact on the financial situation of Latvian companies and their willingness to invest, despite there

being some variation across sectors. Overall, the indicators of corporate financial health have remained stable, and the willingness of companies to invest continues to be solid. Looking ahead, lower interest rates and higher economic activity will further support the need to finance corporate investment. At the same time, access to financing is constrained by the high cost of financing and stringent collateral requirements, which reduce corporate demand for bank loans and force them to rely on their own funds as well as other alternatives.

The availability of financing across Latvian municipalities is very uneven. This is clearly shown by differences in housing lending. The amount of outstanding housing loans in Pieriga municipalities comes close to the euro area average. Meanwhile, in other regions of Latvia, lending activity remains very sluggish, accounting for no more than 10% of municipal GDP. This also applies to the State cities* and municipalities with a high level of economic activity. These disparities stem from several structural issues that hinder lending development in the housing market, including the widespread shadow economy, the gap between real estate valuations and construction costs, as well as various loan supply constraints (minimum amount, etc.). To address these issues, a wide range of policy measures is needed, including reviewing regional lending support programmes which have already been discussed with AS Attīstības finanšu institūcija Altum (Altum), and reducing the state fee** for registering property rights in the Land Register.

The significant variation in housing lending underscores a broader decline in access to financial services across Latvia's regions. With the reduction in cash transactions and the expansion of digitalisation, the number bank branches has fallen sharply in Latvia. While this trend is evident across other parts of the euro area, the most significant percentage decline has occurred in Latvia. In response, to ensure consistent access to financial services across Latvia, Latvijas Banka has submitted proposals to the Budget and Finance (Taxation) Committee of the Saeima to amend the Credit Institution Law, thus obliging the largest banks to provide in-person services in the State cities and municipal administrative centres.

* In the present report, the term State cities is used within the meaning of the Law on Administrative Territories and Populated Areas.

** In the present report, the term state fee is used within the meaning of the Regulation Regarding State Fee for Registering Ownership rights and Pledge Rights in the Land Register.

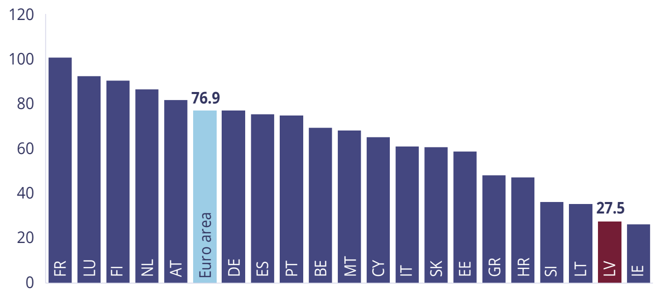
1. Loan supply and competition in the banking sector

Lending activity in Latvia continues to be among the lowest in the euro area (Chart 1.1). Outstanding loans to non-financial corporations and households stood at a mere 27.5% of GDP in the first quarter of 2024. This is 1.4 percentage points lower than at the beginning of 2023 and nearly 3 times below the euro area average.

Chart 1.1

Outstanding loans to non-financial corporations and households in the euro area countries in Q1 2024

(% of GDP)

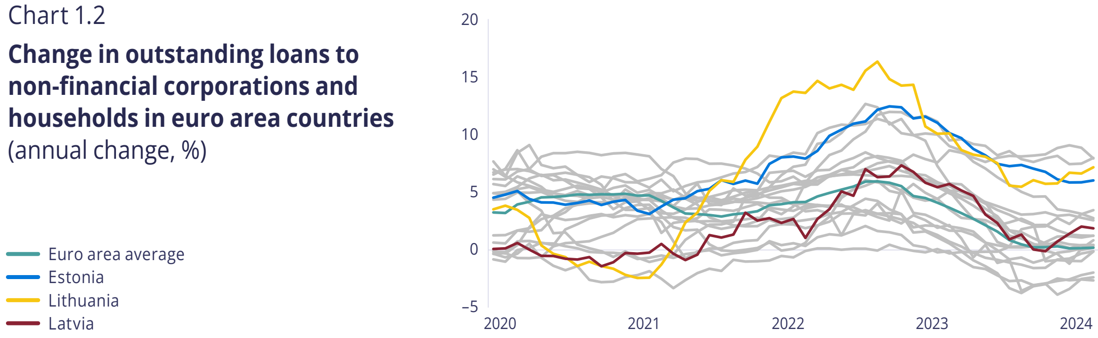


Sources: ECB Balance Sheet Items (BSI), Eurostat.

A decline in lending activity in late 2023 and early 2024 was observed in almost all euro area countries (Chart 1.2). As interest rates increased, the willingness of companies and households to take on new liabilities decreased, as did the willingness of banks to lend due to higher risks. Thus, in several euro area countries, the annual rate of change in loans turned negative, while in other countries, including Latvia, although still positive, the rate lagged behind the pace of nominal GDP growth. Only in a few euro area countries, including Lithuania and Estonia, did outstanding loans grow faster than GDP.

Chart 1.2

Change in outstanding loans to non-financial corporations and households in euro area countries
(annual change, %)

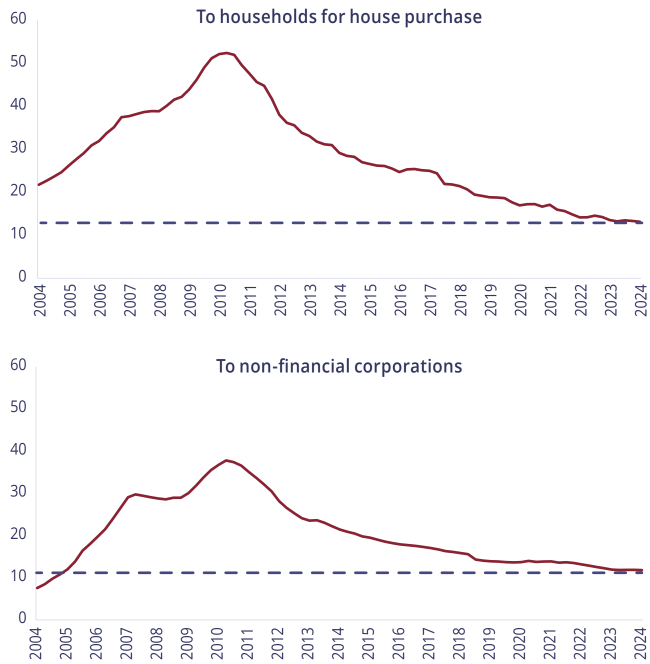


Sources: ECB (BSI), Eurostat.

While the contraction in lending activity is cyclical elsewhere, it has been a long-standing and structural issue in Latvia. Outstanding loans to companies, expressed as a ratio to GDP, are nearing the level last seen in 2004 (Chart 1.3). Meanwhile, the respective indicator for the housing lending segment is currently the lowest since Latvia's accession to the European Union (EU). Not to mention, it more closely resembles the indicators typical of low-income and lower-middle-income economies, rather than those of the high-income economies which include all euro area countries. This implies that Latvia has significant untapped lending potential.

Chart 1.3

Outstanding loans to non-financial corporations and households in Latvia
(% of GDP)

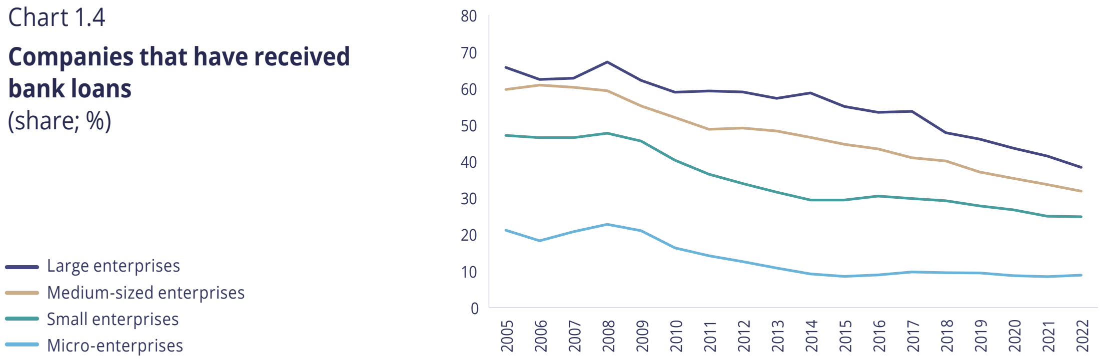


Sources: Latvijas Banka, Eurostat.

Similar dynamics can also be observed in financial statements of companies. Data collected by the State Revenue Service (SRS) on corporate financial statements reveals that the share of companies that have received bank loans is at its lowest point in 17 years. Moreover, this applies not only to small and medium-sized enterprises, but also to large enterprises (Chart 1.4).

Chart 1.4

Companies that have received bank loans
(share; %)



Sources: Central Statistical Bureau of Latvia (CSB), SRS, Latvijas Banka's calculations.

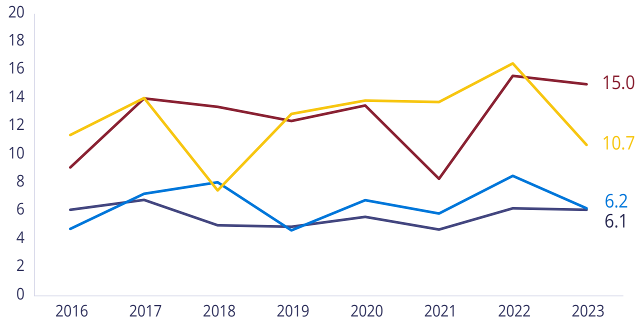
Note. Micro-enterprises – less than 10 employees, small enterprises – from 10 (inclusive) to 50 employees, medium-sized enterprises – from 50 (inclusive) to 250 employees, large enterprises – 250 and more employees.

Surveys of companies also suggest that access to financing remains a significant issue in Latvia. A survey by the European Investment Bank (EIB) shows that the share of financially constrained companies in Latvia in 2023 (15.0%) was only slightly lower than in 2022 (15.6%) and more than two times higher than in Estonia and in the EU on average (Chart 1.5). Financially constrained companies are those companies that have sought external financing but have failed to receive it, have received less than expected, or those that have not sought external financing because of high costs or the risk of being refused.

In turn, the overall satisfaction of companies that have successfully secured external financing has improved (Chart 1.6). Compared to previous years, companies now view the types of available financing, maturity, and collateral requirements more favourably. Against this background, financing costs continue to stand out, with roughly 12% of companies that secured external financing citing it as a reason for dissatisfaction.

Chart 1.5

Financially constrained companies*
(% of all companies that provided answers)



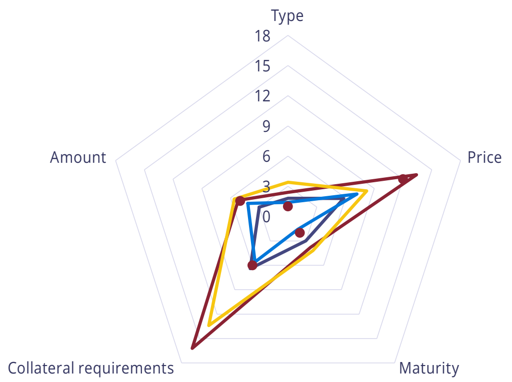
EU average
Latvia
Estonia
Lithuania

Source: EIB Investment Survey Country Overview.

* Financially constrained companies include those companies that have sought external financing but have failed to receive it, have received less than expected, or those that have not sought external financing because of high costs or the risk of being refused.

Chart 1.6

Reasons for dissatisfaction with raising external financing
(% of companies that have used external financing; 2018–2022 average and 2023)



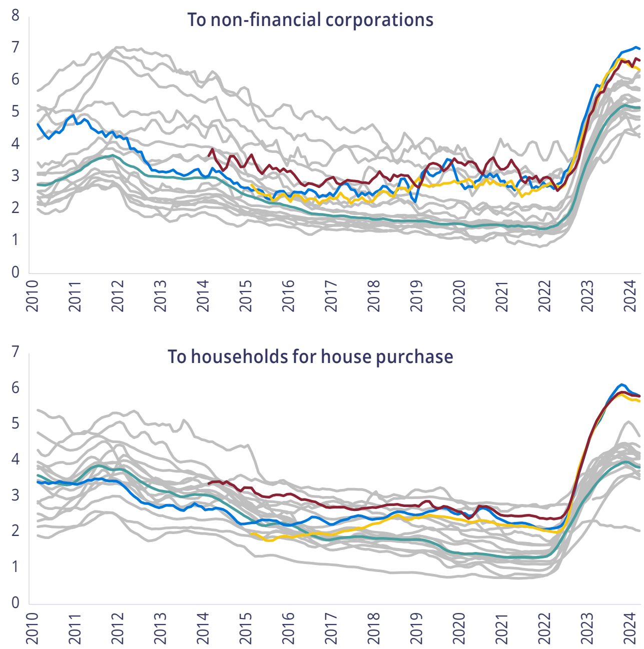
Latvia (5-year average)
EU (5-year average)
Estonia (5-year average)
Lithuania (5-year average)
Latvia

Source: EIB Investment Survey Country Overview.

Lending rates in Latvia are still among the highest in the euro area (Chart 1.7). The same can also be observed in Lithuania and Estonia. In the first quarter of 2024, the interest rates on loans to non-financial corporations in the Baltic States were, on average, 1.5 percentage points higher than the euro area average and 0.6 percentage points above the closest followers, Slovakia and Greece.

Chart 1.7

Interest rates on new loans to non-financial corporations and households for house purchase in euro area countries
(%; 3-month average)



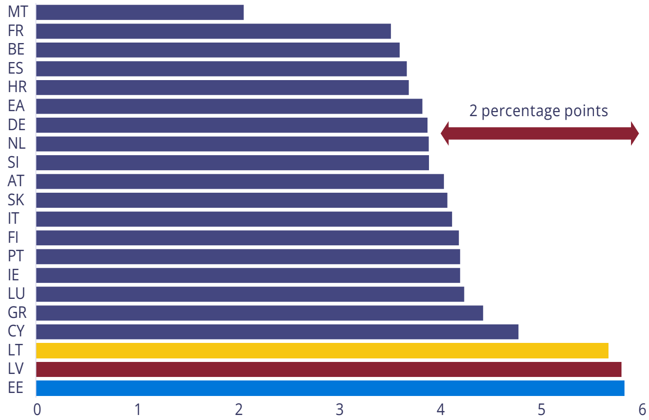
Euro area average
Estonia
Lithuania
Latvia

Source: ECB Monetary Financial Institutions Interest Rate statistics (MIR).

Even larger differences are evident in the housing loan segment (Chart 1.8). In the first quarter of 2024, the interest rates on new housing loans in the Baltic States (5.8% on average) exceeded the euro area average (3.8%) by 2 percentage points. It is also worth highlighting that, in most euro area countries, interest rates on housing loans fall within a relatively narrow range of 3.3% to 4.3%. As a result of this, the Baltic States experience significantly higher rates than other euro area countries.

Chart 1.8

Interest rates on new housing loans in euro area countries
(%, January–April 2024)



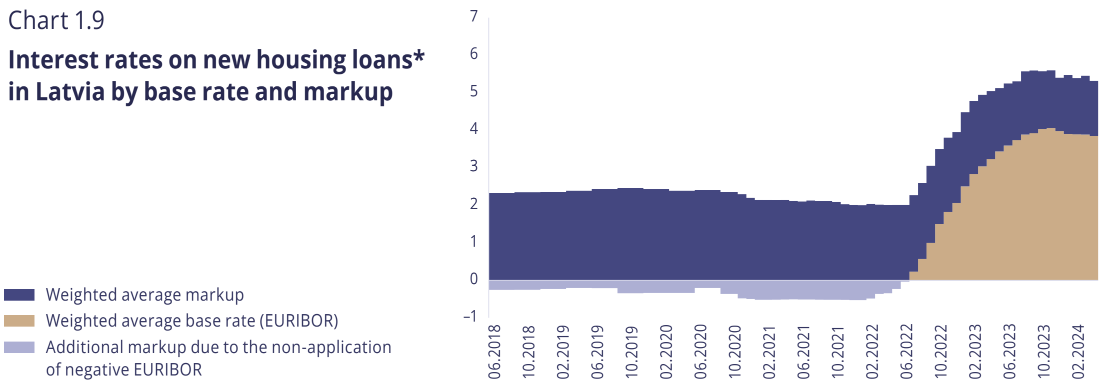
Source: ECB (MIR).

In Latvia, interest rates on nearly all loans consist of two components: 1) the base rate, which is variable over time and is most often pegged to a short-term EURIBOR, and 2) the markup set individually by banks, taking account of the loan-associated risk and other factors (Chart 1.9). A similar loan pricing principle is also applied in Lithuania and Estonia; however, this is not the only way how to price loans. Elsewhere in the euro area, fixed interest rates are far more common. They remain unchanged for the term of the loan agreement or adjust much less frequently (once in a couple of years). In a context of high short-term interest rates, this loan pricing principle allows for the granting of loans at a lower interest rate than a short-term EURIBOR. While banks in Latvia also offer loans at fixed interest rates, their attractiveness is much lower than in other euro area countries (Chart 1.10). As a result of this, Latvia should also seek solutions, including through the regulatory framework, to broaden the range of interest rate fixation options and make them more attractive for borrowers. This will widen the variety of loans available and limit borrowers' exposure to interest rate fluctuations.

However, it is worth noting that, in addition to the above, in countries where variable interest rates prevail, housing loans are issued at significantly lower interest rates than in Latvia. The reasons for this may vary. First, the variable part of lending rates may not be pegged to EURIBOR, but, for example, to bank financing costs. In such a situation, lending rates would be closely linked to deposit rates and the price of other sources of financing. Second, the fixed part of lending rates – the markup – is significantly lower in most other euro area countries.

Chart 1.9

Interest rates on new housing loans* in Latvia by base rate and markup



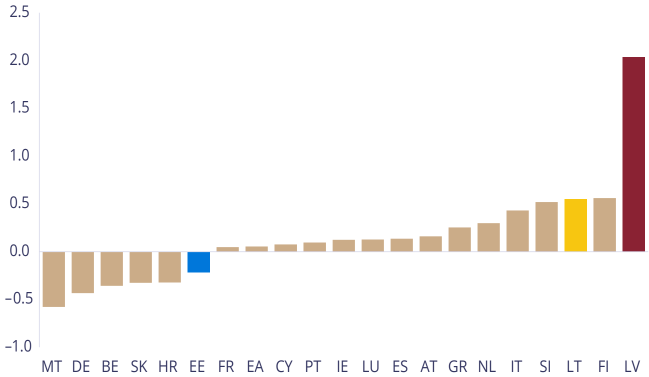
Source: Latvijas Banka.

* Loans with collateral, pegged to EURIBOR, in the four banks with the largest outstanding housing loans.

Chart 1.10

Spread between long and short rate fixation periods on new secured housing loans

(percentage points, 2014–2024 average)



Source: ECB.

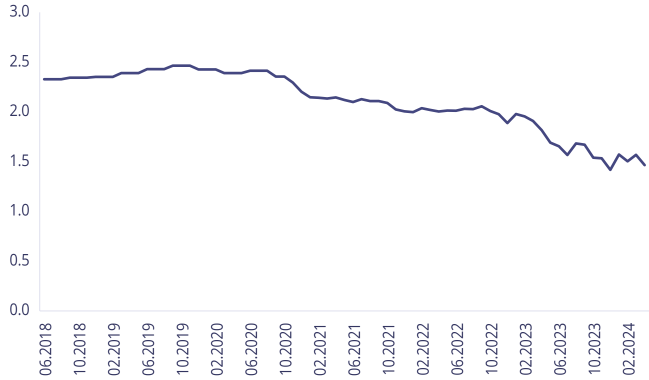
Note. A short interest rate fixation period lasts up to and including 12 months.

Although markups in Latvia remain notably high compared to other euro area countries, they tend to decrease (Chart 1.11). For instance, in 2018, households seeking to receive a loan for house purchase or construction were subject to a markup of about 2.4%, but in early 2024, the average markup stood at approximately 1.6%.

Chart 1.11

Markup on new housing loans* in Latvia

(%)



Source: Latvijas Banka.

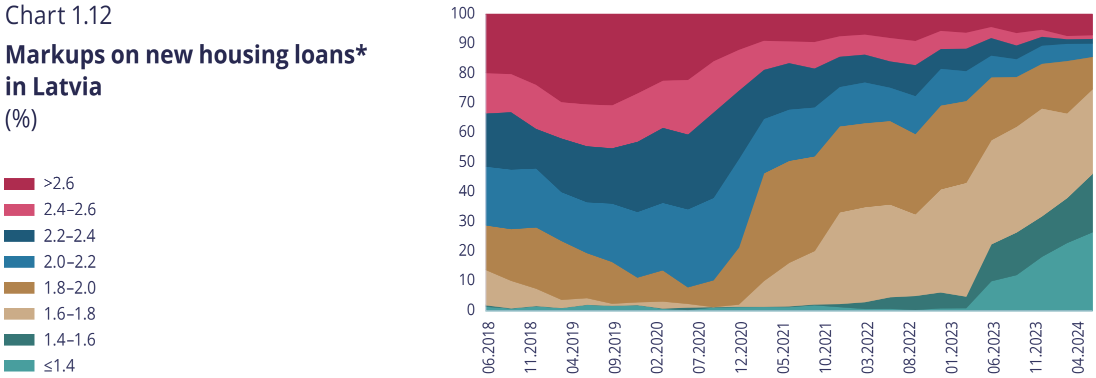
* Loans with collateral, pegged to EURIBOR, in the four banks with the largest outstanding housing loans.

At the beginning of 2020, only around 10% of housing loans were granted at a markup below 2%, while at the beginning of 2024, the share of such loans was already above 80% (Chart 1.12). Furthermore, nearly two thirds of the loans were granted at a markup below 1.8%.

Chart 1.12

Markups on new housing loans* in Latvia

(%)



Source: Latvijas Banka.

* Loans with collateral, pegged to EURIBOR, in the four banks with the largest outstanding housing loans.

One reason for the decrease in markups is the introduction of various promotions: several banks offer reduced markups on loans for a specified time period. However, even without promotions, markups have declined over time. This could be related to the growing profitability of banks. Since the financing costs of banks are closely tied to deposit rates, which have risen more slowly than money market rates (including

EURIBOR), the variable part of lending rates is also profitable. This, in turn, makes it possible to reduce the markup without significantly affecting the overall loan profitability.

The lower markups benefit not only those seeking a new loan, but also the borrowers who were granted loans some time ago, as they now have the possibility to refinance their loans under more favourable conditions. By making regular monthly payments, the borrower improves his/her credit history, in addition to the loan becoming less risky as its principal is gradually reduced. As a result, the borrower's credit risk decreases, making it possible to secure more favourable lending conditions. However, the refinancing of loans has not been a widespread practice in Latvia for at least two reasons. First, loans to individuals could not be advertised, which limited the information on alternative offers. Second, the loan refinancing costs – the fee for issuing the loan at the new bank, the fee for refinancing the loan, the fee for re-registration of collateral, the charge for notary services, and other costs – were very high.

To reduce these obstacles and enhance borrowers' opportunities to secure more favourable conditions, in February 2024, the Saeima of the Republic of Latvia, following an initiative by Latvijas Banka, introduced several regulatory amendments. These amendments eased advertising restrictions and significantly lowered the loan refinancing costs, prohibiting fees for loan refinancing, eliminating the re-registration fee for collateral, and limiting other costs.

These changes will bring several benefits. First, barriers that prevent banks and other lenders from actively attracting customers by offering them more favourable conditions and more appealing services have been removed. Second, loan refinancing costs will be considerably lower and, as a result, the number of borrowers who would benefit from loan refinancing is notably higher.

Box 1. What are the potential benefits of reducing the refinancing costs of housing loans?

To calculate the benefits of refinancing a housing loan, it is necessary to estimate:
1) the potential savings the borrower would achieve by securing a loan with an interest rate lower than the current one, and 2) the costs associated with refinancing the loan.

To calculate the potential savings, data from the Credit Register of Latvijas Banka on all housing loans in Latvia at the end of May 2024 was used. The following equation calibrated on the basis of information on new loans issued between January 2024 and May 2024 was applied:

$PL_i = \partial_j P_{j,i} + \epsilon_i$, where:

- PL_i – the interest rate markup on the loan i;
- $P_{j,i}$ – a set of indicators that includes information on the risk of the loan i (provision-to-amount ratio), the ratio of mortgage, guarantee, and other collateral to the loan, the logarithm of the amount of the loan i, the loan's maturity, the reference rate maturity (3-, 6-, or 12-month EURIBOR), the bank that issued the loan i and the month in which the loan i was granted;
- ∂_j – the estimated regression coefficients;
- ϵ_i – residual.

This equation calculates the interest rate that would be applied to each outstanding housing loan if it would be refinanced in 2024, taking into account various loan-related parameters[1]. The overall level of markups has decreased over time, meaning most loans are now likely to secure a more favourable interest rate compared to those in the year in which the loan was issued.

[1] Potential interest rate benefits are assessed without considering loans with markup discounts. These discounts are mostly temporary and, therefore, do not represent the real lending rate.

In the second step, the costs of refinancing each loan are calculated using the following equations:

$I_{i,2023} = \alpha A_i + G + \beta A_i + N + V$ and

$I_{i,2024} = \alpha A_i + N\downarrow + V$, where:

- $I_{i,2023}$ and $I_{i,2024}$ – loan refinancing costs before and after the regulatory amendments;
- α – the fee for issuing the loan (1% of the loan A_i);
- G – the fee for refinancing the loan (500 euro before, compared to 0 after the amendments);
- β – the fee for re-registration of collateral (0.1% of the loan before, compared to 0% after the amendments);
- N – the charges for notary services and office expenses (73 euro before, compared to 43 euro after the amendments);
- V – real estate valuation costs (175 euro).

Since the regulatory amendments prohibit the fee for loan refinancing, eliminate the re-registration fee for collateral, and reduce the charges for notary services: $I_{i,2023} > I_{i,2024}$.

Following the regulatory amendments, approximately one third of borrowers are financially motivated to refinance their housing loan, marking a significant increase compared to the past. Assuming refinancing would only be considered by those who would save at least 1000 euro during the term of the loan agreement, the total savings in loan interest payments for existing borrowers could reach as much as 125 million euro. Additionally, if the lender were willing to offer even slightly more favourable conditions than those currently offered on the market, the savings could be even greater. The total savings from interest payments could even reach 163 million euro through reducing markups by an additional 0.1 percentage points. Moreover, switching banks is not always a necessary condition. If there is a risk that the customer might switch banks, the current bank can also make a counter-offer. This scenario can be even more advantageous for borrowers, as it eliminates refinancing costs.

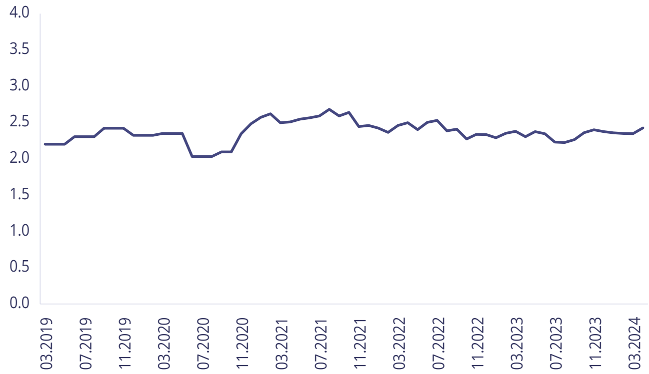
	Share of borrowers that benefit from loan refinancing	Total benefits for those who refinance their loan
Previous situation ($I_{i,2023}$)	20.9–29.2%	59.6–103.9 million euro
Following the amendments ($I_{i,2024}$)	28.7–36.7%	78.2–125.7 million euro
Following the amendments and a reduction of 0.1 percentage points in the lending rate compared to the current most favourable rate	35.8–43.8%	104.3–163.4 million euro
Current bank makes the same offer	48.3–53.5%	145.2–204.1 million euro

Notes. The upper limit of the benefit is calculated assuming that loans are subject to the annuity payment method (70% of loans), while the lower limit of the benefit is calculated assuming that the loans are subject to the linear payment method (30% of loans). In 2024, the benefits of limiting refinancing costs are unlikely to materialise. The amendments of late 2023 to the Consumer Rights Protection Law, which provide for compensation of 30% of total loan interest payments, apply only to the loan agreements concluded by 31 October 2023. A new agreement is signed when refinancing a loan. Thus, the borrower would no longer be compensated.

In contrast to the developments in the housing loan segment, markups on corporate loans have not decreased. Over the past five years, the average markup on corporate loans has largely remained within a rather narrow range of 2.2% to 2.4% (Chart 1.13). Moreover, weighted average markups have remained stable only because companies have borrowed from banks offering lower rates (composition effect). However, the overall level of markups has actually risen (rate effect) (Chart 1.14).

Chart 1.13

Weighted average markup on new loans* to non-financial corporations in Latvia
(%; 12-month average)

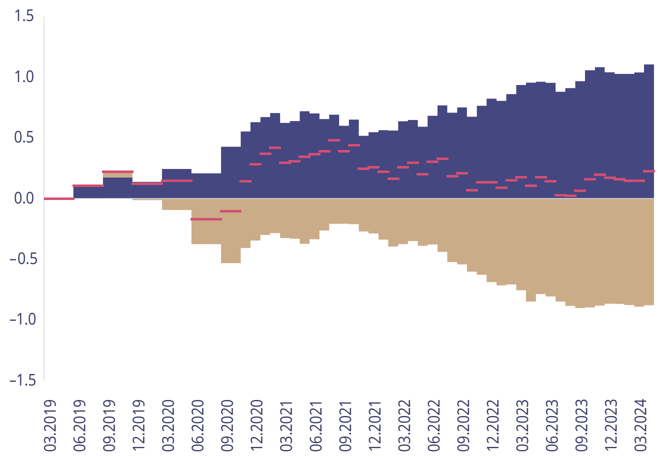


Source: Latvijas Banka.

* Loans pegged to EURIBOR.

Chart 1.14

Decomposition of changes in the weighted average markup on new loans* to non-financial corporations in Latvia
(percentage points; 12-month average; compared to March 2019)



Rate effect
Composition effect
Markup change

Source: Latvijas Banka, Latvijas Banka's calculations.

* Loans pegged to EURIBOR. The weighted average interest rate depends on the changes in lending rates at each credit institution (rate effect) and on the share of each credit institution in the newly issued loans (composition effect).

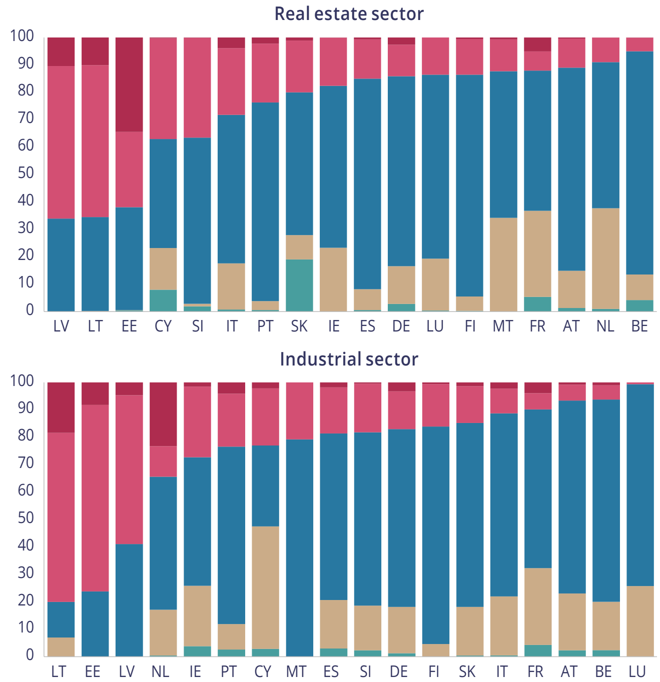
The combination of high markups and a large share of loans with variable interest rates resulted in exceptionally high lending rates. AnaCredit[2] data confirm that corporate lending rates in Latvia, and also in Lithuania and Estonia, are by far the highest in the euro area.

Moreover, the above applies to all sectors of the economy (Chart 1.15). In the Baltic States, over half of the loans in the real estate sector in 2023 were issued at interest rates above 6%. In most other euro area countries, the share of such loans does not exceed 20%. A similar pattern can be seen in the industrial sector.

[2] AnaCredit is the Eurosystem's granular analytical credit and credit risk database collecting data on loans granted to legal entities by the credit institutions of all euro area countries based on harmonised ECB statistical reporting requirements. See https://www.ecb.europa.eu/ecb-and-you/explainers/tell-me-more/html/anacredit.en.html.

Chart 1.15

Breakdown of loans in the real estate and industrial sectors by interest rates in euro area country in 2023
(%)



>8
6–8
4–6
2–4
0–2

Source: AnaCredit.

Just like the housing loan segment, competition in corporate lending must also be intensified, including by reducing the refinancing costs of corporate loans. Barriers to the refinancing of corporate loans are even greater than those for housing loans. Companies looking to refinance a loan must take into account not only the loan agreement fee (typically 1% of the loan), but also an early repayment fee of around 2% of the outstanding loan. These are significant costs that greatly reduce the likelihood of loan refinancing. For example, to make refinancing a 200 000 euro loan with a 7-year term worthwhile, the interest rate of the new loan must be 1.2 percentage points lower than the initial loan rate.[3] Shorter-term loans require an even more favourable offer to cover the loan refinancing costs.

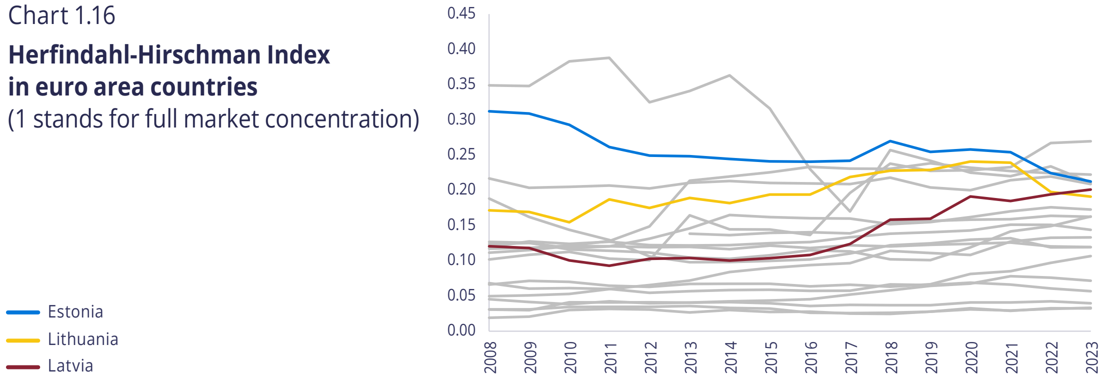
Reducing the loan refinancing costs is thus one of the solutions to strengthen competition in the corporate lending market. Therefore, Latvijas Banka believes it is essential to introduce regulatory amendments to ban the fees for early repayment or refinancing with another lender for certain types of transactions (loans, leasing, etc.).

Lithuanian and Estonian institutions are also exploring the option of following Latvia's example to boost competition in their banking sectors.[4] In all three Baltic States, the indicators characterising competition in the lending market are among the weakest in the euro area (Chart 1.16). This negatively affects both the conditions of financial services and access to financing. The results of the analysis conducted by the OECD and Latvijas Banka suggest that lending rates have risen faster in countries with weaker competition in the lending market compared to countries with stronger competition. The deposit rates, on the other hand, have increased at a much slower pace. Thus, bank profitability has also grown most rapidly in countries where competition is weaker (Chart 1.17).

[3] Assuming that the loan would be refinanced in the third year.
[4] See, for instance, https://haldus.eestipank.ee/sites/default/files/2024-03/pankadevaheline-konkurents_2024_tp1_eng.pdf.

Chart 1.16

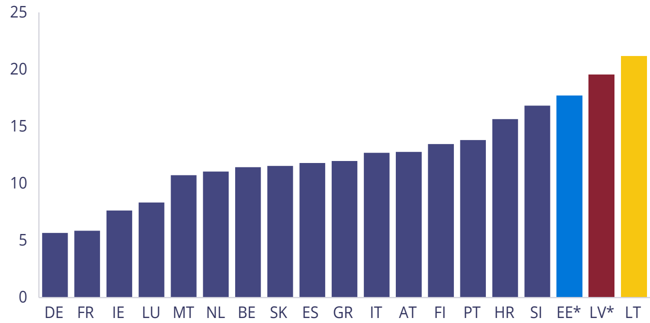
Herfindahl-Hirschman Index in euro area countries
(1 stands for full market concentration)



Source: ECB Banking structural statistical indicators (SSI).
Note. The higher the score, the higher the market concentration.

Chart 1.17

Return on equity of credit institutions in euro area countries in 2023
(%)



Sources: ECB Consolidated Banking data (CBD2), Latvijas Banka, Eesti Pank.
* Indicators include only credit institutions and branches of foreign credit institutions licensed in the respective country.

2. Non-bank financial intermediation

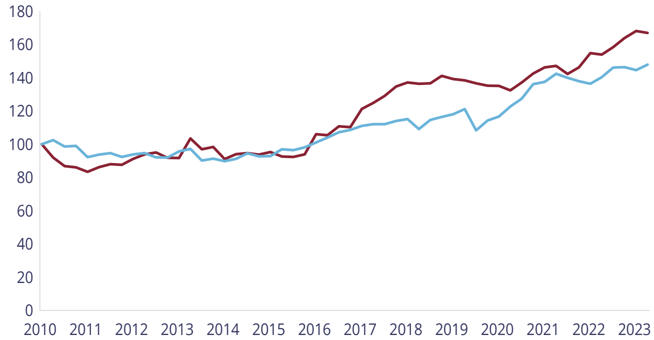
Although Latvian companies and households seek financing mostly from banks, non-bank services are becoming increasingly popular. Households primarily use non-bank financing to finance daily consumption or to make larger purchases. At the same time, in the corporate segment, the range of services offered by non-bank financial intermediaries is wider.

Non-bank financial intermediation is not just limited to lending services. For instance, investment funds, investment firms, crowdfunding service providers, venture capital funds, and other market participants also play a role. The wide range of market participants diversifies the opportunities for companies to raise financing (debt instruments, equity instruments, etc.). This in turn allows companies to adjust the type and conditions of financing to their needs and possibilities.

The growing role of the non-bank sector in financing the economy can be seen in both Latvia and the euro area as a whole. In Latvia, non-bank financing to households and non-financial corporations has increased by around 60% over the last 13 years (Chart 2.1). A sharp rise was recorded around 2018, which corresponds to the period of increased caution in the banking sector that gave the opportunity for non-bank financial intermediaries to increase their market shares.

Chart 2.1

Financing provided by non-banks
(Q3 2010 = 100)



Latvia
Euro area average

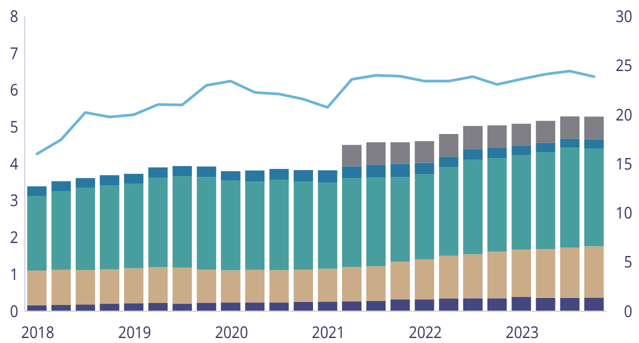
Sources: ECB, Latvijas Banka.

Notes. The calculation methodology is based on Box 2 of the Report on Financial Integration and Structure in the Euro Area, ECB, April 2022. Insurance corporations and pension funds are excluded.

Although on average an increase in financing by the non-bank sector was also observed in the euro area, the composition of the non-bank sector of the euro area differs significantly from that of the Latvian non-bank sector. In the euro area, the assets of this sector mainly comprise of the assets of various investment funds and investment firms, while in Latvia – the assets of leasing companies, as well as those of other lending service providers (Chart 2.2).[5]

Chart 2.2

Assets of the non-bank financial sector by subsector* (billions of euro) **and relative to credit institution assets** (%)



Assets held and administered by investment firms
Investment funds, excluding alternative investment funds, etc.
Financial leases, mainly leasing and factoring
Other providers of lending services
Credit unions, alternative investment funds
Non-banks, % of bank assets (right-hand scale)

* Excluding pension funds.
Sources: CSP, Latvijas Banka.

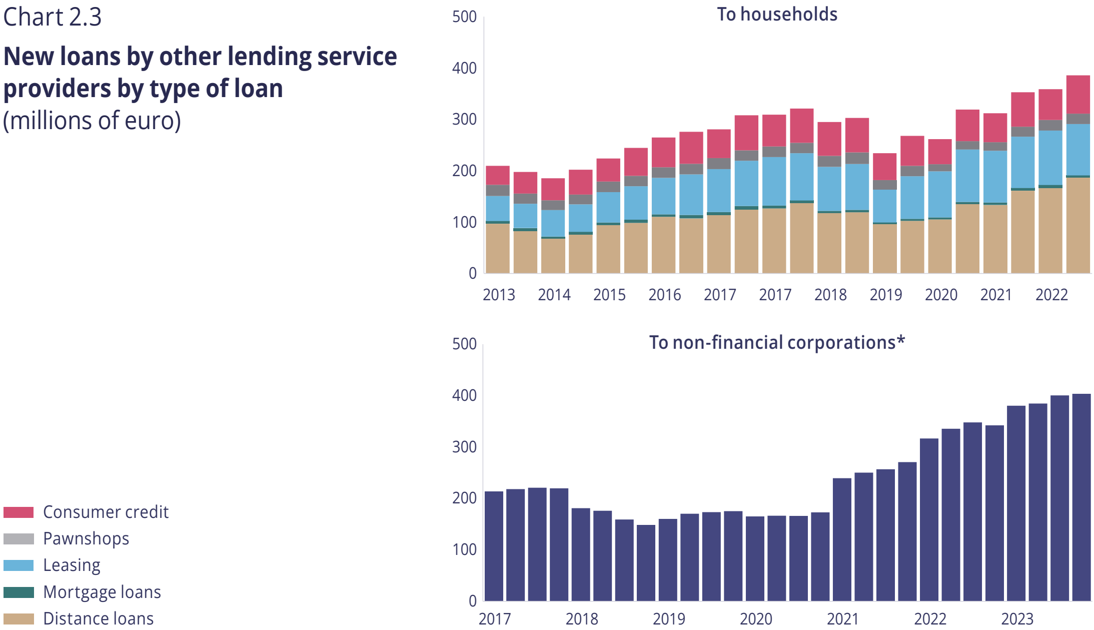
[5] Investment firms have also been active in this sector since 2021.

The popularity of leasing services in Latvia and the Baltic States is overall higher than in most other euro area countries. However, as several important leasing service providers are closely linked to banks, leasing cannot be considered as a competitive alternative to bank loans.

Lending activity of other lending service providers has increased significantly in recent years (Chart 2.3). Although this market segment tends to be associated with household lending, in particular consumer credit, its role in lending to non-financial corporations has notably increased. This is particularly evident in the wake of the Covid-19 pandemic, when the portfolio of loans granted to companies nearly doubled. More detailed analysis of these services offered by market participants to the corporate segment is limited by the lack of official statistics (data on price and other conditions), but the increasing lending volume indirectly points to the ability to find a solution that seems acceptable to an increasing number of companies.

Chart 2.3

New loans by other lending service providers by type of loan
(millions of euro)



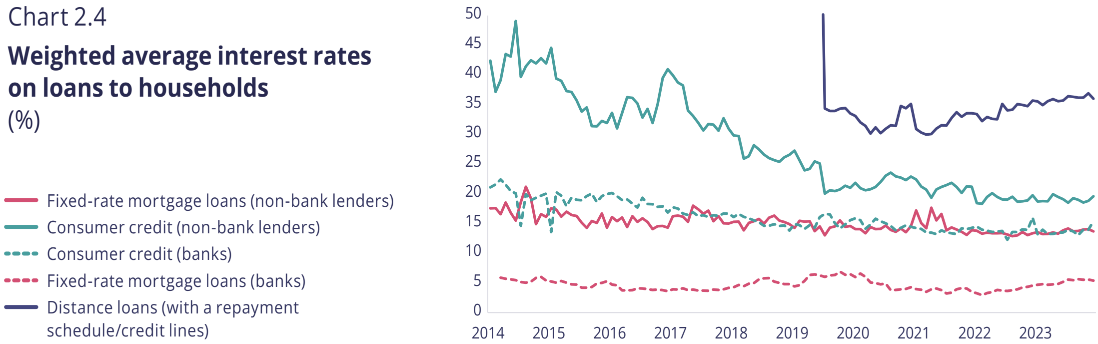
Source: Consumer Rights Protection Centre (PTAC).

* It is impossible to distinguish between different types of loans granted to non-financial corporations, therefore they are grouped together.

Much broader and more detailed statistics are available in the household lending segment. The statistics suggest that the interest rates on loans granted by non-bank lenders are much higher than those on loans granted by banks (Chart 2.4). For instance, the interest rates on bank housing loans were around 5-6% in 2023, while the weighted average interest rate on non-bank housing loans was around 13%. Significant differences are also evident in the consumer credit segment. The objective reasons for such differences may vary: on average higher risk profile of customers, higher administrative costs, less stringent collateral requirements, a higher cost of funding, etc.

Chart 2.4

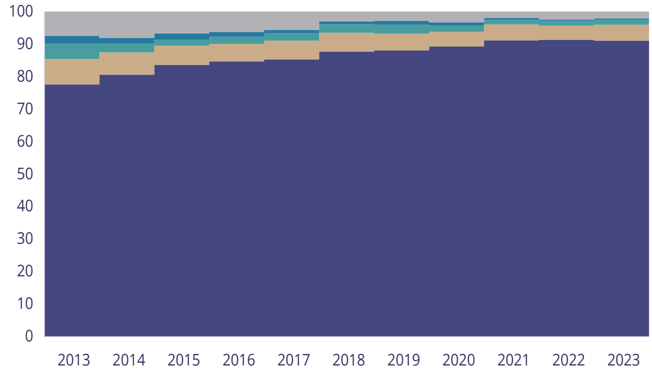
Weighted average interest rates on loans to households
(%)



Sources: PTAC , ECB, Latvijas Banka.

Chart 2.5

Breakdown of outstanding loans issued by non-bank lenders by loan delinquency
(%)



Performing loans
Loans past due less than 30 days
Loans past due between 31 and 90 days
Loans past due between 91 and 180 days
Loans past due over 180 days

Sources: PTAC , ECB, Latvijas Banka.

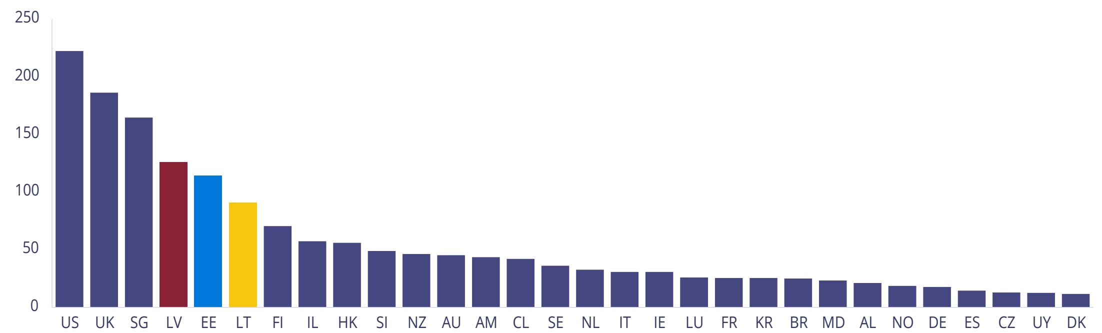
Although the difference in interest rates on bank and non-bank loans remains rather wide, it has narrowed over time, reflecting, inter alia, an improvement in the quality of the non-bank loan portfolio (Chart 2.5).[6]

Notably, the popularity of the significantly more expensive non-bank loans has grown rapidly, despite the continuous improvement in the financial health of Latvian households and companies. This implies an insufficient supply of bank loans.

Another alternative way to facilitate access to financing is through peer-to-peer lending platforms enabling people to channel their savings directly into the financing of households or companies. Over the past 10 years, peer-to-peer lending platforms have rapidly increased their operations not only around the world, but also in Latvia (Chart 2.6).

Chart 2.6

Global alternative financing market volume in 2020
(volume of transactions per capita; in US dollars)



Source: *The 2nd Global Alternative Finance Market Benchmarking Report.*

Notes. The report covers a wide range of companies operating outside the traditional financial system, such as crowdfunding platforms and peer-to-peer lending platforms. The data used for the preparation of the report are obtained by means of surveys. The indicator is calculated on the basis of the volume of transactions processed by alternative financing companies.

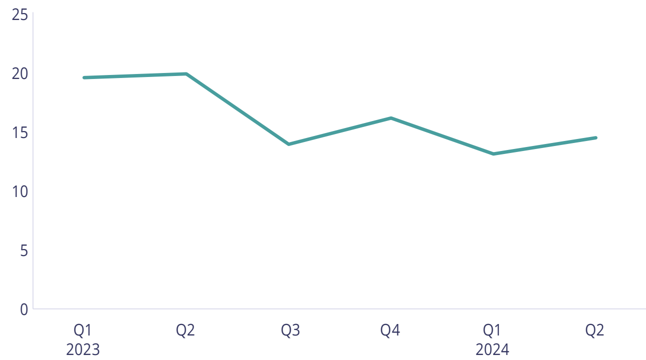
Although several peer-to-peer lending platforms with sizeable financial resources are active in Latvia, their role in the financing of the Latvian economy is not significant (Chart 2.7). Only around 13 cents of each euro invested in these platforms reach Latvian households or companies. The most common destination for financing invested in peer-to-peer lending platforms is in different developing countries.

[6] It should be noted, though, that the balance of the portfolio of out-of-court debt collectors has grown rapidly in recent years. This provides lenders with opportunities to cede doubtful loans, thus improving the quality indicators of the loan portfolio. Therefore, the analysis of these indicators may not provide a fully objective view of the borrowers' ability to meet their credit obligations. It should be noted, however, that the services of out-of-court debt collectors have been used much more actively by banks than by non-bank lenders in recent years.

Chart 2.7

Securitised loans of Latvian peer-to-peer lending platforms to Latvian non-financial corporations and households

(% of the total amount)



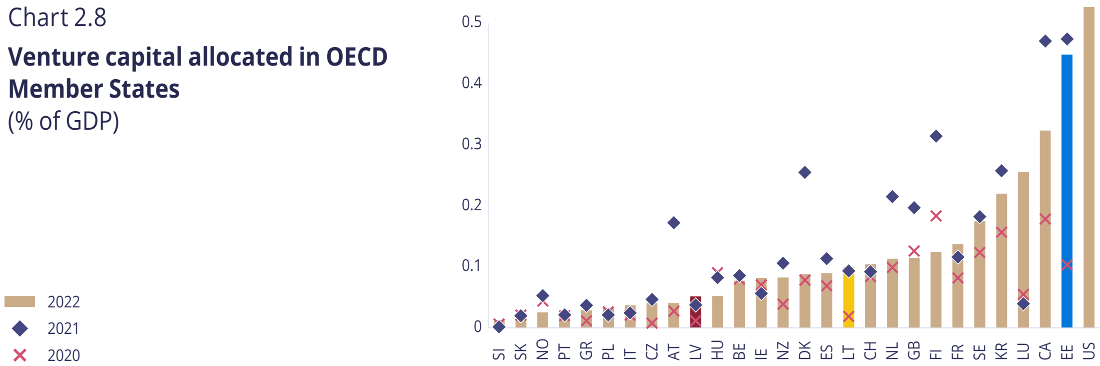
Source: Latvijas Banka.

In addition to debt financing, companies can raise financing through equity investments. Private equity and venture capital fund financing allows prospective start-ups to quickly scale up operations and capitalise on investors' expertise in companies' various development issues. The State has also developed regulatory framework and support programmes to promote the development of start-ups. Despite these initiatives, however, fundraising has so far been sluggish, especially compared to neighbouring countries (Chart 2.8). This is also evidenced by the information collected by Baltic Private Equity and Venture Capital Market Overview 2023, which shows that Latvia attracted the least venture capital among the Baltic States from 2018 to 2023. At the same time, for example, the venture capital available for deployment in the Baltic States in 2023 was 1.54 billion euro, but the amount of investments located in Latvia – only 65 million euro.

Chart 2.8

Venture capital allocated in OECD Member States

(% of GDP)

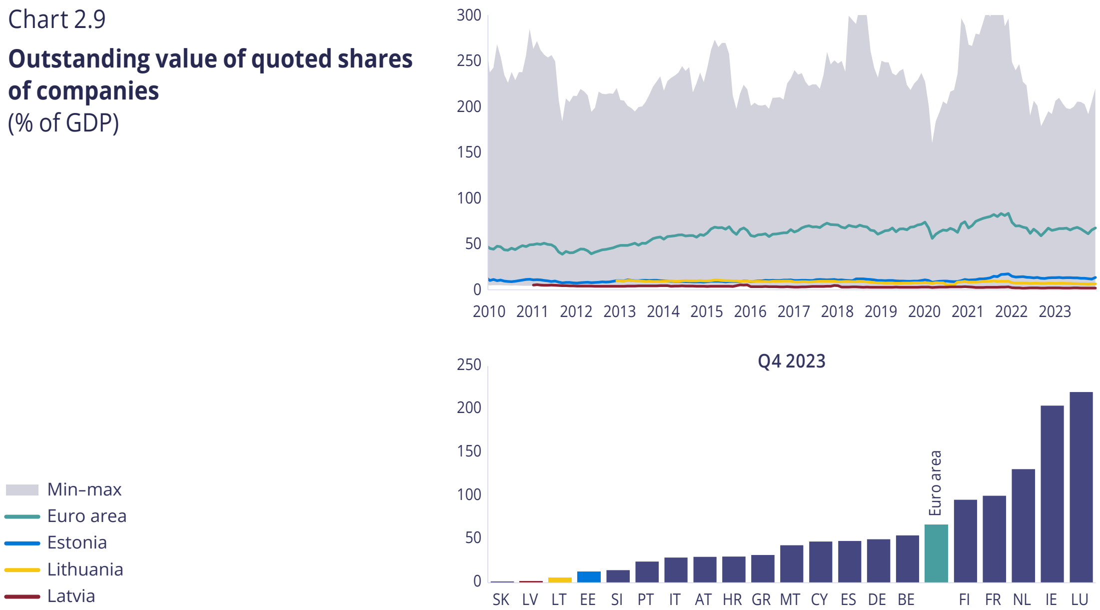


Sources: OECD, Baltic Private Equity and Venture Capital Market Overview 2023.

The traditional capital market segments – the stock and bond markets – are relatively small in Latvia. The stock and bond market capitalisation as a percentage of GDP is small compared to the capitalisation in other euro area Member States (Charts 2.9 and 2.10). The sluggish situation on the stock market was further exacerbated by the decision of AS Latvijas Gāze to exclude its shares from the stock exchange AS Nasdaq Riga. This reduced the Latvian stock market capitalisation by more than half.

Chart 2.9

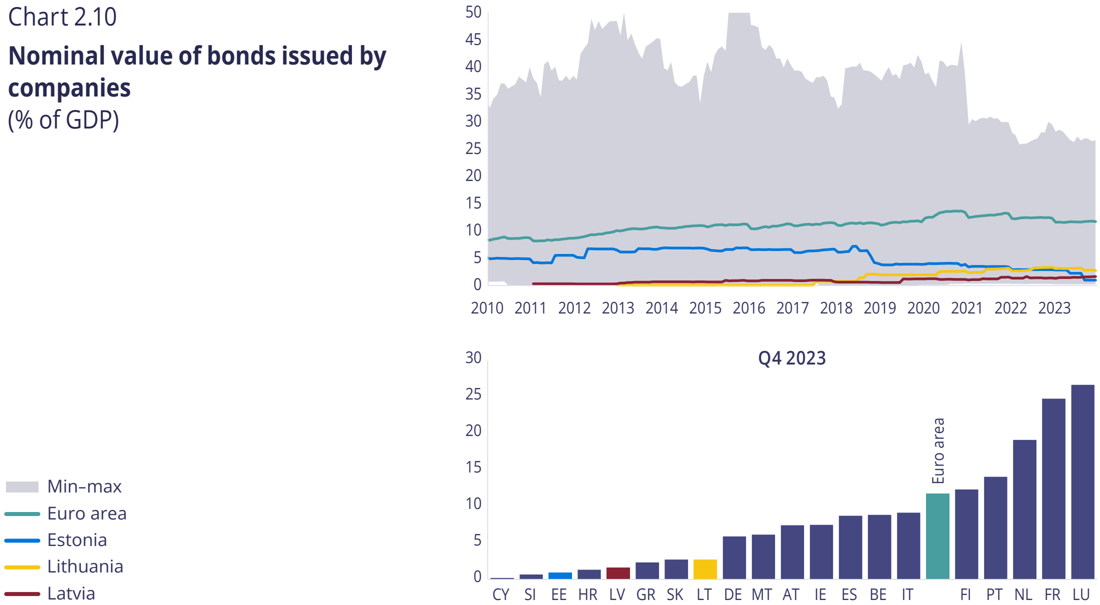
Outstanding value of quoted shares of companies
(% of GDP)



Sources: ECB, Eurostat, Latvijas Banka's calculations.

Chart 2.10

Nominal value of bonds issued by companies
(% of GDP)



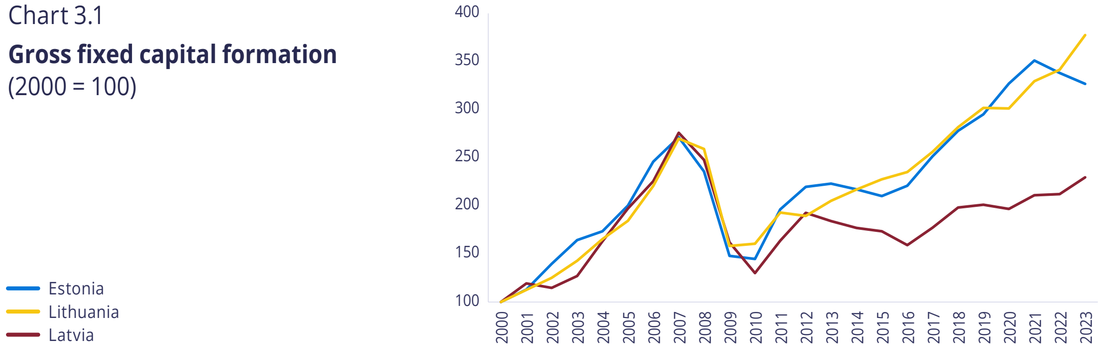
Sources: ECB, Eurostat, Latvijas Banka's calculations.

3. Corporate demand for external financing and the financial health of companies

Investment activity in Latvia increased in 2023, despite sluggish economic development and high interest rates (Chart 3.1). Moreover, the rise in investment activity in Latvia was driven by private sector investment, which reached almost 20% of GDP (Chart 3.2). This only slightly reduced the investment gap with Estonia, where the weakness in the export markets and the deterioration of the economic situation were reflected in a drop in investment activity. Meanwhile, investment activity in Lithuania is still significantly higher than in Latvia.

Chart 3.1

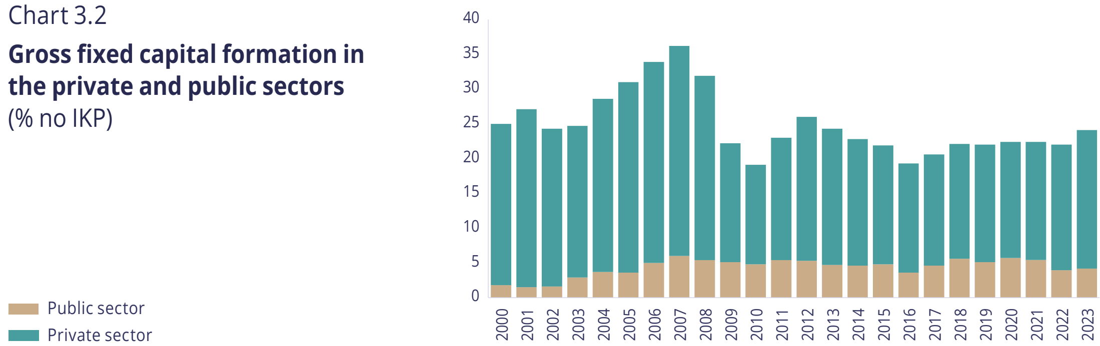
Gross fixed capital formation
(2000 = 100)



Sources: Eurostat, Latvijas Banka's calculations.

Chart 3.2

Gross fixed capital formation in the private and public sectors
(% no IKP)

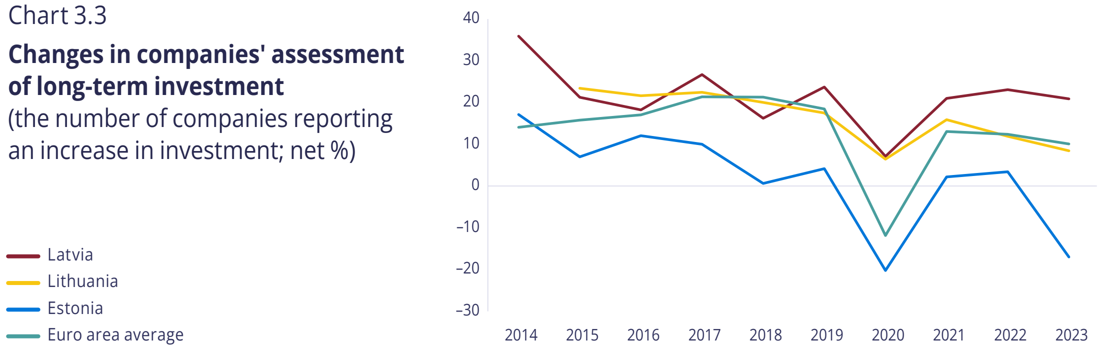


Source: EC and the ECB's SAFE survey.

The results of company surveys also suggest that the willingness of Latvian companies to invest remains stable. The SAFE survey of the European Commission (EC) and the ECB, which examines companies' vision of investment plans, shows that the number of Latvian companies reporting an increase in long-term investment continues to significantly exceed that of companies reporting a decline in investment (Chart 3.3).

Chart 3.3

Changes in companies' assessment of long-term investment
(the number of companies reporting an increase in investment; net %)

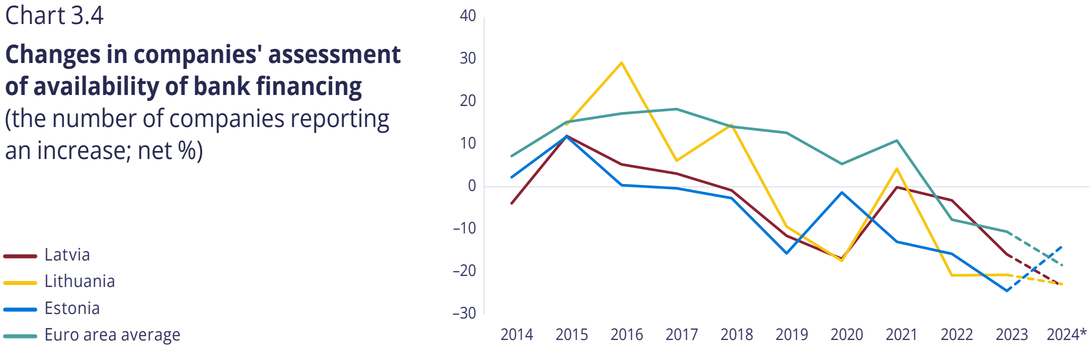


Source: EC and the ECB's SAFE survey.

At the same time, access to financing, including bank loans, continues to deteriorate in companies' assessments. The number of companies that assessed access to bank loans as deteriorating significantly exceeded that of companies reporting an improvement in the situation (Chart 3.4). Moreover, expectations regarding the evolution of access to financing are even more pessimistic in 2024. The deterioration of the situation, however, is not related to Latvia-specific factors and reflects developments affecting the euro area economy as a whole, including restrictive monetary policy. This is confirmed by the fact that the assessment of access to financing has also significantly deteriorated in Lithuania, Estonia, and elsewhere in the euro area. However, sustained demand for investment coupled with a deteriorating access to external financing makes companies increasingly rely on their own funds, which are not always sufficient to finance more extensive development plans.

Chart 3.4

Changes in companies' assessment of availability of bank financing
(the number of companies reporting an increase; net %)



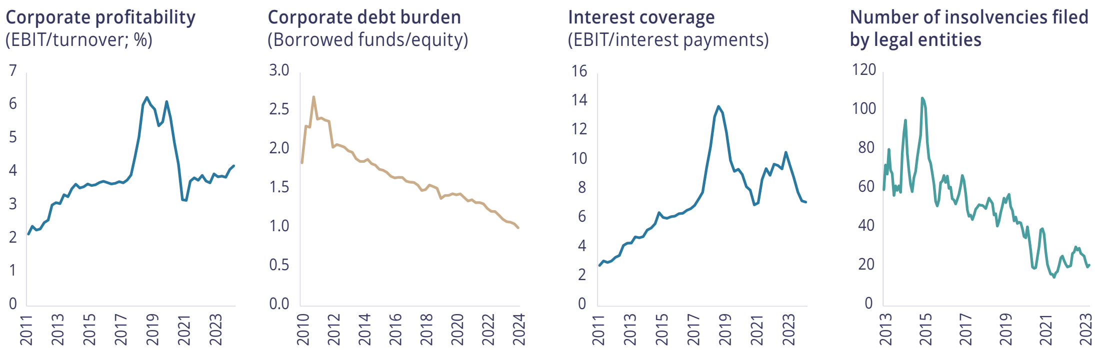
Source: EC and the ECB's SAFE survey.

* Expectations.

Despite the economic challenges experienced in the last couple of years, the financial situation of Latvian companies has not significantly deteriorated, although the situation varies across sectors of the economy. Corporate profitability remains high, the debt burden continues to decline and, while interest payments have naturally increased as a result of higher interest rates, the ability to cover them remains at historically high levels (Chart 3.5). Furthermore, Russia's invasion of Ukraine and the related energy crisis have not notably increased the number of insolvency cases, which has remained broadly unchanged, fluctuating around 20 cases per month (three times less than 10 years ago). Estimated indicators characterising the financial health of companies, such as the Altman indicator (see Box 2), also show an overall improvement in the financial health of companies.

Chart 3.5

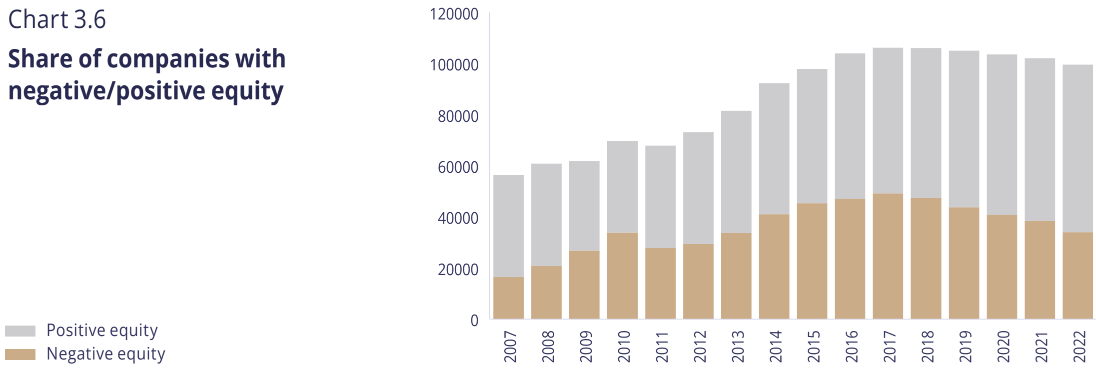
Indicators characterising the financial health of Latvian companies



Sources: CSB, Insolvency Control Service, Latvia's Open Data Portal.

It is worth noting that the share of companies with negative equity also continued to decline. The SRS data show that in 2022 the share of such companies accounted for 34% of all Latvian companies, which is the lowest indicator since 2008 and is 10 percentage points lower than in 2014 (Chart 3.6).

Chart 3.6
Share of companies with negative/positive equity



Sources: CSB, SRS.

Box 2. How has the financial health of Latvian companies developed?

Corporate financial health is characterised by a wide range of factors, such as profitability, operational efficiency, availability of cash and other liquid assets, the company's funding structure, and a number of other factors. The assessment of the importance of each factor also adds to the complexity of the analysis of the financial situation of companies.

Various assessment methods can be used to bring together key information on the situation of companies. The most common is the Altman Z-score model, which determines the probability of a company's insolvency on the basis of several indicators from the company's balance sheet and profit and loss statement. This model not only allows for the aggregation of a wide range of information in one number, but also makes it easily comparable across companies.

In this box, the Altman indicator is calculated for most Latvian companies on the basis of the information provided by the SRS on companies' financial statements from 2005 to 2022. Taking into account the differences in the specific nature of companies' activities, the indicator has been calculated separately for companies in the manufacturing and service sectors. The following equations are used:

$$Altman_{AR} = 0.717 \times X_1 + 0.847 \times X_2 + 3.107 \times X_3 + 0.42 \times X_4 + 0.998 \times X_5$$

$Altman_P = 6.56 \times X_1 + 3.26 \times X_2 + 6.72 \times X_3 + 1.05 \times X_4$, where:

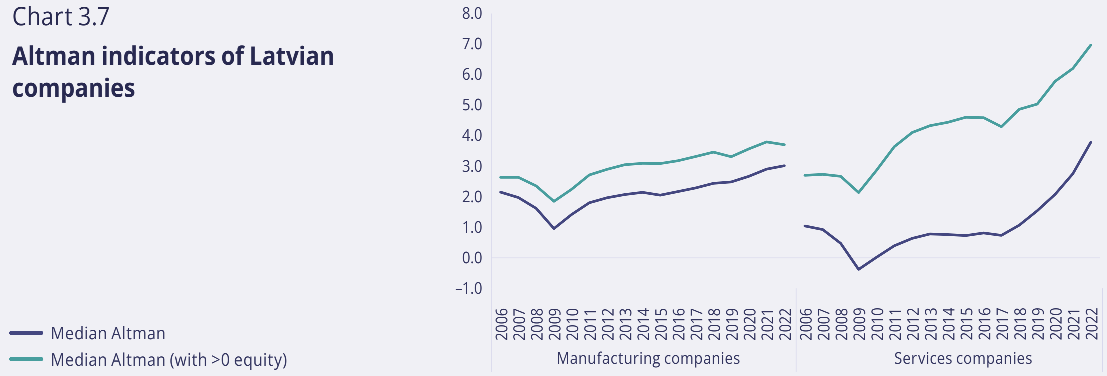
- $Altman_{AR}$ – the Altman indicator for manufacturing companies;
- $Altman_P$ – the Altman indicator for companies in the services sector;
- X_1 – the ratio of current assets to assets;
- X_2 – the ratio of retained earnings of the previous reporting years to assets;
- X_3 – the ratio of earnings before interest and taxes to assets;
- X_4 – the ratio of equity to borrowed funds and
- X_5 – the ratio of turnover to assets.

It is important to note, however, that the calculation of the Altman indicator used does not always accurately describe the situation of each individual company. The objective of this box is to provide an insight into the overall dynamics of the financial health of companies. It should also be noted that the values used in the calculation of the Altman indicator are not adapted to the situation in Latvia, therefore only the dynamics of the indicator should be interpreted, not the level.

The calculated Altman indicators suggest that the financial health of Latvian companies has improved rapidly following a decline during the global financial crisis (Chart 3.7). This is particularly evident in the service sectors. It is worth emphasizing that improvements were not caused only by a lower share of companies with negative equity. Separately distinguishing between companies with positive equity and those with negative equity, the conclusion that financial health has improved significantly remains unchanged.

Chart 3.7

Altman indicators of Latvian companies



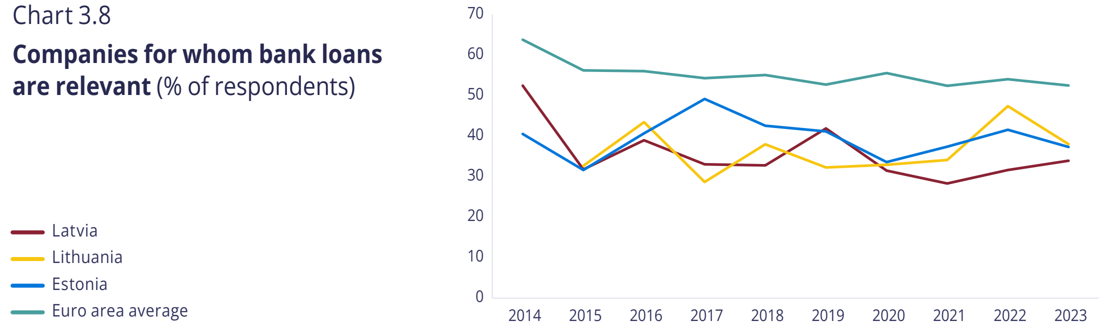
Sources: CSB, SRS, Latvijas Banka's calculations.

Notably, the analysis carried out by other institutions, including the banks themselves, also confirms that the financial health of Latvian companies continues to improve, despite challenging economic environment.[7] This leads to the conclusion that the financial health of companies is unlikely to be the reason behind the weak lending activity in recent years.

In turn, one of the reasons for the weak lending activity is a lower demand for bank loans. The results of the SAFE survey show that bank loans are only relevant[8] to a third of Latvian companies (Chart 3.8). By contrast, in the euro area, the average share of such companies exceeds 50%. About two thirds of companies for whom bank loans are not relevant have deemed loans as unnecessary, while the remaining third is not satisfied with the price of loans, the collateral requirements, the complex bureaucracy, and the lack of general access to financing (Chart 3.9). The importance of these factors is much higher in Latvia than in the euro area on average. In the context of improving financial health of Latvian companies, this points to bottlenecks on the loan supply side.

Chart 3.8

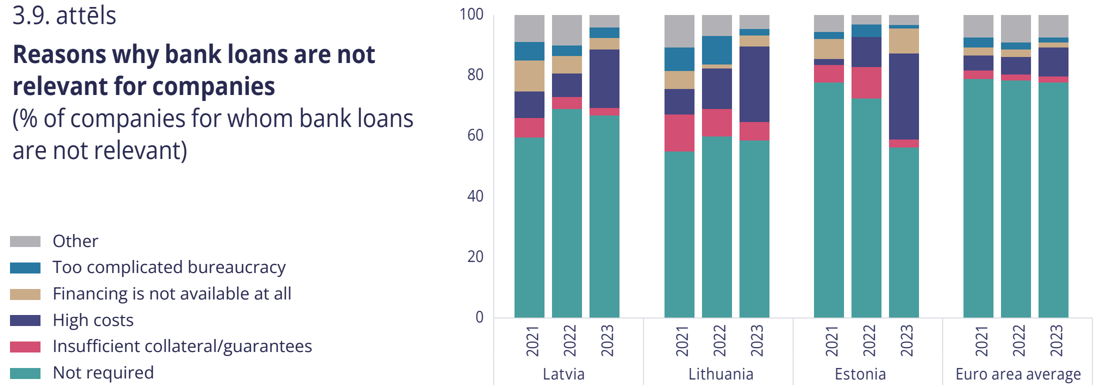
Companies for whom bank loans are relevant (% of respondents)



Source: EC and the ECB's SAFE survey.

3.9. attēls

Reasons why bank loans are not relevant for companies
(% of companies for whom bank loans are not relevant)



Source: EC and the ECB's SAFE survey.

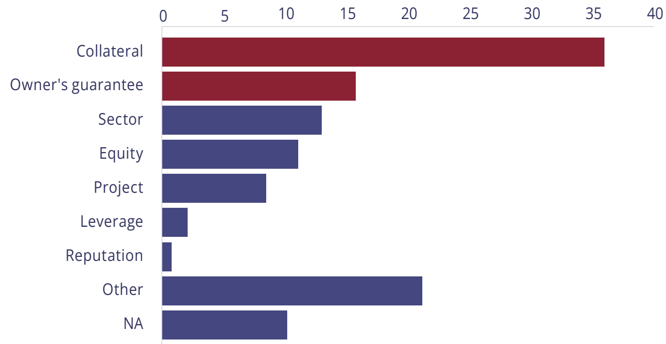
[7] https://www.seb.lv/en/cross-sectional-analysis-latvian-companies-where-are-untapped-lending-opportunities

[8] The company has received or wished to receive a loan..

The survey of Latvian CEOs conducted by Latvijas Banka and SKDS in December 2023 indicates that high collateral requirements are an important reason for the unavailability of loans. One fifth of the 750 companies surveyed had applied for a bank loan over the past year. Almost half of them received a loan in full. For a fourth of them, the loan was refused, while the other companies received a loan in a limited amount or withdrew the loan application themselves due to high costs or impracticable conditions. The main reason for the bank's refusal or the withdrawal by the companies themselves was most often a lack of collateral and owners' guarantees (Charts 3.10 and 3.11).

Chart 3.10

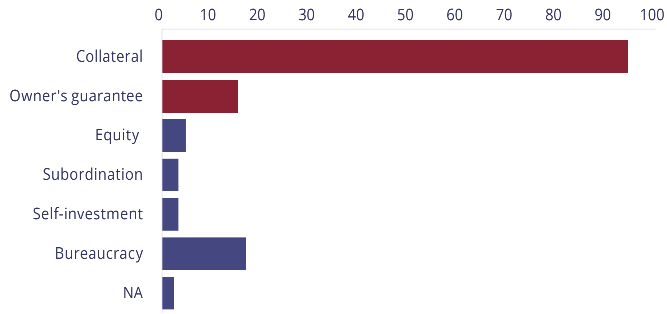
Companies' answers on the reason for loan rejection
(%)



Source: SKDS.

Chart 3.11

Companies' answers on the impracticable condition that led to the withdrawal of the loan application
(%)



Source: SKDS.

Collateral plays an important role in lending as it protects the creditor from losses that would arise as a result of the borrower's insolvency. At the same time, excessive collateral requirements may limit the range of companies that have access to loans and potentially also discourage financially healthy companies from obtaining bank loans, especially if the company owner has to provide a personal guarantee.

A comparison of collateral requirements in different countries is possible using the ECB's AnaCredit database, which contains information on all bank loans granted to euro area companies if their total liabilities in the respective bank exceed 25 000 euro. Almost all loans granted in 2023 were fully secured in Latvia, with the collateral value covering or exceeding the principal amount of the loan. In addition, the collateral value of almost three fourths of loans is at least one and a half times higher than the loan value, and even double the loan value for roughly half of the loans (Chart 3.12). It shows that Latvia has one of the strictest collateral requirements in the euro area. The situation is similar in Lithuania and Estonia, as well as in Malta, Portugal, and Cyprus. In a significant number of other euro area countries, the collateral value mostly falls below the loan value.

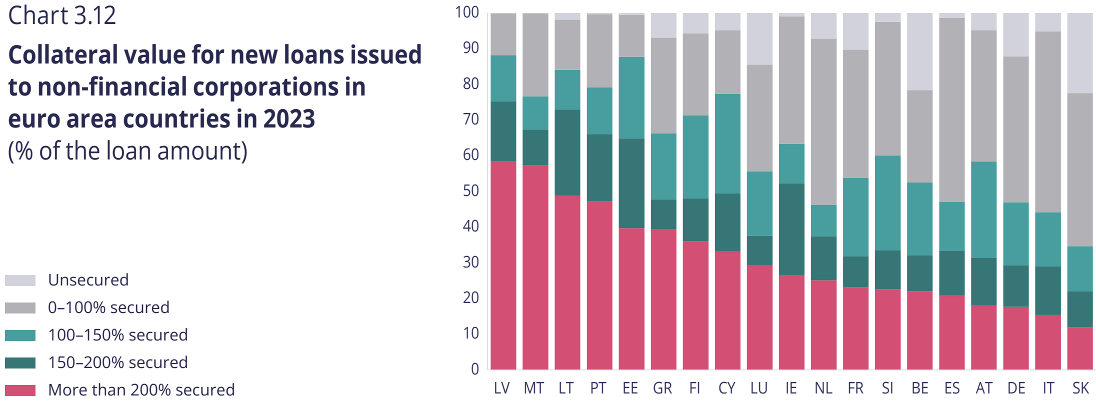
When assessing the proportionality of collateral requirements, it should be taken into account that even the largest companies in Latvia (and also in the other Baltic States) are smaller and, therefore, often have higher risk indicators than companies in the largest euro area countries. Stricter collateral requirements could therefore be objectively justified. However, selecting only loans granted to companies corresponding in size to typical[9] Latvian companies does not change the conclusions materially. Almost all loans in the Baltic States are fully secured, and almost 60% of loans are secured by 150% of the loan value (Chart 3.13). In other euro area countries, however, collateral requirements for equivalent companies are much lower.

[9] Companies whose number of employees and turnover are between the 40th and 60th percentiles of Latvian companies.

Chart 3.12

Collateral value for new loans issued to non-financial corporations in euro area countries in 2023

(% of the loan amount)

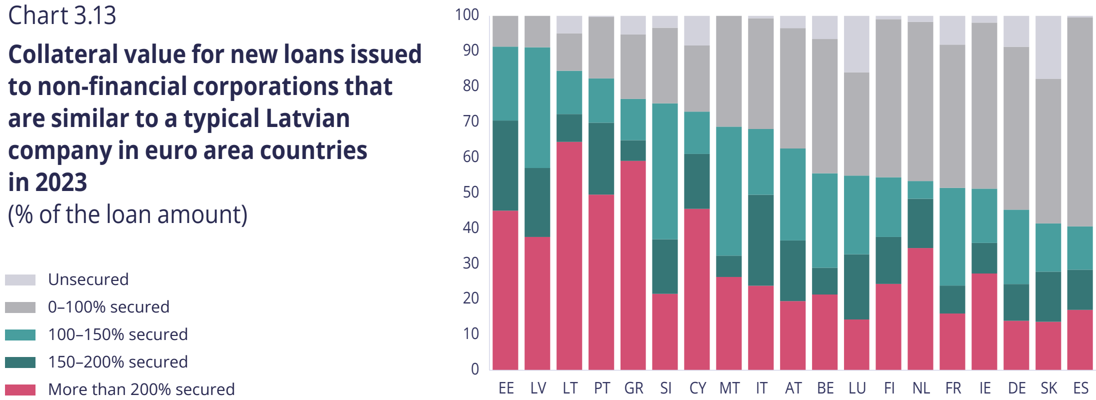


Sources: AnaCredit, Latvijas Banka's calculations.

Chart 3.13

Collateral value for new loans issued to non-financial corporations that are similar to a typical Latvian company in euro area countries in 2023

(% of the loan amount)



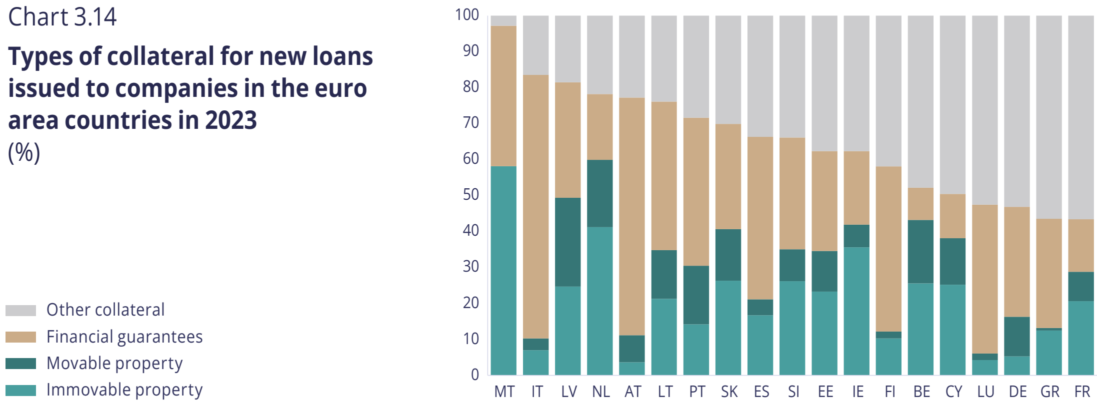
Sources: AnaCredit, Latvijas Banka's calculations.

In Latvia, collateral in the form of immovable and movable property is demanded more than elsewhere in the euro area (Chart 3.14). The experience of other countries shows that this is far from being a common practice and in a number of cases accounts receivable or current assets are also accepted as collateral. The requirement to secure a loan with immovable and movable property collateral may be a particularly significant problem in sectors characterised by low capital intensity and, thus, a limited range of assets that can be used as collateral, such as the services sector.

Chart 3.14

Types of collateral for new loans issued to companies in the euro area countries in 2023

(%)



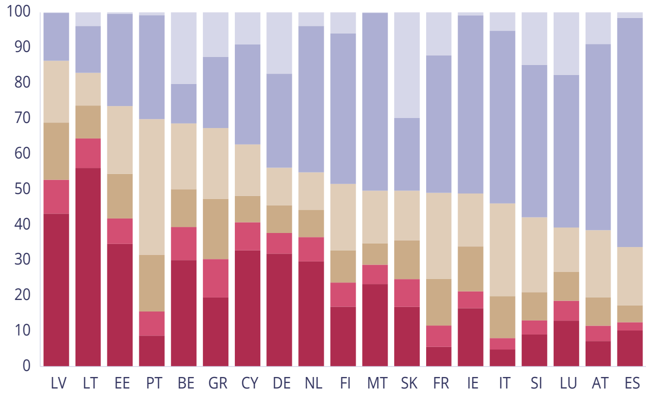
Sources: AnaCredit, Latvijas Banka's calculations.

The relatively stringent requirements in Latvia and the Baltic States are, in general, also demonstrated by the high share of loans secured by more than one collateral (Chart 3.15). Nearly 90% of loans to non-financial corporations are secured by two or more collaterals, with about half of these loans secured by four and more. The practice of securing a loan with more than one collateral is much less common in other parts of the euro area. This shows that loans in Latvia are secured not only by much more valuable collateral than in other euro area countries, but also Latvian companies often are required to put up multiple collaterals to secure a loan.

Chart 3.15

Number of collaterals for new loans issued to companies in euro area countries in 2023

(%)



Unsecured
1 collateral
2 collaterals
3 collaterals
4 collaterals
5 and more collaterals

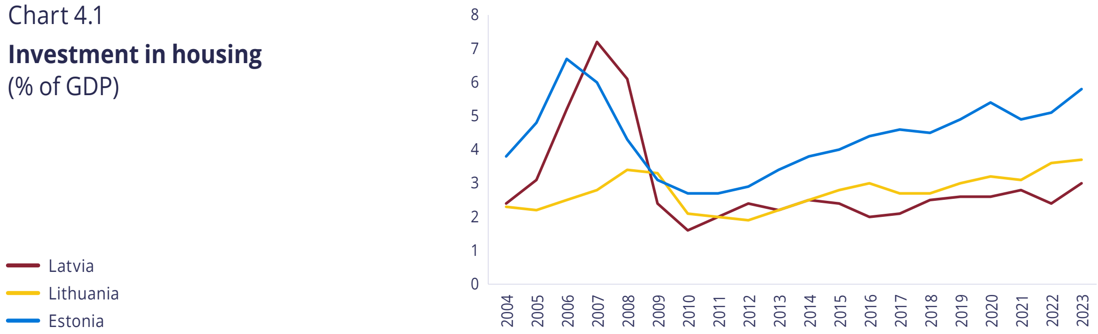
Sources: AnaCredit, Latvijas Banka's calculations.

4. Demand from households for external financing and their financial health

Although investment in housing grew in Latvia in 2023, it still lagged significantly behind that of Lithuania and Estonia (Chart 4.1). This is further confirmed by the fact that the total floor area of new housing per capita in Latvia was only about one third of that in the neighbouring Baltic countries (Chart 4.2).

Chart 4.1

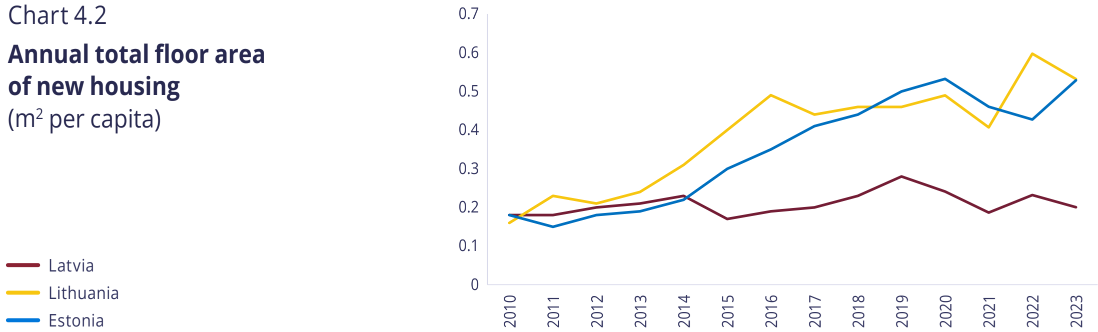
Investment in housing
(% of GDP)



Source: Eurostat.

Chart 4.2

Annual total floor area of new housing
(m^2 per capita)

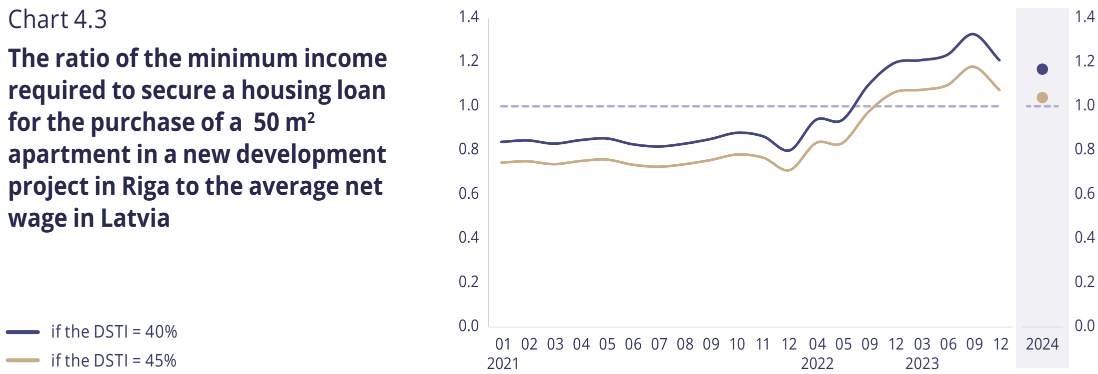


Sources: Eurostat, statistical offices of Latvia, Lithuania and Estonia.

Following the pandemic, the affordability of real estate, particularly new housing, in Latvia worsened significantly due to rapidly rising construction costs and, later, increasing interest rates. In 2021, purchasing a 50 m^2 apartment in a new development project in Riga with housing loan financing required an income of at least 85% of the average net wage in Latvia. By September 2023, the required income had already risen to 130% of the average net wage (Chart 4.3).

Chart 4.3

The ratio of the minimum income required to secure a housing loan for the purchase of a 50 m^2 apartment in a new development project in Riga to the average net wage in Latvia



Sources: SIA ARCO REAL ESTATE, ECB SDW, Refinitiv (six-month EURIBOR, 16.05.2024), Latvijas Banka's wage forecasts, Latvijas Banka's calculations.

Notes. DSTI – debt service-to-income ratio. Annuity payment schedule, 30-year maturity, 15% down payment, 2.0% interest rate + 6-month EURIBOR of current or futures contracts. After stabilising in 2023, the supply prices of new housing have remained unchanged in 2024.

The situation improved slightly at the end of 2023. As the growth rate of construction costs slowed and the number of new housing purchases declined significantly, the increase in the prices of new housing has moderated. Meanwhile, as the financial health of households continues to improve gradually, housing is becoming more affordable. The affordability of new, energy-efficient housing is further enhanced by relaxed credit standards for housing with an energy efficiency rating of C or higher.[10]

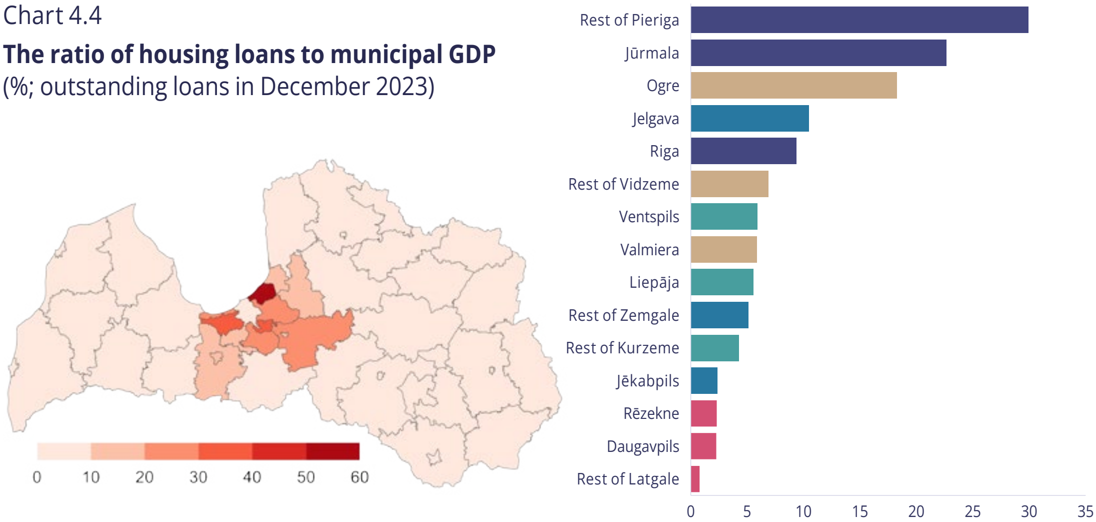
Housing lending activity in Latvia has been more resilient than in other euro area countries; however, it still remains low. In 2023, the outstanding amount of housing loans in Latvia grew by 1.6%, while the euro area average was only 0.6%. Despite this growth, the total amount of outstanding housing loans in Latvia remains the lowest in the euro area. At the end of 2023, the housing loan portfolio represented only 12% of GDP (one third of the euro area average of 36%). It is important to note, however, that this situation varies greatly across different regions of Latvia.

Housing lending across Latvia's regions

Linking the data from the Credit Register of Latvijas Banka with the data from the State Land Service (SLS) gives a very detailed understanding of the differences in housing lending across Latvia's municipalities.[11]

The amount of outstanding housing loans in Pieriga municipalities is much closer to the euro area average, representing approximately 30% of the region's GDP. Additionally, in some municipalities, such as Ādaži, it even exceeds 55% of the municipality's GDP (Chart 4.4). In Riga, the amount of outstanding housing loans is significantly lower, comprising only 9% of the capital's GDP.

Chart 4.4
The ratio of housing loans to municipal GDP
(%; outstanding loans in December 2023)



Sources: Credit Register of Latvijas Banka, SLS, CSB.

Note. GDP data by municipality are available for 2021. It is assumed that municipal GDPs in 2022 and 2023 grew in line with the overall growth rate of Latvia's GDP.

Outside Riga and Pieriga, relatively high housing lending activity can be observed in municipalities that are geographically close to Riga, such as Ogre, Saulkrasti, and Jelgava municipalities, as well as in Jelgava State city. Outstanding housing loans in these municipalities account for 10%–28% of municipal GDP.

Apart from Pieriga region, no other municipality, including State cities, has outstanding housing loans exceeding 10% of municipal GDP. In Liepāja, Ventspils, and Valmiera, outstanding housing loans account for 5–6% of the municipal GDP. In Daugavpils, Rēzekne, and Jēkabpils they constitute only 2% of municipal

[10] https://www.bank.lv/en/news-and-events/news-and-articles/news/16756-latvijas-banka-reviews-regulation-on-credit-risk-management

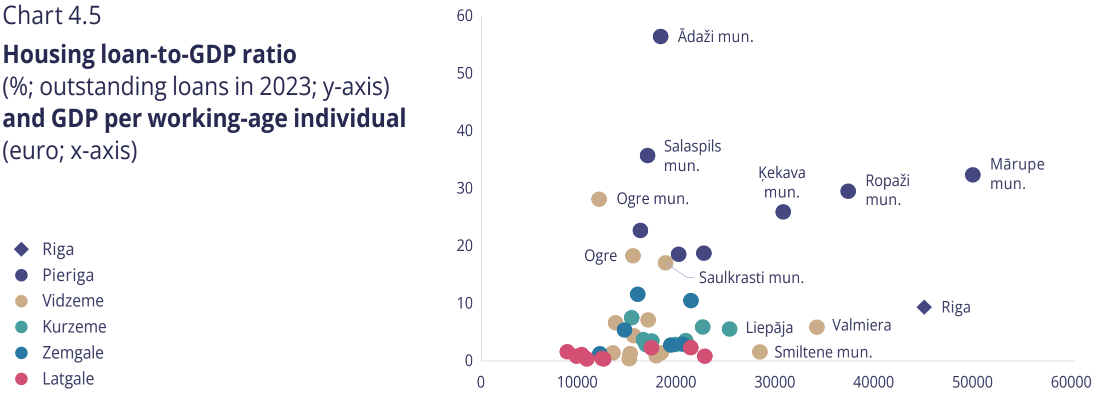
[11] The data extracted from the Credit Register pertain to the housing loans that have been secured by real estate collateral and issued by one of the four largest credit institutions by outstanding loan amounts. Consequently, the analysis is based on data covering approximately 80% of all housing loans. For the remaining housing loans, the necessary information for the analysis is unavailable. The geographical affiliation of the loan is determined by the cadastral territory of the collateral.

GDP. Overall, in nearly half of Latvia's municipalities, outstanding housing loans account for less than 3% of municipal GDP.

The amount of outstanding housing loans does not always closely correlate with the economic activity of the respective municipality or city (Charts 4.5 and 4.6). For example, housing lending activity in Valmiera, Liepāja, and Smiltene municipalities remains sluggish despite relatively high GDP per capita and low unemployment rates. A similar situation can be observed in Dobele, Saldus, and Līvāni municipalities.

Chart 4.5

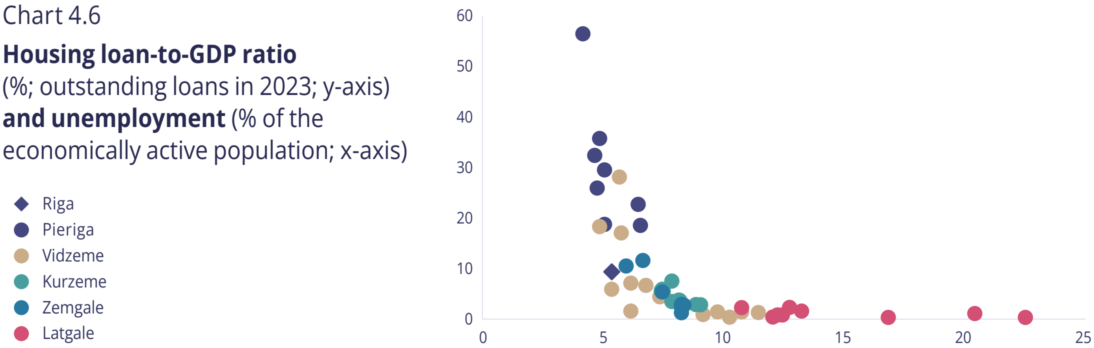
Housing loan-to-GDP ratio
(%; outstanding loans in 2023; y-axis)
and GDP per working-age individual
(euro; x-axis)



Sources: Credit Register of Latvijas Banka, SLS, CSB, and Latvijas Banka's calculations.

Chart 4.6

Housing loan-to-GDP ratio
(%; outstanding loans in 2023; y-axis)
and unemployment (% of the economically active population; x-axis)



Sources: Credit Register of Latvijas Banka, SLS, CSB.

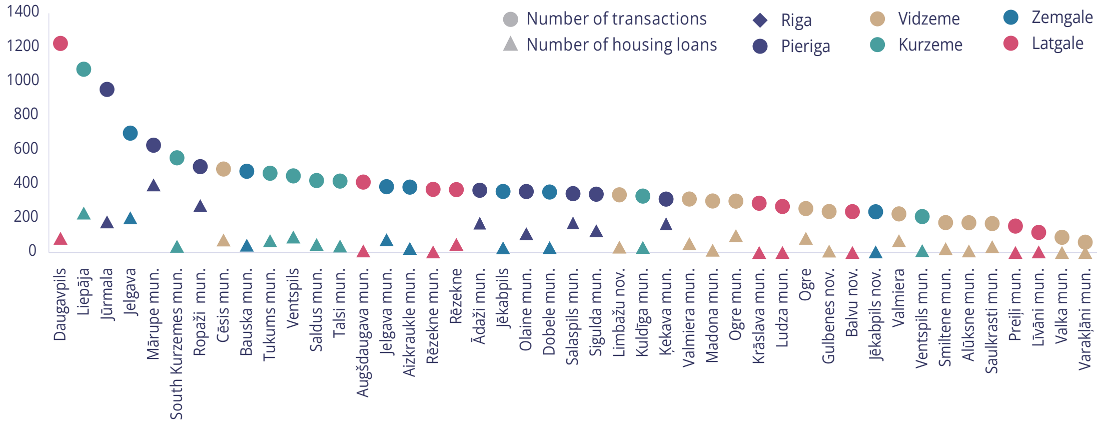
The geographical location is significantly more important than the economic environment. Regardless of the level of economic activity, housing lending is higher in the municipalities of Pieriga region as well as in the municipalities of other regions that are geographically close to Riga. Meanwhile, housing lending activity in other municipalities of Latgale, Kurzeme, Vidzeme, and Zemgale is very low.

Weak lending in these municipalities may not always be explained by shallow real estate markets. In many municipalities, despite relatively low lending activity, the number of transactions with residential buildings and groups of residential premises is by no means low. For example, in Liepāja and Ventspils, only one in five transactions is financed by a housing loan, while in Dobele, Bauska, and Cēsis municipalities, only one in ten transactions receives such financing (Chart 4.7).[12] In contrast, approximately half of all transactions in the municipalities of Pieriga region are financed by loans, with Mārupe municipality reaching as high as two thirds of such transactions.

[12] In several municipalities, the number of real estate transactions financed by housing loans is no more than 10.

Chart 4.7

Number of transactions involving residential buildings and groups of residential premises by municipality (2023; excluding Riga)



Sources: Credit Register of Latvijas Banka, SLS.

Note. The data used pertain to transactions involving buildings and groups of premises classified as residential buildings and premises (Building Classification Code 11), excluding co-residential buildings for various social groups (Building Classification Code 113). In municipalities where the number of residential loans issued does not exceed two, the figure has been reported as 0 for confidentiality reasons.

The weak lending activity outside of Pieriga is linked to several structural issues[13] that hinder the healthy development of lending in the Latvian housing market, including: 1) the prevalence of the shadow economy, 2) the discrepancy between property valuations and construction costs, and 3) restrictive lending conditions.

The high prevalence of the shadow economy is evident not only in the use of envelope wages, which limits access to loans, but also in the under-reporting of true transaction values. An analysis by Cenu Banka reveals that the difference between advertised apartment prices and registered transaction prices in Latvian State cities typically ranges from 10% to 40%. For certain types of real estate in Daugavpils and Rēzekne, this gap can reach as high as 60% to 80%. The motivation to conceal the true value of transactions may stem from various factors, including the desire to hide income, avoid paying personal income tax on capital gains, and reduce the State fee for registering property rights in the Land Register.

This situation has significant negative consequences for honest market participants and the housing market as a whole. When the values of a significant proportion of transactions are deliberately under-reported, it complicates the objective assessment of property values, which is crucial for granting housing loans. This issue is especially pronounced in smaller municipalities, where the limited number of transactions available for assessment exacerbates the problem.

To address this issue, policy measures should be enacted to encourage all parties involved to report the true values of their transactions. One such measure is to reduce the state fee for registering property rights in the Land Register, which is significantly higher in Latvia than in Lithuania and Estonia. In Latvia, the full amount of the state fee is 1.5% of the transaction value[14], while in Estonia it ranges from 0.1% to 0.2%[15], and in Lithuania, it is a fixed payment of 17 to 34 euro[16].

Currently, the fee in Latvia can be significantly reduced (to as low as 0.5% for housing purchases up to 100 000 euro[17]), if the purchase is supported by Altum's housing guarantee programme. This often creates financial incentives for buyers who can afford the down payment of their housing loan to take advantage of the guarantee programme (Chart 4.8). This partly explains the programme's popularity, with 33% of the new housing loans granted under the Altum guarantee in the first quarter of 2024.

[13] At the same time, it is important to consider that the low proportion of transactions financed by loans in some municipalities, particularly in border regions, can be attributed to significant foreign investment in the real estate market.

[14] Yet, no more than 50 000 euro.

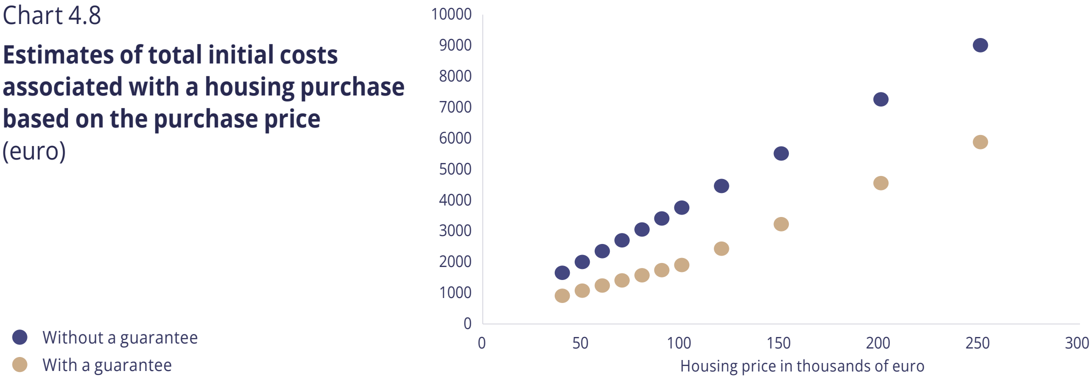
[15] See https://www.riigiteataja.ee/en/eli/519022016005/consolide un https://www.riigiteataja.ee/tolkelisa/5270/2202/4001/annex2.pdf#.

[16] See https://www.registrucentras.lt/p/1532.

[17] If the value of the housing purchase exceeds 100 000 euro, the portion of the amount exceeding 100 000 euro is subject to a fee rate of 1.5%..

Chart 4.8

Estimates of total initial costs associated with a housing purchase based on the purchase price
(euro)



Source: Latvijas Banka's estimate based on the regulations on the state fee for the registration of land and property rights with the Land Register.

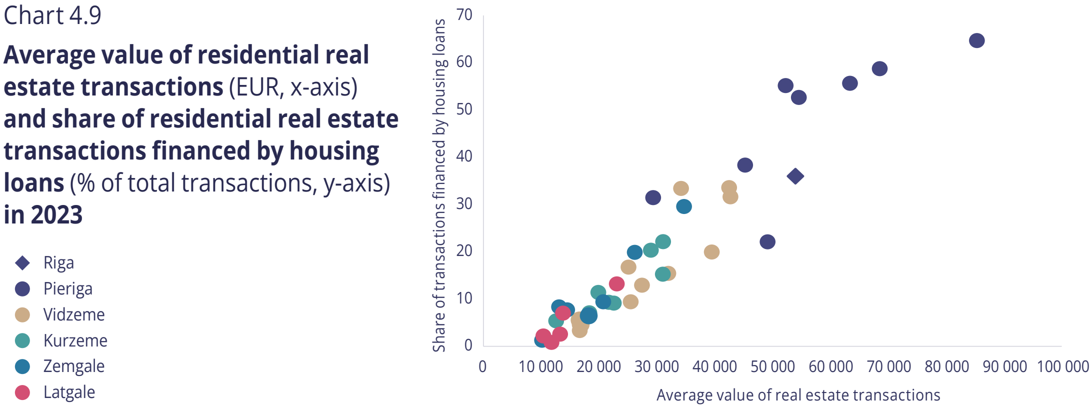
Notes. The total cost without a guarantee reflects the borrower's costs associated with assuming a housing loan with a 15% down payment. For standard apartments, the down payment is typically much higher. The total cost with a guarantee reflects the borrower's costs associated with assuming a housing loan with a 10% guarantee provided by the housing guarantee programme. Additionally, it is assumed that a loan supported by the housing guarantee programme benefits from a discounted fee for issuing that loan.

However, the Altum guarantee programme, which offers a state fee reduction, is available only to specific groups of the public – families with children and members of the National Armed Forces. A broader solution would be to reduce the state fee for all citizens. This would not only stimulate housing market activity and improve the accuracy of real estate valuations (thereby encouraging regional lending), but it would also decrease the incentive for borrowers who do not actually need guarantees to use the Altum programme. Moreover, the reduced demand for guarantees could, to some extent, compensate for the budget revenue loss resulting from the reduction of the state fee.

Another key factor hindering housing lending and real estate market activity in Latvia's regions is the disparity between real estate valuations and construction costs. This challenge, frequently cited in discussions with entrepreneurs and residents in Latvia's regions, is a significant barrier to more active lending.[18] While real estate prices (market values) vary significantly across Latvia's municipalities, construction costs remain relatively uniform. SLS data[19] highlight this disparity: in 2023, the average transaction value for residential premises and buildings in Mārupe and Ādaži municipalities was 86 000 euro and 69 000 euro respectively. However, in many other regional municipalities, this figure does not exceed 25 000 euro (Chart 4.9). For instance, in Saldus and Bauska municipalities, the average transaction value involving residential buildings or premises was just 20 000 euro. These low real estate prices are reflected in lower valuations, which makes it more difficult to secure housing loans for construction.

Chart 4.9

Average value of residential real estate transactions (EUR, x-axis) **and share of residential real estate transactions financed by housing loans** (% of total transactions, y-axis) **in 2023**



Sources: Credit Register of Latvijas Banka, SLS, and Latvijas Banka's calculations.

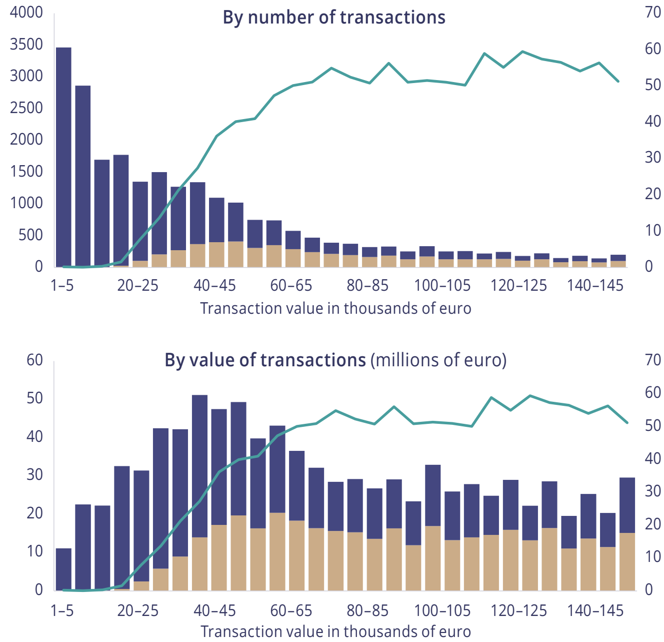
[18] https://www.bank.lv/aktualitates-banklv/zinas-un-raksti/jaunumi/16924-latvijas-banka-ar-pasvaldibu-vaditajiem-un-uznemejiem-parrunas-finansu-pakalpojumu-pieejamibu-regionos

[19] It should be noted that the reported transaction values may not always represent the true values.

Relatively low real estate prices may also dampen lending activity for other reasons. First, they reduce the demand for loans, as the amount of savings needed to purchase property without bank financing decreases with lower prices. Second, banks may be less inclined to provide smaller loans due to the fixed costs. This is supported by the fact that only a very small fraction of transactions up to 20 000 euro are financed by bank loans. Specifically, less than 1% of transactions up to 20 000 euro are financed by loans (Chart 4.10). In contrast, loans finance well over half of the transactions exceeding 60 000.

Chart 4.10

Breakdown of residential real estate transactions by transaction value in 2023



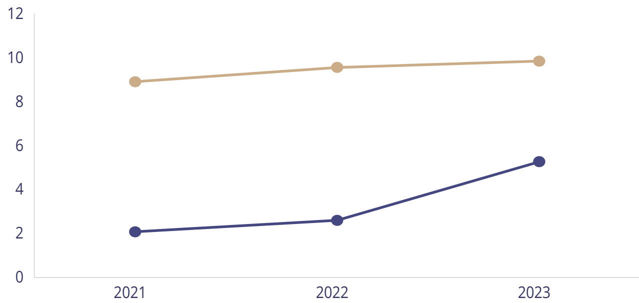
Sources: Credit Register of Latvijas Banka, SLS, and Latvijas Banka's calculations.

Publicly available information from banks' websites[20] also indicates that loans secured by real estate collateral are not issued below a certain threshold, typically around 10 000–20 000 euro. Specifically, if the property costs between 15 000 and 30 000 euro and requires a down payment of 20–30%, options for obtaining a standard housing loan are limited. This significantly affects access to credit in the regions where real estate prices are generally lower.

However, loans secured by real estate collateral are not the only type of loans that provide financing for housing purchases in Latvia. Approximately 65% of all housing loans are issued without real estate collateral (making it impossible to determine their distribution across municipalities). These loans, which also include those for property repairs, are generally lower in value, comprising just 13% of the total housing loan portfolio at the end of 2023. Additionally, these unsecured loans typically come with much less favourable terms. In 2023, the average interest rate for housing loans secured by real estate collateral was 5.2%, whereas for unsecured housing loans, it was nearly 10% (Chart 4.11).

Chart 4.11

Average interest rates on new housing loans in Latvia
(%)



Source: Credit Register of Latvijas Banka.

[20] See, for instance: https://www.swedbank.lv/private/credit/loans/home (last accessed on 17 July 2024).

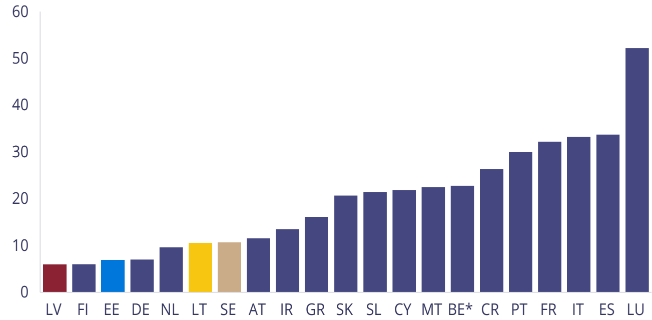
Although higher interest rates for this type of loan are generally justified by the absence of collateral and the associated higher risk, collateral is often implicitly incorporated into the terms of these loan agreements. For instance, if the loan is used to purchase property, the contract may stipulate that ownership rights must be transferred to the borrower, thereby, providing an indirect form of collateral.

Therefore, the availability of reasonably priced loans for smaller transactions is an issue, especially in the regions. To address this, the State, Altum, and/or municipalities could establish a small-scale secured loan programme for property purchases. This would address market failures by enhancing loan availability in the regions, while still maintaining the market for unsecured loans intended for repairs as well as other purposes that are unrelated to the purchase of a property.

The significant variation in housing lending underscores a broader decline in access to financial services across Latvia's regions. With the reduction in cash transactions and the expansion of remote services, the number of bank branches has fallen sharply. Since 2014, the number of bank branches per capita in Latvia has decreased by nearly 71%, with the largest banks having no branches in most municipalities. This trend is not unique to Latvia; it has been observed in many countries. According to International Monetary Fund (IMF) data, the number of bank branches has declined across all euro area countries and Sweden; however, Latvia has experienced the most pronounced decrease in percentage terms (Charts 4.12 and 4.13).

Chart 4.12

Number of commercial banks' branches per 100 000 adults in 2022

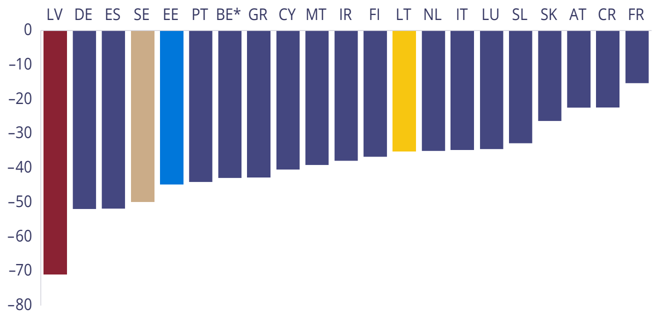


Avots: SVF.

* Information on Belgium is available only for 2021.

Chart 4.13

Changes in the number of commercial banks' branches per 100 000 adults between 2014 and 2022
(%)



Avots: SVF.

* Information on Belgium is available only for 2021.

However, the reduction in bank branches has notable side effects, particularly for lending. The issuance of new loans requires a thorough assessment and often personalised solutions, which is especially true for small and medium-sized enterprises. As banks close their branches, their ability to understand the plans and needs of local businesses diminishes, leading to more limited access to credit. Sveriges Riksbank provides evidence of this issue, noting that municipalities most affected by the reduction in bank branches have experienced significant declines in access to credit and weakening economic activity.[21]

Residents in Latvia's regions, who have been most impacted by the decline in the availability of in-person services, are experiencing similar consequences (see Box 3). In response, Latvijas Banka has submitted proposals to the Budget and Finance (Taxation) Committee of the Saeima to amend the Credit Institution

[21] https://www.riksbank.se/globalassets/media/rapporter/working-papers/2023/no.-430-banking-without-branches.pdf

Law, aiming to ensure consistent access to financial services across Latvia. The proposals include requirements for credit institutions to maintain a permanent presence in the State cities and municipal administrative centres that meet specific criteria, such as the distance from other cities with established in-person services, the market share, and the number of residents in the municipality, as well as other criteria. Conversely, in the State cities and municipal administrative centres where banks will not be required to provide permanent in-person services, these services will be available upon the request of customers. Credit institutions will determine the method for providing such in-person services, which could include an option such as a mobile customer service unit.

Box 3. Does the presence of banks in a region influence corporate lending?

Evidence of the importance of bank branches can also be found in Latvia. The SKDS survey of Latvian CEOs provides comprehensive information, covering not just the company's size, sector, and primary place of business, but also the CEO's experience with banks, including when applying for loans.

The survey results reveal that municipalities with an operating bank branch have a higher proportion of companies seeking funding and attempting to attract bank financing (75%) compared to municipalities without branches (62%). However, these differences alone do not necessarily indicate that the presence of a bank branch directly facilitates lending. It is possible that bank branches are simply located in municipalities with larger and more active companies, which are also more likely to receive loans. Therefore, it is important to address the question: "Does access to credit for otherwise similar companies vary depending on whether a bank branch is present in the municipality?"

To answer this, a sample of companies that applied for bank loans was selected using the following equation:

$Y_i = \beta U_i + \mu F_i + \gamma M_i + u_i$, where:

- Y_i – is a binary variable indicating whether a loan was not refused to company i (1 = not refused, 0 = refused);
- U_i – represents the factors characterising the company (sector, number of employees, turnover, origin of paid-up share capital, and whether the company is active in export markets);
- F_i – represents the factors characterising the municipality (whether a bank branch is situated in the municipality of company i, GDP per capita in the municipality, the binary variable for Riga);
- M_i – is the correction factor for the sample bias (Heckman correction)[22] and
- u_i is the error.

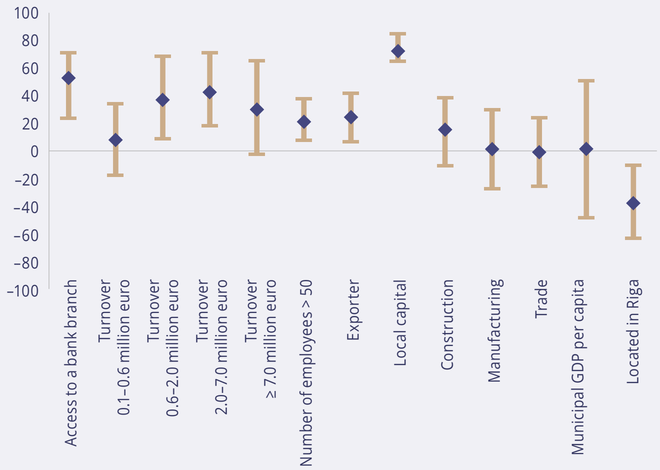
The results show that companies in municipalities with at least one bank branch are 52 percentage points more likely to receive a loan than otherwise similar companies in municipalities without a branch (Chart 4.14). The analysis also reveals that larger companies and exporters, in terms of both turnover and number of employees, have better access to credit.

[22] The sample does not include companies that could receive loans but have not applied for them, so the results of the assessment may not be representative. To prevent sample deviation, Heckman correction is used. Specifically, the selection of all companies begins with assessing the probability that a company applied for a loan, followed by calculating the sample deviation correction factor to be included in the loan approval equation.

Chart 4.14

Estimated average marginal impact on companies' access to credit

(percentage points)



Sources: SKDS, Latvijas Banka, CSB, Latvijas Banka's

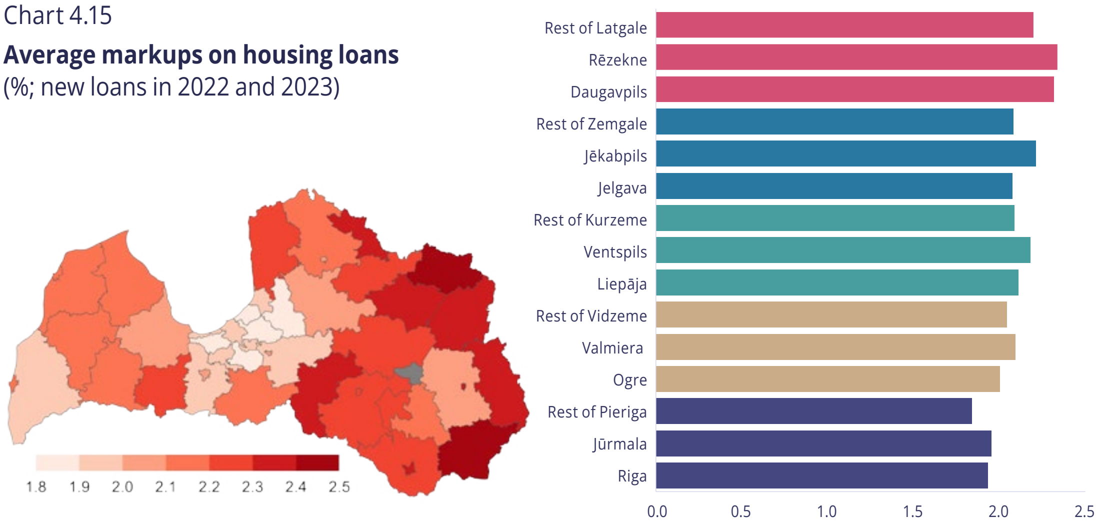
Notes. The chart illustrates the average marginal impact of the indicators on companies' access to credit. For example, companies in municipalities with an in-person bank service centre are 52 percentage points more likely to receive a loan than similar companies in municipalities without one. The lines represent a 95% confidence interval.

Although housing lending activity varies across Latvian municipalities, interest rates on loans are broadly similar (Chart 4.15). The average markups on housing loans granted over the past two years range from 1.8% in Riga and Pieriga to 2.3% in Latgale municipalities.

Chart 4.15

Average markups on housing loans

(%; new loans in 2022 and 2023)



Sources: Credit Register of Latvijas Banka, SLS, and Latvijas Banka's calculations.

Note. No eligible mortgage loans were issued in Varakļāni municipality in 2022 and 2023.

Additionally, interest rates on loans are more closely tied to economic conditions in a municipality than the total volume of loans. Specifically, municipalities with lower GDP per capita and higher unemployment rates tend to have higher average interest rates on loans.

5. Conclusions

Lending activity in Latvia remains sluggish, with outstanding loans to non-financial corporations and households, relative to GDP, among the lowest in the euro area. Beyond the cyclical factors that hinder lending across the euro area, structural issues, such as weak competition in the credit market, further constrain lending in Latvia.

In Latvia, interest rates on loans, particularly on housing loans, are notably among the highest in the euro area. In the first quarter of 2024, the average interest rates on housing loans in Latvia and the Baltic States were approximately 2 percentage points higher than the euro area average. This situation is partly due to the high proportion of variable interest rate loans in the Baltic States. Elsewhere in the euro area, loans with fixed interest rates, i.e. interest rates that remain unchanged for the term of the loan agreement or adjust much less frequently, thereby protecting borrowers from frequent fluctuations in short-term interest rates, are far more common.

- Latvia should also seek solutions to broaden the range of interest rate fixation options and make them more attractive for borrowers. This would expand the range of loan options and allow borrowers to shield themselves from frequent changes in interest rates.

At the same time, the housing loan segment has seen some positive developments – while interest rate markups remain high, they have decreased. The lower markups benefit not only those seeking a new loan, but also those who have already been granted loans, as they now have the opportunity to refinance their loans under more favourable conditions. This is particularly relevant in light of the regulatory amendments introduced at the beginning of 2024, which have substantially reduced the costs associated with refinancing housing loans.

In the corporate segment, however, interest rates on loans have not decreased and remain considerably higher compared to other euro area countries. This elevates the investment costs for Latvian companies and weakens their competitiveness. To improve the lending conditions, competition in corporate lending must also be intensified .One potential solution is to limit the costs associated with refinancing corporate loans. Currently, companies looking to refinance a loan must take into account not only the loan agreement fee (typically 1% of the loan), but also an early repayment fee of around 2% of the outstanding loan.

- Therefore, Latvijas Banka deems it necessary to introduce legislative amendments to prohibit the imposition of early repayment or refinancing fees in specific types of transactions, such as loans and leasing agreements.

The high interest rates on loans in Latvia cannot be attributed to poorer credit quality. In fact, Latvian credit institutions impose very stringent collateral requirements to mitigate the risk of losses. For approximately 75% of loans to non-financial corporations, the value of collateral exceeds the loan amount by one and a half times, and in half of the cases, it is even double the loan amount. Nearly 90% of loans to non-financial corporations are secured by two or more collaterals and about a half of the loans are backed by four or more. Compared to other euro area countries, Latvia, and the Baltic States as a whole, generally have the most rigorous collateral requirements.

Although activity in the Latvian capital markets remains very sluggish, the non-bank sector has become increasingly important in financing the economy. This is especially true for non-bank lenders which have significantly increased their financing to both households and non-financial corporations. Notably, the demand for these relatively costly loans has surged despite ongoing improvements in the financial health of Latvian households and non-financial corporations, thus indirectly pointing to insufficient supply of bank loans.

Lending activity in Latvian municipalities is far from uniform, as evidenced by differences in the housing lending market. For example, the amount of outstanding housing loans in Pieriga municipalities is nearing the averages seen across the euro area. Meanwhile, in other regions of Latvia, lending activity remains quite sluggish, accounting for no more than 10% of municipal GDP. The significant variation in housing lending activity highlights a broader decline in the availability of financial services across Latvia's regions. This underscores the need to seek solutions that enhance access to lending and other financial services across Latvia.

- Latvijas Banka has submitted proposals to the Budget and Finance (Taxation) Committee of the Saeima to amend the Credit Institution Law, aiming to ensure consistent access to financial services across Latvia. The proposals include requirements for credit institutions to maintain permanent presence in the State cities and municipal administrative centres that meet specific criteria, such as the distance from other cities with established in-person services, the client proportion and the number of residents in the municipality, as well as other criteria. Conversely, in the State cities and municipal administrative centres where banks will not be required to provide permanent in-person services, these services will be available upon the request of customers. Credit institutions will determine the method for providing such in-person services, which could include an option such as a mobile customer service unit.

- Latvijas Banka has discussed the possibility of creating a small-scale secured loan programme for purchasing real estate in the regions with Altum. Such a programme would address market failures by enhancing access to loans with more favourable conditions in these regions, while still maintaining the market for unsecured loans for repairs and other purposes.

- To stimulate housing market activity and reduce the incentive to under-report the true values of transactions involving housing purchases, it is advisable to consider lowering the state fee for registering property rights with the Land Register. This state fee is currently significantly higher in Latvia than in Lithuania and Estonia.