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Summary

Lending activity in Latvia has started to improve: outstanding loans to both non-financial corporations and households increased in 2024, with growth rates above those of gross domestic product (GDP). This positive momentum also continued in early 2025. Thus, after a prolonged stagnation, lending is showing a positive trend.

The decline in lending rates has been a major factor driving the recovery in lending activity. This is explained both by the fall in money market interest rates, including the short-term EURIBOR rates, and by lower markups. EURIBOR rates, frequently used as reference rates for loan pricing in Latvia, have decreased by more than 2 percentage points after peaking in October 2023. At the same time, markups on new loans have also fallen significantly, particularly in the mortgage loan segment, owing, among other things, to borrowers' growing interest in loan refinancing possibilities.

The rising interest was driven by amendments to several laws and regulations[1], which resulted in substantially lower costs for mortgage loan refinancing. In the first eight months of this year, markups were reduced for 9356 mortgage loans valued at almost EUR 690 million (or 14% of the entire mortgage loan portfolio in Latvia). This has allowed Latvian borrowers to save an average of EUR 350 to 515 in interest payments per year. The total potential savings of borrowers over the lifespan of the refinanced loans are estimated at approximately EUR 44.7 million. Despite the already high activity, refinancing could still be financially justified for a large number of existing mortgage loans.

While lending activity has grown, the loan-to-GDP ratio remains well below the euro area average. Outstanding mortgage loans in Latvia stood at only 13% of GDP at the beginning of 2025, significantly less than in Lithuania (17%) and Estonia (31%). The low level of mortgage lending stems from both financial availability factors, including high markups and a limited diversity of financial intermediaries, as well as from the structure of the housing stock.

Housing lending activity can be improved with solutions that encourage new lenders to enter the mortgage market. One direction would be to improve the availability of alternative sources of financing for lenders, e.g. through mortgage securitisation. The issuance of mortgage-backed securities would enable lenders to attract external financing and free up capital for new loans. Given the small mortgage loan portfolios of most lenders in Latvia, and the relatively high costs associated with issuing securities, the involvement of state financial institutions should be considered.

In the corporate lending segment, the interest rate developments have been less favourable: markups on loans have changed only slightly and remain high. Corporate lending is also characterised by a high dispersion of markups across both lenders and borrowers, which may indicate segmentation of the lending market and thus limited competition. To improve this situation, it is essential to promote borrower mobility, e.g. by reducing early repayment fees, which currently make refinancing financially unattractive for most companies. To promote customer mobility and enhance competition in the corporate lending market, Latvijas Banka, in collaboration with the Ministry of Finance, has drafted a regulatory proposal to limit these fees.

The financial situation of Latvian companies has improved in recent years: at the end of 2024, corporate equity exceeded borrowed funds for the first time in at least 15 years. Profitability has remained steady, with companies maintaining a solid ability to cover interest payments. The number of insolvency cases has remained at a historically low level. At the same time, many companies still operate with negative equity, which not only directly limits their ability to attract external financing, but also creates a negative image of the business environment in Latvia. However, an analysis carried out by Latvijas Banka shows that this problem is often exaggerated: the large increase in the number of companies with negative equity following the global financial crisis was mainly due to the emergence of companies with low initial capital rather than

[1] The Consumer Rights Protection Law, the Insurance Contract Law, the Credit Institution Law, the Notariate Law, Cabinet Regulation No 691 "Regulations Regarding Consumer Credit" of 25 October 2016, Cabinet Regulation No 95 "Regulations Regarding the State Assistance in Purchase or Construction of Residential Space" of 20 February 2018.

to a general deterioration in the financial health of companies. Moreover, while companies with negative equity account for a significant share of all Latvian companies, their role in the economy is relatively minor.

Despite the improvement in the financial situation, access to external financing for companies remains difficult in Latvia. Credit institutions in Latvia apply some of the strictest collateral requirements in the euro area, and this is only partly due to a different loan structure and borrower profile. In 2024, the average collateral value for loans to non-financial corporations in Latvia stood at 162% of the loan amount. Furthermore, for a large share of loans, the collateral value is as much as twice the loan amount. In Latvia, it is also fairly common to require personal guarantees when issuing corporate loans, which is a key factor limiting lending.

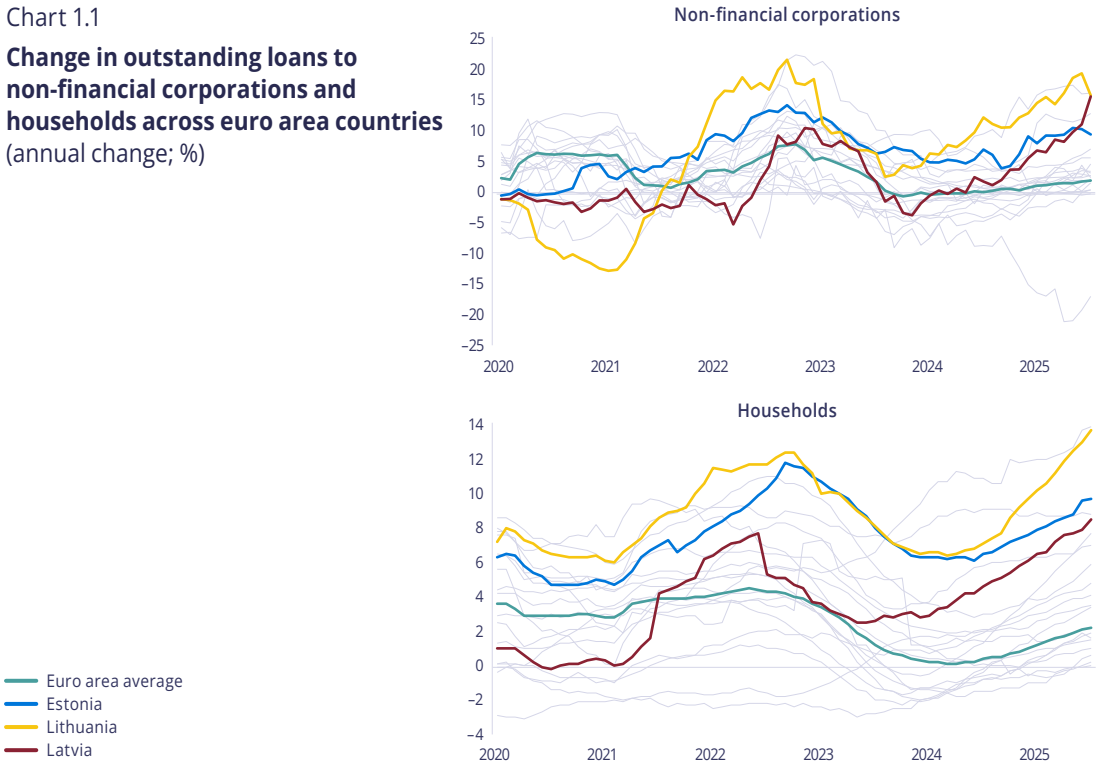
Such lending practices severely weaken competition in the lending market. To reduce these obstacles, a more balanced approach to collateral requirements should be promoted. This would both protect the interests of lenders and not hinder business development. A potential solution is for public authorities to provide an independent assessment of the financial situation of the company. This would be useful reference material for both lenders and companies on their financial health. This could lessen cautious behaviour from companies and encourage them to apply for loans, while also lowering the administrative costs for lenders associated with issuing loans.

1. Loan supply and competition in the banking sector

After a prolonged stagnation, lending activity in Latvia has started to improve. In 2024, outstanding loans to non-financial corporations and households increased by 5.8% and 6.2% respectively (Chart 1.1). This rise was faster than GDP growth[2]. As a result, the loan-to-GDP ratio also increased by 1.1 percentage points. This trend continued in 2025: in the first eight months, outstanding loans to non-financial corporations grew by 18.6% year on year, while outstanding loans to households rose by 8.9%.

Chart 1.1

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



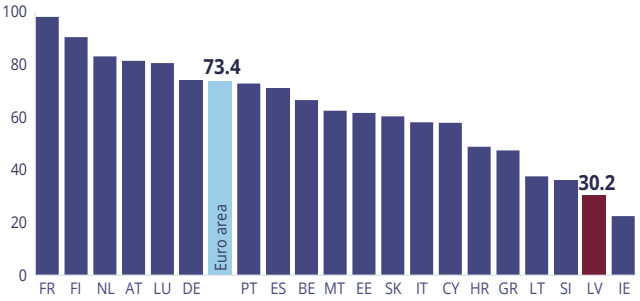
Sources: ECB Balance Sheet Items (BSI), Eurostat.

Despite the gradual recovery in lending activity, the overall loan-to-GDP ratio in Latvia still lags significantly behind that of most other euro area countries. The ratio of outstanding loans to non-financial corporations and households to GDP in Latvia is less than half of the euro area average, as well as approximately 6 percentage points lower than in Lithuania and 31 percentage points lower than in Estonia (Chart 1.2). Nonetheless, it is encouraging that the gap with most other euro area countries is gradually narrowing – in 2024, Latvia ranked third in the euro area in terms of changes in the loan-to-GDP ratio.

[2] At current prices.

Chart 1.2

Outstanding loans to non-financial corporations and households across euro area countries in Q2 2025
(% of GDP)

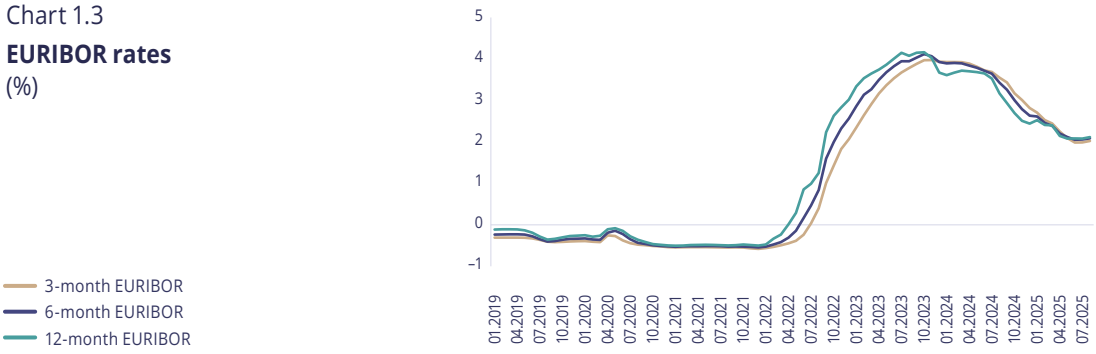


Sources: ECB (BSI), Eurostat.

The decline in lending rates has been a major factor driving the recovery in lending activity. This is explained both by the fall in money market interest rates, including the short-term EURIBOR rates, and by lower markups (Charts 1.3 and 1.4). After peaking in October 2023, the 6-month EURIBOR rate, frequently used as the reference rate for loan pricing in Latvia, has decreased by more than 2 percentage points, reaching 2.1% in August 2025. At the same time, markups on new loans – in particular, mortgages – have also fallen substantially. Since July 2024, the average markup on mortgage loans has been in the range between 1.2% and 1.5% (between 1.4% and 1.6% excluding temporary discounts). This is significantly lower than in 2022 (2.0%) and 2023 (1.75%).

Chart 1.3

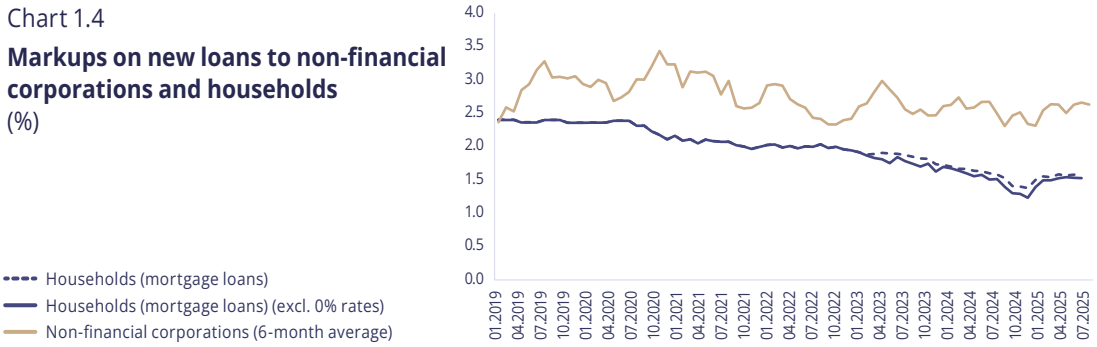
EURIBOR rates
(%)



Source: LSEG.

Chart 1.4

Markups on new loans to non-financial corporations and households
(%)



Source: Credit Register of Latvijas Banka.
Notes. The sample includes active bank loans to residents in euro with variable/mixed interest rates. Loans to non-financial corporations other than overdrafts, revolving loans, or credit card loans. Mortgage-secured housing loans to households.

Lower markups on new loans were also reflected in a decrease in the average markup on the entire mortgage loan portfolio. In mid-2021, the average markup on outstanding mortgage loans in Latvia stood at 2.2%, but by the beginning of 2025, it had already fallen to 1.9%. From early 2025, the decline in mortgage loan markups has also been significantly influenced by the strong interest of Latvian borrowers in mortgage refinancing opportunities.

The rising interest was driven by amendments to several laws and regulations[3], which resulted in substantially lower mortgage loan refinancing costs. During the first eight months of this year, Latvian mortgage borrowers have shown much greater interest in improving their loan conditions than over the past three years combined. According to the Credit Register of Latvijas Banka, 9356 mortgage loans were refinanced between January and August 2025. Out of these, 8717 loans were refinanced by the current lenders and 639 loans were refinanced with other lenders. The total value of these loans amounts to nearly EUR 690 million or 14% of the total mortgage loan portfolio in Latvia (Charts 1.5 and 1.6).

Chart 1.5

Count of mortgage loans with reduced markups
(thousands)

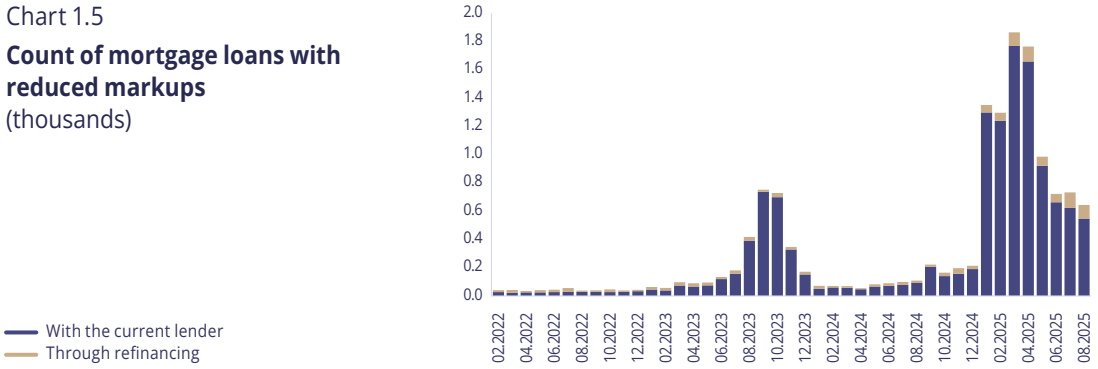
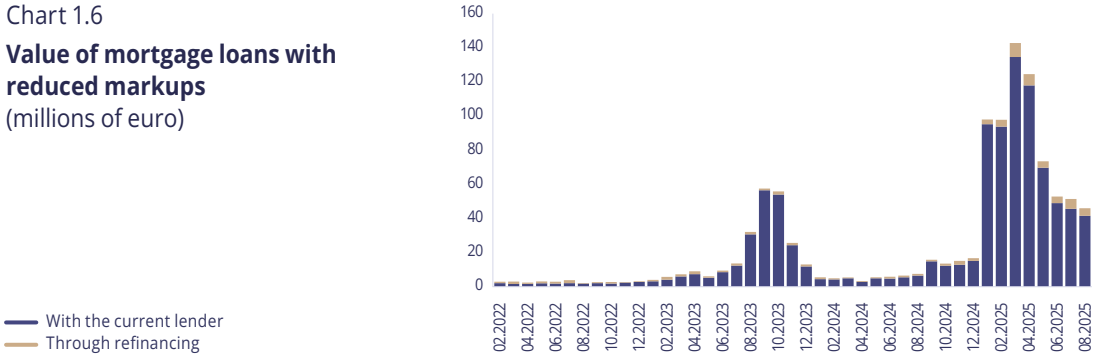


Chart 1.6

Value of mortgage loans with reduced markups
(millions of euro)



Source: Credit Register of Latvijas Banka, Latvijas Banka's calculations.
Note. The sample includes active mortgage-secured bank loans to residents in euro with variable/mixed interest rates.

The benefit to borrowers from improving mortgage loan conditions has by no means been small. On average, markups on loans that were refinanced by the current lender declined by 0.45 percentage points. Meanwhile, the decrease in markups on the loans refinanced with another lender was as high as 0.8 percentage points on average. Refinancing was particularly common among borrowers receiving guarantees from AS Attīstības finanšu institūcija Altum (Altum).

For the vast majority of loans that were refinanced by the current lenders, the new markup ranges from 1.3% to 1.9%, despite the initial dispersion being significantly higher (Chart 1.7). The differences between the initial and the new markups were even larger when refinancing with another lender took place (Chart 1.8). This is most likely due to the various discounts applied by lenders when attracting new customers.

[3] The Consumer Rights Protection Law, the Insurance Contract Law, the Credit Institution Law, the Notariate Law, Cabinet Regulation No 691 "Regulations Regarding Consumer Credit" of 25 October 2016, Cabinet Regulation No 95 "Regulations Regarding the State Assistance in Purchase or Construction of Residential Space" of 20 February 2018.

Chart 1.7

Dispersion of markups on mortgage loans where markups have been reduced by the current lender
(volume; x-axis – markups before and after change)

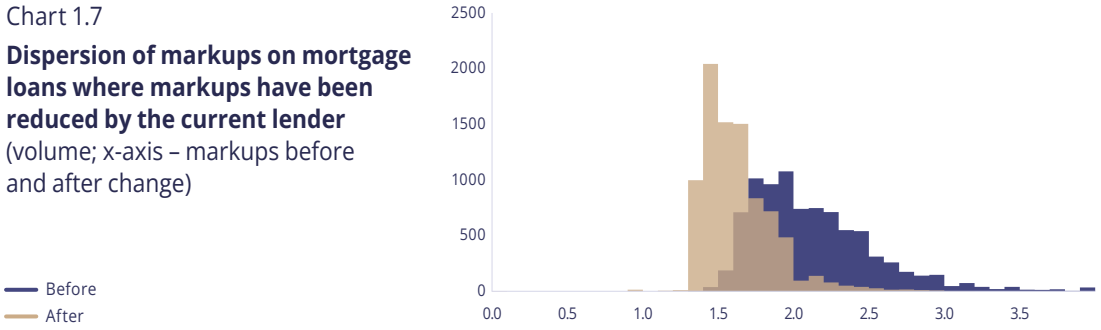
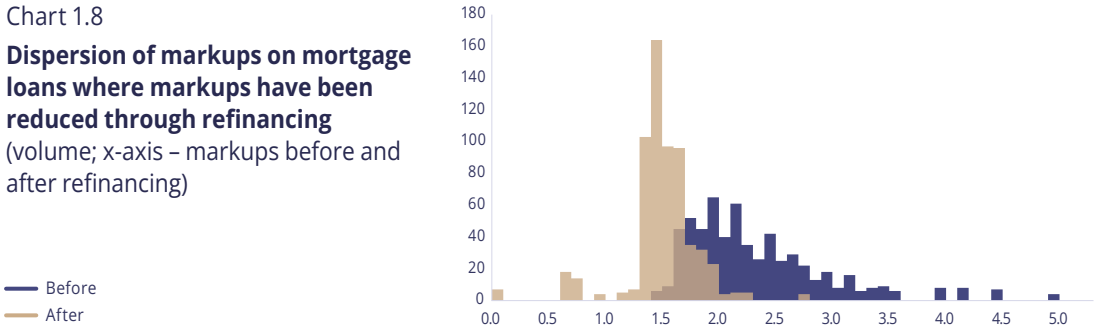


Chart 1.8

Dispersion of markups on mortgage loans where markups have been reduced through refinancing
(volume; x-axis – markups before and after refinancing)



Source: Credit Register of Latvijas Banka, Latvijas Banka's calculations.
Notes. Dispersions exclude observations with markups in the first percentile and intervals of less than three observations. January 2025–August 2025.

Loan refinancing enables Latvian borrowers to significantly lower their interest expenses: those that refinanced their loans with the current lender saved an average of EUR 350 per year, while those who refinanced their loans with other lenders saved even more – on average EUR 515. (Charts 1.9 and 1.10). Assuming that the loan is not repaid ahead of schedule, the average savings for borrowers during the entire remaining lifespan of the loan amount to EUR 4850 and EUR 8375 respectively. The total savings of all borrowers reach EUR 44.7 million.

Chart 1.9

Calculated reduction in interest payments per year for mortgage loans with a lowered markup
(x-axis – euro; y-axis – volume)

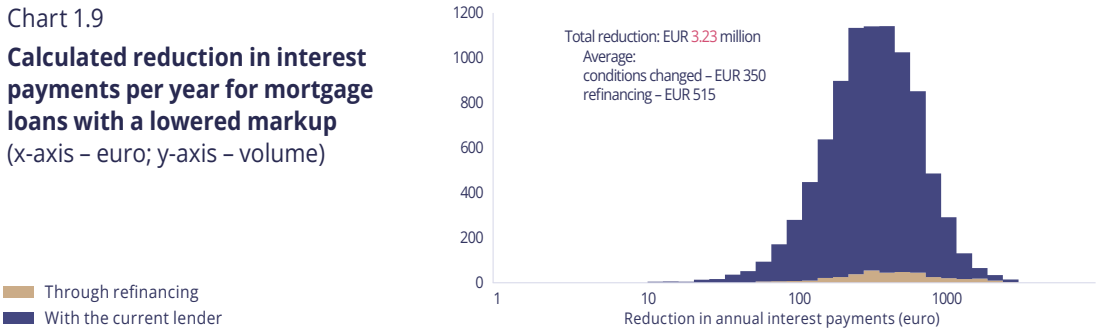
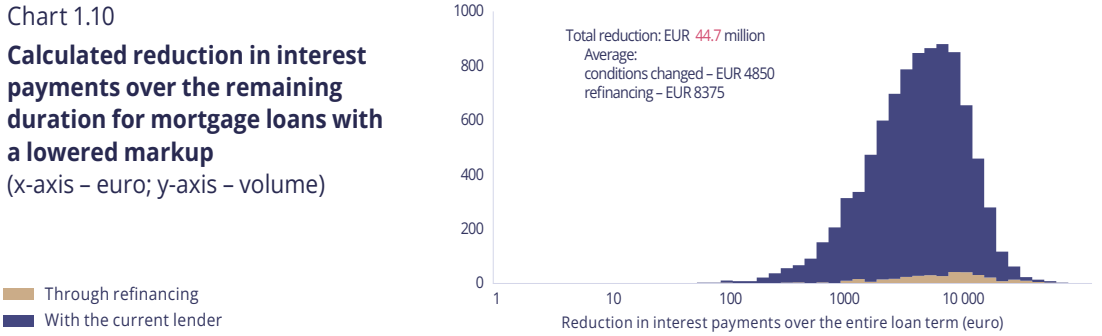


Chart 1.10

Calculated reduction in interest payments over the remaining duration for mortgage loans with a lowered markup
(x-axis – euro; y-axis – volume)



Source: Credit Register of Latvijas Banka, Latvijas Banka's calculations.
Notes. Interest payments are calculated for loans with original and new remaining maturity of at least 12 months, assuming a constant base interest rate and considering the loan repayment schedules. Intervals with fewer than three observations are not included.

Whether and to what extent markups can be reduced depends not only on the creditworthiness of borrowers and of sufficient official income, but also on the initial interest rate. Statistics show that the higher the initial interest rate, the greater the average decrease. For example, mortgage loans with markups between 2% and 2.25% saw an average markup reduction of around 0.55 percentage points. In contrast, for mortgage loans with initial markups above 3%, the average decrease was even greater than a full percentage point. In turn, for loans with initial markups below 2%, the reduction is more moderate – roughly 0.3 percentage points on average.

Markups on around half of all outstanding mortgage loans in Latvia still exceed 2%. They are much higher than average markups on new mortgage loans and can possibly be reduced through loan refinancing. However, most of these loans have a relatively small outstanding principal which reduces the potential benefit in absolute terms.

Nevertheless, almost one in four relatively large mortgage loans has a markup exceeding 2% (Charts 1.11 and 1.12). Thus, a significant share of mortgage borrowers may still have a financial incentive to consider refinancing their mortgage loan.

Chart 1.11

Breakdown of markups on mortgage loans with outstanding balances above EUR 50 000
(%; by loan value)

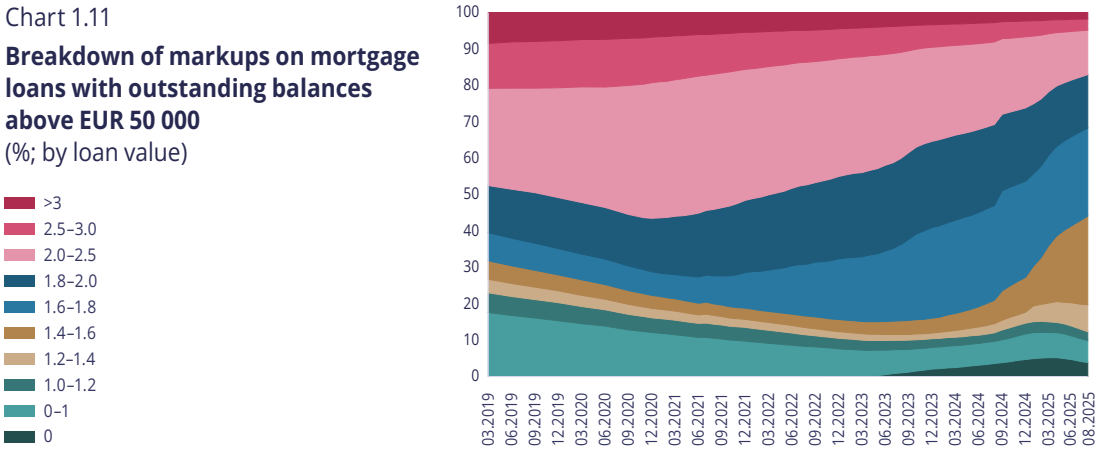
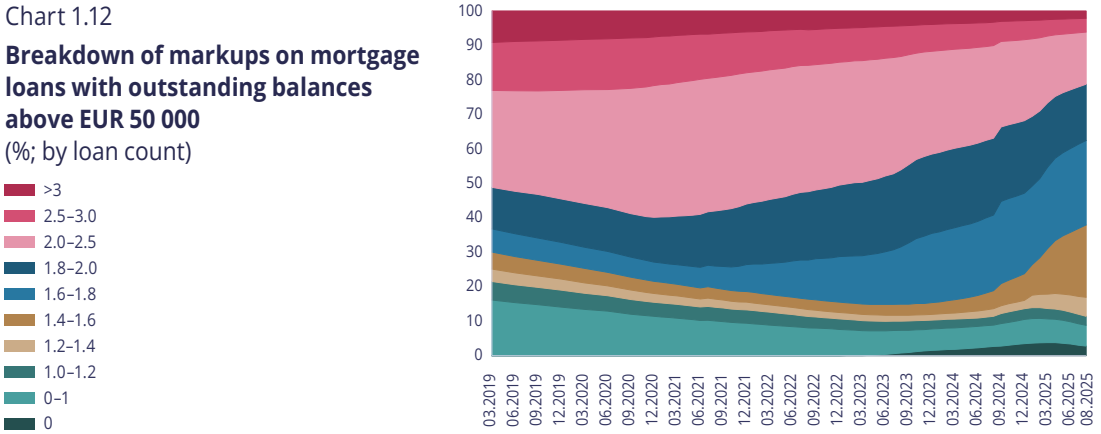


Chart 1.12

Breakdown of markups on mortgage loans with outstanding balances above EUR 50 000
(%; by loan count)

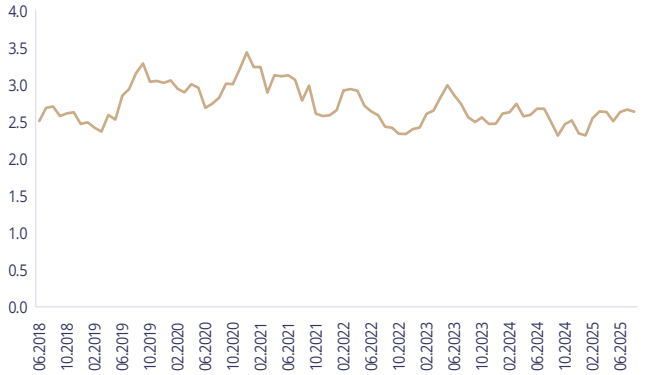


Source: Credit Register of Latvijas Banka, Latvijas Banka's calculations.
Note. Active mortgage-secured loans in euro with variable/mixed interest rates issued by banks to resident households.

Corporate lending has also experienced a rapid increase in activity, but it is not driven by lower markups. Unlike in the mortgage loan segment, markups on corporate loans have declined only slightly and have remained fairly stable over the past eight years, mostly ranging from around 2.5% to 3.0% (Chart 1.13).

Chart 1.13

Markups on new loans to non-financial corporations
(%)

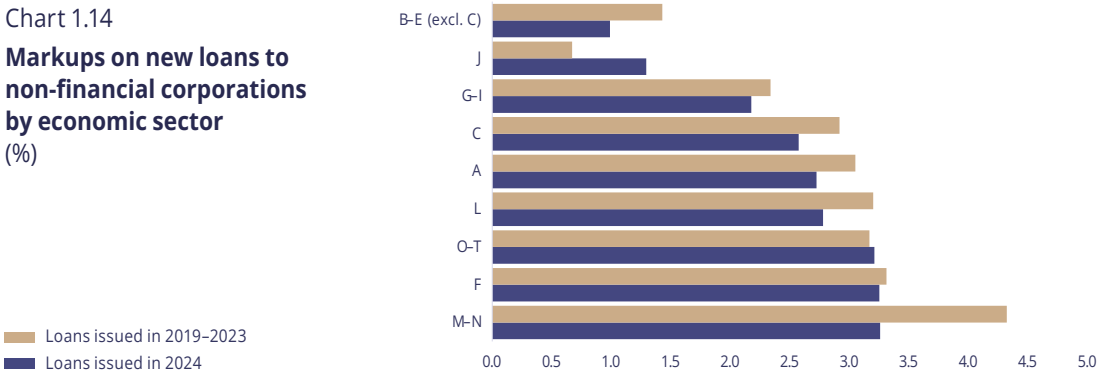


Source: Credit Register of Latvijas Banka, Latvijas Banka's calculations.

Markups on loans to non-financial corporations differ across economic sectors. For example, in the industrial sector (excluding manufacturing (B–E, excluding C) [4]), the average markup on loans issued since January 2024 is only 1.4%. Meanwhile, it exceeded 3.2% in the sectors of professional, scientific, and technical activities and administrative and support service activities (M–N; Chart 1.14). The wide variation in markups across economic sectors has been quite persistent.

Chart 1.14

Markups on new loans to non-financial corporations by economic sector
(%)



Source: Credit Register of Latvijas Banka, Latvijas Banka's calculations.

Markups also vary considerably among lenders. While the variation has narrowed over the past couple of years, significant differences in average markups remain even among major lenders, particularly for loans issued to small and medium-sized enterprises. The wide variation in interest rates for both borrowers and lenders may, in turn, point to segmentation in corporate lending – the specialisation of lenders in certain loan segments, such as by business sector or size.

Evidence of segmentation in corporate lending is also provided by the analysis conducted by Latvijas Banka. The key factor determining the level of markups on loans to non-financial corporations is the credit institution issuing the loan (Table 1.1). The loan issuer fixed-effect accounts for 26% of the variation in markups, making it a far more significant factor than the sector or size of the borrower or even the type and maturity of the loan. These results suggest that the availability of competing offers for Latvian companies is more limited than it may seem, bearing in mind the relatively large number of credit institutions in Latvia.

[4] Hereinafter, sectors are denoted by the letter codes of the NACE Rev. 2 classification.

Table 1.1. **Factors explaining the variation in markups on corporate loans in Latvia between Q1 2024 and Q1 2025**

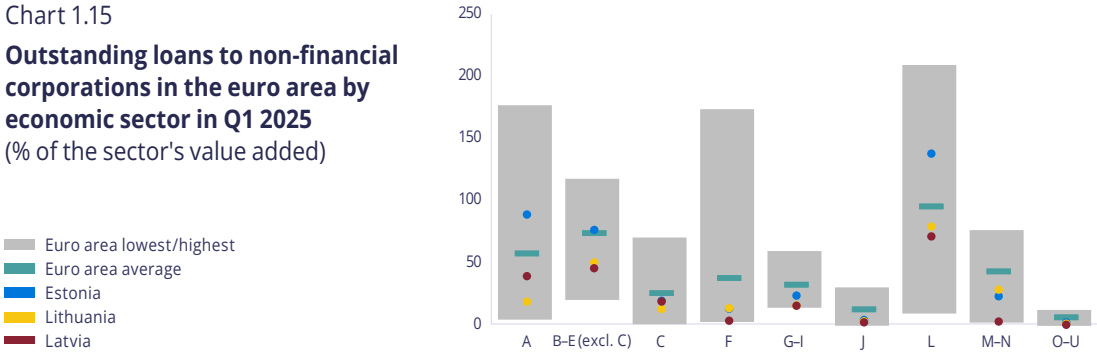
Explanatory variables	Dominance statistics	Rank
Loan issuer	26 %	1
Type of interest rate (fixed/variable)	9 %	2
Borrower's sector	6 %	3
Type of loan	5 %	4
Volume of loan	5 %	5
Company size	5 %	6
Loan maturity	3 %	7
Year of loan issuance	1 %	8
Real estate collateral (yes/no)	1 %	9
Total (R^2)	**60 %**	

Sources: Credit Register of Latvijas Banka, Latvijas Banka's calculations.
Notes. Dominance statistics reflect how much of the variation in markups is determined by a given factor. Together, the factors included in the analysis account for 60% of the variation in markups.

Segmentation is also reflected in the relatively limited lending activity across several economic sectors. While lending activity in Latvia remains below the euro area average across all sectors of the economy, it is the lowest in the euro area in several sectors – construction (F), wholesale and retail trade, transportation and storage, and accommodation and food service activities (G–I), professional, scientific, and technical activities and administrative and support service activities (M–N) (Chart 1.15).

Chart 1.15

Outstanding loans to non-financial corporations in the euro area by economic sector in Q1 2025
(% of the sector's value added)



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

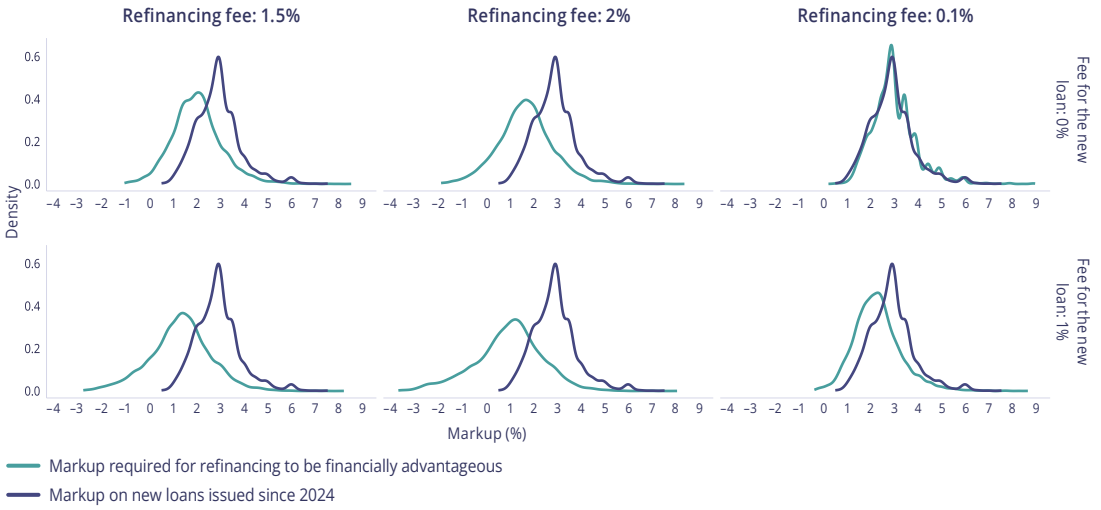
One way to reduce segmentation and strengthen competition in the corporate lending segment is to facilitate borrower mobility and lower barriers to refinancing. Companies seeking to refinance a loan must take into account not only the fee for issuing a new loan (typically 1% of the loan amount), but also the fee for early repayment, approximately 1.5–2% of the outstanding loan. These substantial fees greatly reduce the motivation of companies to refinance their loans.

According to the Credit Register of Latvijas Banka, only a small number of companies with loans of five-year maturity or more and at least one year remaining until maturity would benefit financially from refinancing (factoring in early repayment and payment of a 1.5–2.0% fee). For refinancing to be advantageous, markup reduction would generally need to be far greater than typically observed in lending practice (Chart 1.16).

If the fee for early repayment is reduced to 0.1% and the fee for issuing the new loan remains at 1% of the loan amount, refinancing becomes attractive for a broader set of companies.

Chart 1.16

Loans by markup on loans to non-financial corporations in Latvia and by markup required for refinancing to be financially advantageous
(%)



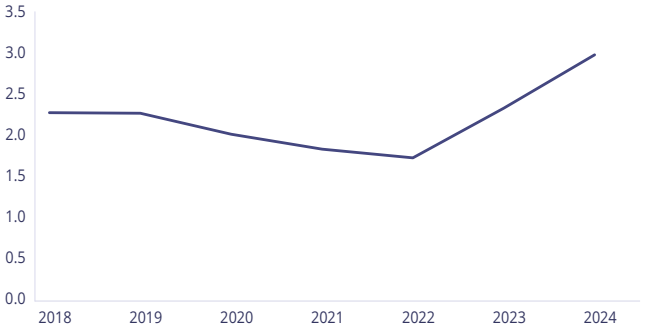
Source: Credit Register of Latvijas Banka, Latvijas Banka's calculations.

Thus, the fee for early repayment has a significant impact on refinancing activity. According to a survey conducted by Latvijas Banka in 2024, credit institutions base this fee on various direct and indirect costs incurred when companies repay the loan early and refinance it with another credit institution. The responses provided by credit institutions show that the majority of total costs are indirect costs associated with cost of funding. However, Latvian credit institutions mostly cover their financing needs from the deposits of domestic non-financial corporations and households. Deposits represent roughly 80% of the liabilities of credit institutions, equity accounts for around 13% (see Box 1 for capital requirements), and the other liabilities make up the rest. This means that the cost of financing for credit institutions is also closely tied to deposit costs.

While deposit rates have risen in recent years, especially for longer maturities, they have on average been the lowest in the euro area and well below the central bank deposit facility rate and money market rates. As a result, credit institutions benefit from relatively low costs of attracting funds (Chart 1.17). If loans are repaid early, they can reinvest the funds in low-risk assets (such as the central bank's deposit facility or government bonds) that offer yields above the costs of attracting funds.

Chart 1.17

Estimates of the weighted average cost of funding for credit institutions
(%)



Source: Latvijas Banka's calculations.
Notes. The calculations are based on the financial information from the FINREP and COREP consolidated reports. Quarterly averages are used for each year. The required return on equity is assumed to be 15% per year.

Non-bank lenders attract funds in other ways, including through loans from credit institutions. Thus, in case of early repayment, non-bank lenders not only have the opportunity to reinvest funds in other types of assets, but also to repay their own borrowed funds ahead of schedule.

Meanwhile, the direct labour costs associated with early loan repayment are essentially similar to those incurred when a loan is repaid at the contractual maturity. The refinancing process entails more actions to be performed than in the case of early repayment, so the application of fees can be objectively justified by the need to cover costs. An objectively justified fee could be calculated by dividing the direct costs (according to credit institutions – on average EUR 140) by the average outstanding loans (including leasing, revolving loans, overdrafts, and credit facilities) to non-financial corporations, which, according to the Credit Register of Latvijas Banka, stand at EUR 109 thousand. Excluding leasing, revolving loans, overdrafts, and credit facilities, the average outstanding loans to non-financial corporations amount to EUR 462 thousand. Thus, an objectively justified fee for refinancing would range between 0.03% and 0.13% of the outstanding loan.

Reducing refinancing costs by prohibiting or limiting the possibility of applying a fee for early repayment or refinancing with another lender that exceeds 0.1% of the outstanding loan or lease (except in cases of fixed-rate agreements) would enhance customer mobility and competition among credit institutions. This, in turn, would encourage credit institutions to develop solutions for non-financial corporations and bring down the high interest rates on loans.

Box 1. Minimum capital requirements and credit risk models for credit institutions

Minimum capital requirements for credit institutions are an important tool in ensuring the stability of the financial system and protecting the interests of depositors. Capital acts as a safety cushion that allows credit institutions to absorb losses during economic difficulties without compromising customer deposits. By maintaining a sufficient capital level, the credit institution mitigates its insolvency risk, thereby reducing potential threats to the entire financial system. Capital also strengthens the confidence of the investors and other financial market participants in the ability of credit institutions to fulfil their obligations.

Minimum capital requirements are closely linked with international financial regulations, such as the Basel banking supervision standards, which set uniform and secure operational standards worldwide and are introduced in the Capital Requirements Regulation and the Credit Institution Law.

- The total capital ratio must be at least 8% of the risk-weighted assets[5]. This requirement is divided into three levels: Common Equity Tier 1 (CET1) constitutes 4.5%, Additional Tier 1 – 1.5 %, and Tier 2 – 2%.
- Credit institutions must comply with additional requirements or buffers that provide extra protection: a capital conservation buffer of 2.5% of risk-weighted assets, a countercyclical capital buffer of 1% in Latvia in 2025, as well as a capital buffer of a systemically important institution applicable to systemically important credit institutions.

In Latvia, the minimum total capital requirement for major credit institutions reaches 13.5% of risk-weighted assets in 2025, while it may be slightly lower for smaller credit institutions or branches of foreign credit institutions. In Latvia, compliance with capital requirements is supervised by Latvijas Banka and the ECB.

Two main approaches are used to calculate the credit risk capital requirements of credit institutions: the standardised approach (SB) and the advanced internal ratings-based approach (IRB). The SB is simpler, more conservative, and suitable for smaller credit institutions.

[5] Risk-weighted assets (RWA) represent the value of a credit institution's assets adjusted for risk. For example, a loan to the government may be considered a 0% risk asset, while a corporate loan may be subject to a 100% risk weight. Thus, the minimum capital requirement is expressed as a percentage of those RWAs.

It determines risk weights based on the type of exposure. In turn, the IRB approach requires credit institutions to model their own risk parameters based on historical data. This approach uses indicators such as probability of default (PD), loss given default (LGD), and exposure at default (EAD). While credit institutions calculate these parameters internally, the use of the IRB approach for the calculation of capital requirements must be authorised by the supervisory authority – either Latvijas Banka or the ECB.

Table 1.2 illustrates how capital requirements are calculated under both approaches, using a EUR 200 000 mortgage loan as an example.

Table 1.2. **Illustrative calculation of capital requirements under the SB and IRB approaches for a EUR 200 000 mortgage loan**

	SB	IRB
Loan amount (EAD)	EUR 200 000	EUR 200 000
PD	—	0.5 %
LGD	—	15 %
Risk weights	20% (LTV < 50%)	Calculated using parameters: PD × LGD × 12.5
Risk-weighted assets (RWA)	200 000 × 0.20 = EUR 40 000	0.5% × 15% × 12.5 × 200 000 = EUR 18 750
Capital requirement (8% of RWA)	40 000 × 0.08 = **EUR 3 200**	18 750 × 0.08 = **EUR 1 500**

Source: Latvijas Banka's calculations.
Note. The calculation is simplified and is intended for illustrative purposes only.

This stylised example shows that the IRB approach, which uses more accurate and data-driven assessments, can lead to significant reductions in capital requirements. It is important to note, however, that the introduction of the IRB approach is much more complex and costly.

The IRB modelling process involves several important stages. Data on customer behaviour, delays, and recoveries must be collected and prepared. Data quality is ensured by checking their completeness, accuracy, and consistency. This is followed by the development of models using statistical methods. The models must comply with the Capital Requirements Regulation and the regulatory technical standards governing the assessment procedures for PD and LGD. The next stage involves model validation, including by external experts. During the validation, statistical performance is assessed, e.g. by comparing the forecasted PD with the actual delays. Additionally, back-testing and stress testing are conducted. Once implemented, the IRB models are subject to ongoing monitoring. Credit institutions must assess model performance at least once a year. If significant changes are identified in the macroeconomic environment or the portfolio, models must be recalibrated. Model management falls under the competence of the credit institution, and the supervisory authorities only respond to actions or requests from the credit institution.

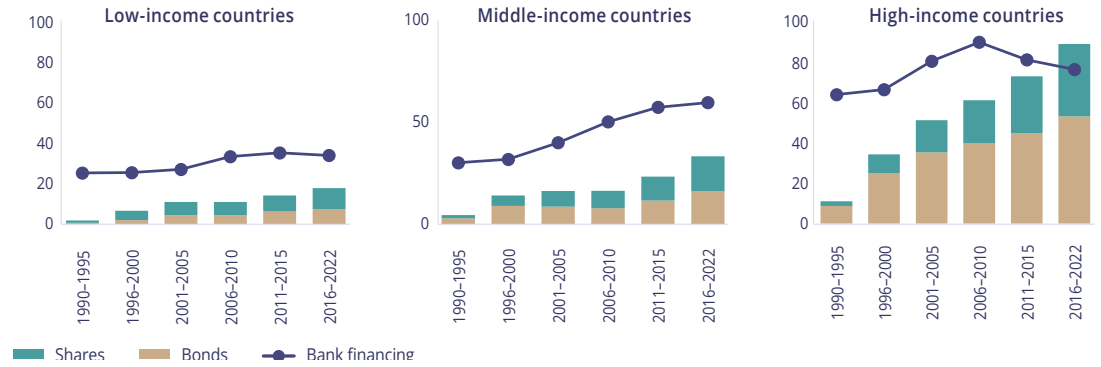
Consequently, the choice of the modelling approach depends on whether the benefits of implementing the IRB method outweigh the costs of creating, maintaining, and developing these models.

2. Non-bank financial intermediation

A well-functioning non-bank sector and capital markets are important drivers of economic growth, contributing to a more efficient allocation of financial resources towards productive investment. The conclusions of international institutions also confirm the close link between a country's prosperity and the level of its capital markets development (Chart 2.1). The role of Latvia's non-bank sector in financial intermediation remains relatively limited, with the results of a business survey conducted by Latvijas Banka in 2025 suggesting that companies continue to rely largely on internal reserves or bank loans. To facilitate further progress of the Latvian economy towards high-income status, a faster and broader development of the financial sector is necessary.

Chart 2.1

Outstanding credit institution loans to the private sector, net issuance of equities and bonds
(% of GDP)

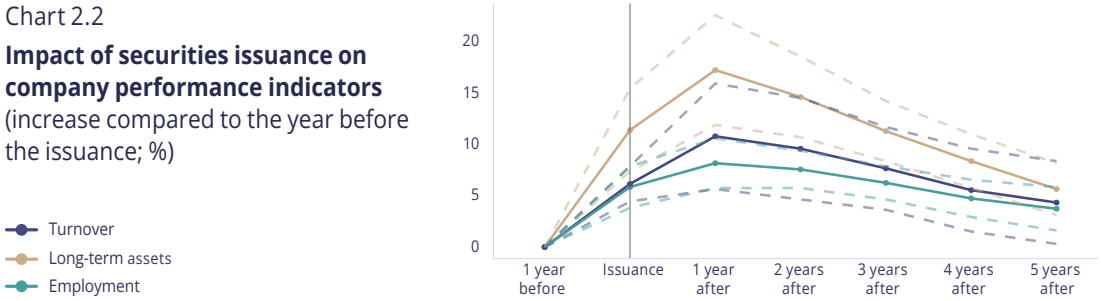


Source: World Bank.

Capital markets provide companies with broader financing opportunities, often offering lower interest rates, longer maturities, and more flexible conditions than traditional credit institutions. This aspect is particularly important for stimulating investment, as Latvia is still lagging behind not only the EU average but also Lithuania and Estonia in this area. The World Bank calculations based on individual company data suggest that raising finance through the capital market contributes to turnover and employment growth, and, most importantly, to investment in long-term assets (Chart 2.2)[6].

Chart 2.2

Impact of securities issuance on company performance indicators
(increase compared to the year before the issuance; %)



Source: World Bank.
Note. Estimates are obtained using a local projections approach, where the dataset includes 147 companies from various countries since 1990, and where changes in company indicators are explained by the dummy variables for securities issuance, as well as for the company, country, time, and industry fixed effects. The dashed lines represent a 95% confidence interval

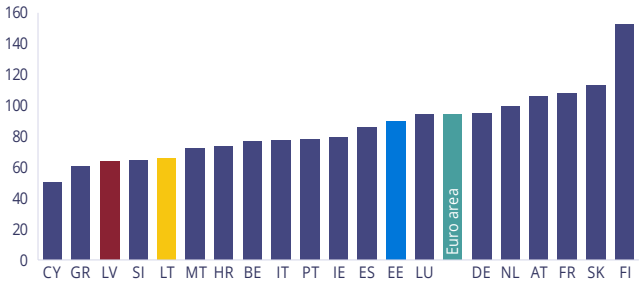
Sufficient savings by local non-financial corporations and households, which can be channelled into investments, are an essential prerequisite for fostering the development of the capital market. Several indicators indirectly suggest that such potential exists in Latvia. For example, the loan-to-deposit ratio in Latvia's credit institution sector is only 64%, which is one of the lowest in the euro area (about 94% on

[6] Financing Firm Growth: The Role of Capital Markets in Low- and Middle-Income Countries, International Bank for Reconstruction and Development / The World Bank, International Finance Corporation Research Series, 2025.

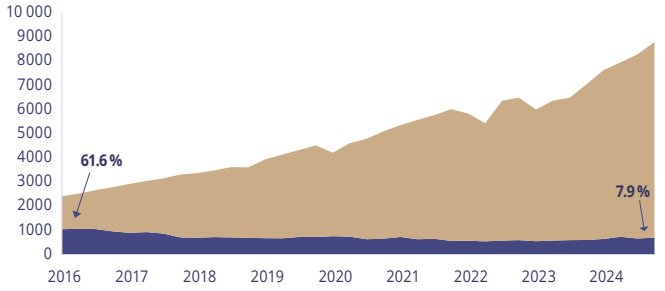
average; Chart 2.3). This indicates that a large share of funds deposited with Latvian credit institutions is not actively used to finance the economy. One solution to improve the situation is to mobilise these funds through local capital market instruments.

Chart 2.3

Loan-to-deposit ratio in the credit institutions of the euro area
(%; Q2 2025)



Latvia's 2nd pension pillar investments in Latvia and the rest of the world
(millions of euro)



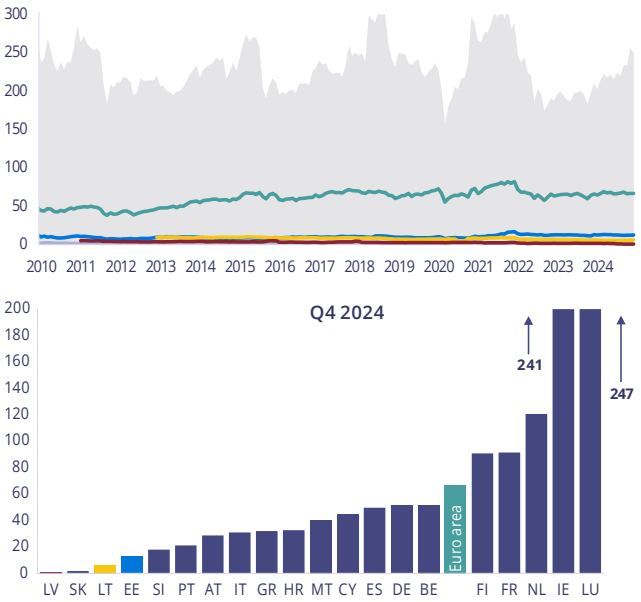
Sources: ECB, Latvijas Banka, Lietuvos bankas, Eesti Pank.
Data are compiled by the country of registration of the investment instrument (fund domicile or securities issuer), rather than by the location of the underlying assets.

Latvia's 2nd pension pillar savings have also increased significantly over the past 15 years, but their share of investment in assets in Latvia has declined sharply (from 61.6% in 2010 to just 7.9% in 2024). This is much lower than the level of investment by Lithuanian and Estonian pension funds in their local markets (22.9% and 12.0 % respectively). These data show that available savings are sufficient, and experience from neighbouring countries indicates that a proportionally higher share could be redirected to the local capital market.

The underdevelopment of the Latvian capital market is due not only to the lack of demand from investors, but also to limited supply. The potential of the capital market as an alternative source of financing is not being fully exploited. For example, the outstanding value of companies' quoted shares was the lowest in the euro area at the end of 2024 (Chart 2.4). The situation was further aggravated by AS Latvijas Gāze's decision to remove its shares from the Baltic Secondary List.

Chart 2.4

Outstanding value of quoted shares of companies in the euro area
(% of GDP)



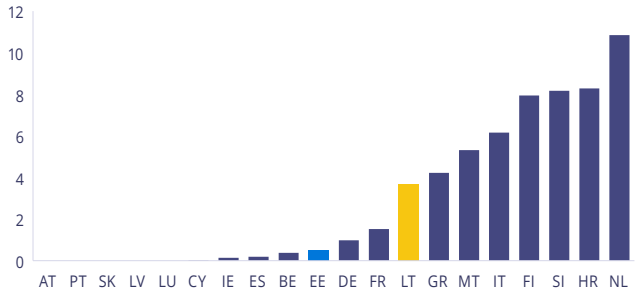
Sources: ECB, Eurostat., Latvijas Banka's calculation.

The presence of state-owned enterprises on the stock exchange is also essential, as it provides market size and liquidity, attracts foreign investors, and creates opportunities for local investors to invest capital in local companies.

However, the shares of Latvian state-owned enterprises – unlike those of several other euro area companies – are currently not listed on the stock exchange (Chart 2.5). Listing state-owned enterprises on the stock exchange also contributes to greater transparency in their governance. International institutions point out that state-owned enterprises often operate in strategic sectors – energy, infrastructure, and utilities – and that these market segments display oligopolistic, or sometimes even monopolistic, characteristics, which justify the need for high governance standards[7].

Chart 2.5

Market capitalisation of state-owned enterprises with shares in public circulation in euro area countries, June 2025
(% of GDP in 2024)

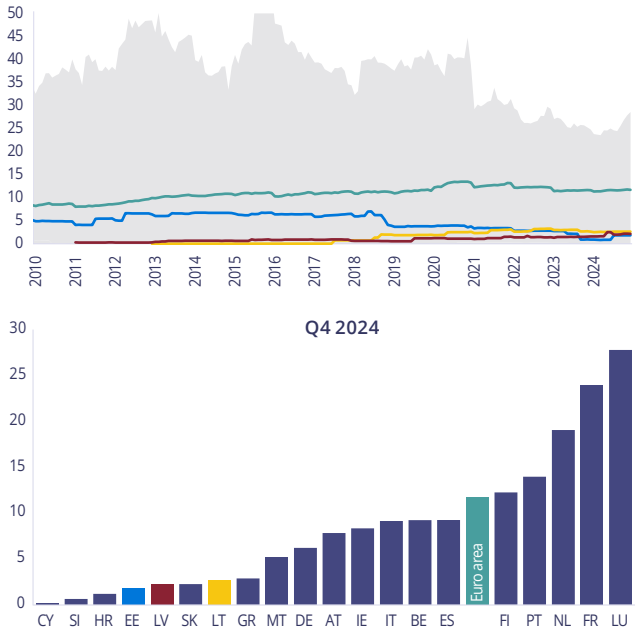


Sources: Eurostat, LSEG, Latvijas Banka's calculation.
Note. An enterprise is classified as a public enterprise if the public sector holds at least 25% of its total voting capital.

In contrast to the stagnation of the stock market, the bond market in Latvia shows more positive trends. At the beginning of 2020, the nominal outstanding amount of bonds issued by non-financial corporations stood at 1.2% of GDP and had already reached 2.2% by the end of 2024. Latvia is closer to Lithuania and Estonia in this segment, although it still lags significantly behind the euro area average, which typically hovers around 11% (Chart 2.6).

Chart 2.6

Nominal outstanding value of bonds issued by non-financial corporations
(% of GDP)



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

Bond issues offer several advantages: longer maturities, less restrictive collateral requirements, and the ability to raise funds when credit institutions are cautious and unwilling to provide financing. However, the further development of this market segment is hindered by several factors, including the high cost of

[7] See OECD and World Bank reports on the participation of state-owned enterprises in the capital market and the impact this has on their management (Broadening the Ownership of State-Owned Enterprises, OECD, 4 February 2016; Listing State-Owned Enterprises In Emerging And Developing Economies, World Bank, 2021).

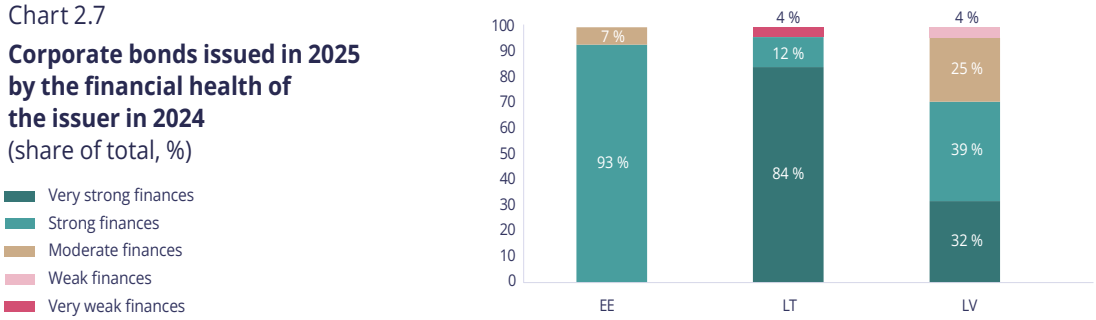
issuance. The cost of issuing bonds in Latvia is around 2% of the issue, whereas in other parts of the euro area, it rarely exceeds 1%. This is partly due to the relatively small size of typical bond issues in Latvia.

Support for addressing this situation is already available through the EU funding programme developed by the Ministry of Economics, which offers co-financing of up to 50% of the costs associated with preparing the issue: up to EUR 120 000 for bond issues and up to EUR 200 000 for share issues. The programme conditions for 2025 were relaxed in the first half of the year, and several companies have already benefited from the available support. However, the total funding – EUR 1.41 million from the ERDF and EUR 0.25 million from the state budget – is limited and may soon be exhausted. In the first months of the renewed programme, two issuances have already been made, using approximately EUR 0.16 million.

The conditions for bond issues do not always fully reflect the associated risk levels. In addition, bond interest rates in Latvia are high compared with the yields on Latvian government bonds of similar maturity and are sometimes nearly identical for companies with varying financial positions. This insufficient differentiation of risks signals limits market depth and does not inspire confidence in the pricing efficiency of this segment of the capital market. As a result, companies with strong financial health and a lower risk profile more often refrain from issuing bonds, instead relying on internal funds and loans from credit institutions, or seeking financing opportunities abroad (Chart 2.7).

Chart 2.7

Corporate bonds issued in 2025 by the financial health of the issuer in 2024
(share of total, %)



Sources: Nasdaq, Latvijas Banka's calculations.
Note. The classification of the financial position takes into account the interest coverage ratio, the debt-to-equity ratio, and the profit-to-turnover ratio. Each ratio is assessed as follows: interest coverage ratio <1.0 = weak, up to 3.0 = medium, >3.0 = strong; debt-to-equity ratio >4.0 or negative = weak, >1.5 = medium, <1.5 = strong; negative profit-to-turnover ratio = weak, <5 % = medium, >5 % = strong. Strong, medium, and weak levels are assigned 1, 2, and 3 points respectively; the interpretation of the sum of the three indicators is as follows: 3 = very strong, 4–5 = strong, 6 = medium, 7–8 = weak, 9 = very weak financial position. Companies in sectors K and L that did not operate in 2024 are excluded from the analysis of the financial position.

Latvia also has a very underdeveloped market for mortgage-backed securities (MBS), which are widely used by lenders in other countries to raise funds for lending. In a traditional securitisation process, the lender sells part of its loan portfolio to a special purpose vehicle, which groups these loans by risk level and uses them as collateral to issue debt securities with varying risk levels.[8] They are purchased by investors, although part of the issuance can also be retained by the lender on its balance sheet. Such instruments are popular worldwide, including across Europe and play a key role in financial markets.

Converting loans into tradable securities allows the lender to obtain new financing for the loans sold while simultaneously reducing the credit risk on its balance sheet, thereby freeing up capital that would otherwise need to be held against those assets. The released capital can, in turn, be used to grant new loans.

The EU securitisation market is relatively small – at around 3% of GDP (AMFE data for the first quarter of 2025). It is concentrated mainly in France, Italy, the Netherlands, and Germany, although it also plays an important role in smaller economies such as Ireland and Belgium. Securitisation can contribute to the diversification of investment financing models and the deepening of the capital market in Europe. However, its development requires improved regulation, the removal of other barriers, and potentially also greater involvement of public financial institutions in MBS issues, either directly or indirectly through credit guarantees.

[8] In addition to the traditional approach, there is also synthetic securitisation (the lender does not sell the loans but transfers the credit risk to investors through financial guarantees or derivatives).

The US securitisation market is much larger – at around 50% of GDP. This is due to the central role of state- and government-sponsored institutions (mainly Fannie Mae and Freddie Mac). These institutions purchase mortgage loans from bank and non-bank lenders, pool them into portfolios, and issue MBS that are sold to investors. Importantly, these loans and their originators must meet certain criteria (e.g. loan size, loan-to-collateral ratio, borrower's debt-to-income ratio, and borrower's creditworthiness, etc.) to ensure the standardisation of loans intended for securitisation, while also influencing industry lending standards. In addition, the guarantees provided by these institutions make MBS safe and attractive to investors (with credit ratings close to those of US government securities). This, in turn, encourages investment in the US housing market by investors who face regulatory or risk-related constraints. Overall, the activities of government-backed institutions increase liquidity in the secondary housing market, lower borrowing costs for households, improve mortgage accessibility, and support securitisation and capital market activity.

Experience from the US is not directly transferable to Europe or Latvia, and it should not be, due to the potential risks involved. However, a certain level of state involvement in the securitisation process, with a public financial institution playing a key role, may be one possible solution to facilitate the development of securitisation and capital markets in European countries. At the same time, the 2007 sub-prime mortgage crisis in the United States, which evolved into a global financial crisis and required substantial state support for both government-sponsored institutions and the broader financial market, highlights the need to carefully assess the design of programmes involving state participation and guarantees, as well as the proportionate assumption of potential risks.

Securitisation in Latvia could be beneficial in several ways. First, for lenders that do not have access to, or sufficient levels of, domestic deposit funding, opportunities to raise external financing in Latvia are limited and considerably more expensive. By selling part of their loan portfolios, lenders could obtain new financing while simultaneously freeing up capital for new loans. Second, securitisation could increase the availability of high-quality financial assets in Latvia (including for institutional investors) and provide alternatives for the placement of excess savings.

However, certain preconditions are necessary for the securitisation market to develop in Latvia.

1. Lenders' interest in securitising part of their loan portfolios.

Such interest may arise among credit institutions and other lenders whose mortgage lending is constrained by capital requirements or high funding costs. At the same time, their ability to issue MBS independently is limited by the small size of their mortgage portfolios and the fixed costs associated with issuance of securities. Unlike, for example, covered bonds, non-bank sector participants can also take part in this form of securitisation.

2. Involvement of a public financial institution.

The challenges related to the small mortgage portfolios of individual lenders and the high issuance costs could be partly addressed through the involvement of a public financial institution. By establishing a dedicated programme, a public institution could, under specific criteria and at a defined price, purchase mortgage loans from lenders and use them as underlying assets to issue MBS. Under such a programme, it is essential to clearly define the criteria (which loans qualify and at what price) and to provide initial funding for its launch.

3. Investor demand for MBS.

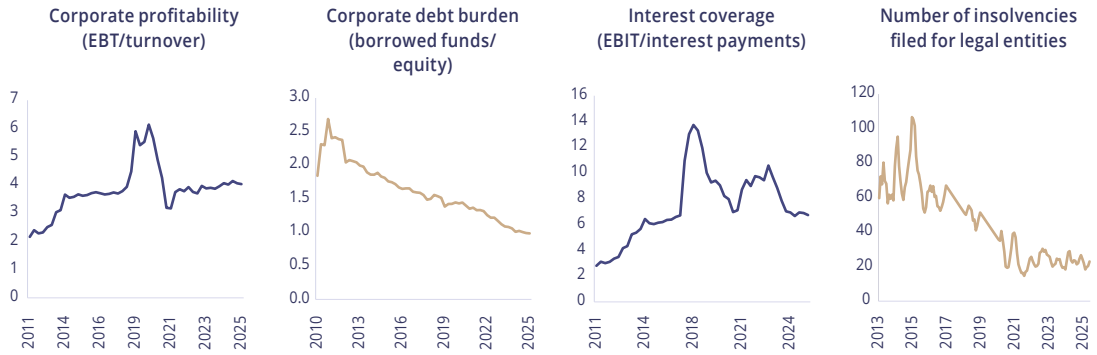
The involvement of a public institution could stimulate interest among local and international investors. Among local investors, Latvian pension funds, which currently have limited opportunities to invest in the domestic economy, could play a significant role given their considerable potential: the assets of the 2nd pension pillar funds reached EUR 8.8 billion at the end of 2024.

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

The dynamics of indicators characterising the financial health of Latvian companies remain positive (Chart 3.1). Corporate profitability has been stable, which in turn has strengthened companies' equity positions. As a result, at the end of 2024, the equity of Latvian companies exceeded their debt for the first time in more than 15 years. The overall debt servicing capacity of companies has declined in recent years, albeit remaining largely at healthy levels, and is expected to improve further in an environment of lower interest rates. The financial health of companies is also reflected in the relatively low number of insolvencies filed for legal entities, which, despite geopolitical and economic shocks, remains at a historically low level.

Chart 3.1

Indicators characterising the financial health of Latvian companies



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

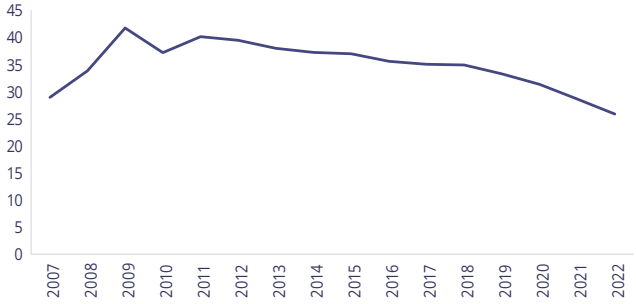
Although the overall situation is improving, the financial health of a large proportion of Latvian companies remains weak. This is reflected in the high share of companies with negative equity. The largest share of such companies was recorded in 2009, when more than 40% of all Latvian companies had negative equity.

Equity is an essential component of a company's balance sheet, representing the amount of money that would be returned to the company's owners if all its assets were sold and all its debts paid. Negative equity indicates that a company does not have sufficient assets to cover all its liabilities; in the long term, such a company is unlikely to be financially viable. Companies with negative equity are directly limited in their ability to attract external financing, and their prevalence also creates a negative perception of the business environment in Latvia, which, in turn, also adversely affects companies with strong financial health.

However, there are at least four reasons to suggest that the problem of companies with negative equity in Latvia may be overstated. First, the share of companies with negative equity has decreased significantly over the last 15 years, particularly since 2016. Around 35% of Latvian companies had negative equity in 2016, but by 2022, this share had fallen to just 25% of all Latvian companies (Chart 3.2).

Chart 3.2

Share of Latvian companies with negative equity
(%)



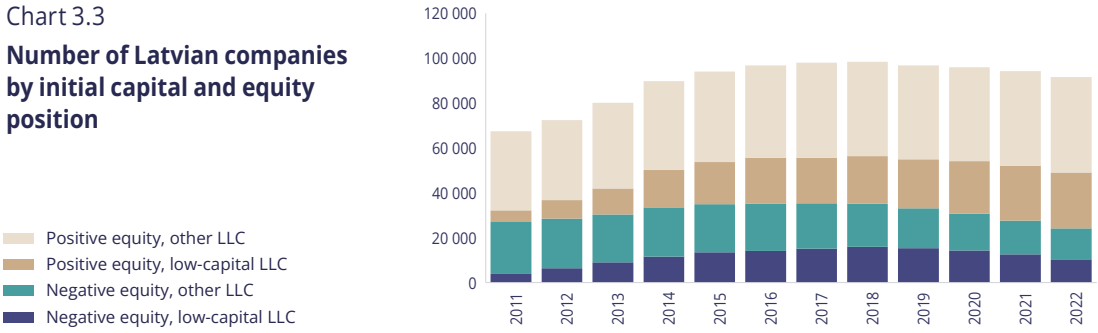
Sources: CSB, SRS, Latvijas Banka's calculations.

Second, by sector, the highest share of companies with negative equity is found in service-oriented sectors with relatively low productivity. For example, in accommodation and food service activities, almost one in two companies operates with negative equity. A similar situation is observed in several other service sectors. In addition, companies in these sectors tend to have relatively few long-term assets, which reduces the need for investments and lending. As a result, the negative equity side-effects are more limited than for companies in sectors with a high share of long-term assets.

Third, almost 42% of all companies with negative equity are companies with low initial capital. Since May 2010, it has been possible, in Latvia, to establish companies with small initial capital – even starting from EUR 1, which is significantly lower than the standard requirement of EUR 2800. This measure was introduced to promote entrepreneurship in the aftermath of the global financial crisis and also led to a sharp increase in the number of companies. However, with the rise in the total number of companies, the number of companies with negative equity also increased (Chart 3.3). This effect is mechanical: even small losses can reduce the equity of a company with an initial capital of EUR 1 to a negative level. Therefore, the higher share of companies with negative equity following the global financial crisis was largely due to the emergence of a new type of business – low-capital companies – rather than a general deterioration in the financial health of companies.

Chart 3.3

Number of Latvian companies by initial capital and equity position



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

Fourth, companies with negative equity play a relatively minor role in the Latvian economy. In 2021, companies with negative equity accounted for around 15% of total employment, while the total number of hours worked in these companies represented less than 10% of all hours worked (Chart 3.4). This suggests that these companies more frequently employ part-time employees. Moreover, their contribution to total turnover and value added is even lower (Chart 3.5).

Chart 3.4

Share of employment and hours worked in Latvian companies with negative equity
(%)

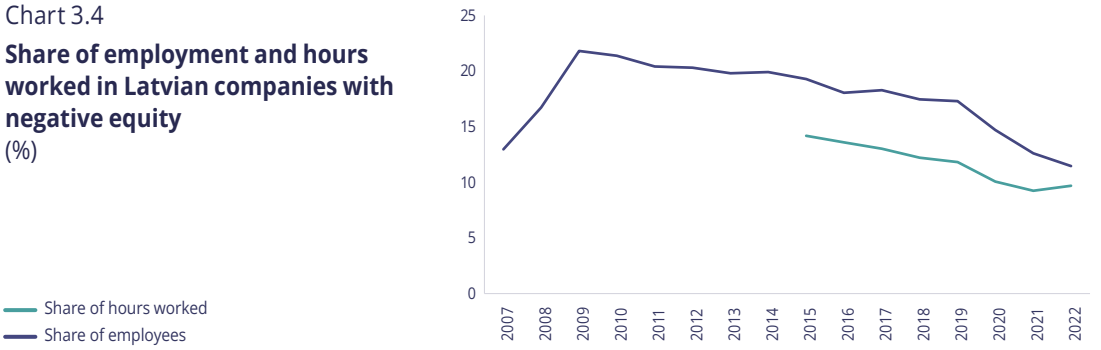


Chart 3.5

Share of turnover and value added in Latvian companies with negative equity
(%)

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

Consequently, while companies with negative equity represent a significant share of all companies in Latvia, their role in the economy is relatively limited. Moreover, the financial difficulties of these companies tend to be temporary. An analysis carried out by Latvijas Banka shows that equity becomes negative for about one in three companies during their first year of operation, and for one in two companies within the first five years of operation (Chart 3.6). Companies with low initial capital are particularly at risk. At the same time, the capitalisation problems of companies are often temporary, with around one third of companies whose equity turns negative recovering within the next five years (Chart 3.7).

Chart 3.6

Estimated probability that a company will have negative equity
(%)

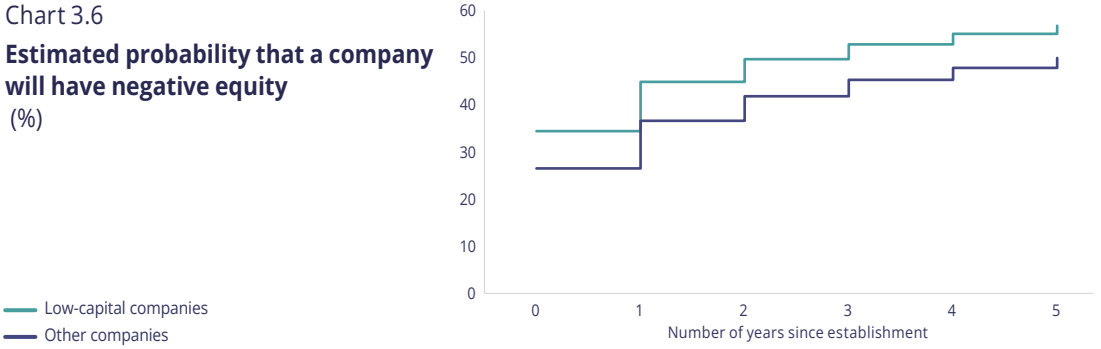
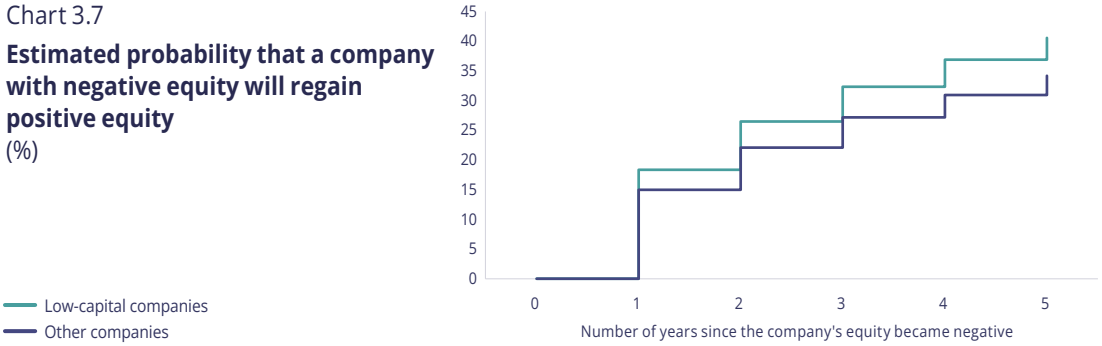


Chart 3.7

Estimated probability that a company with negative equity will regain positive equity
(%)

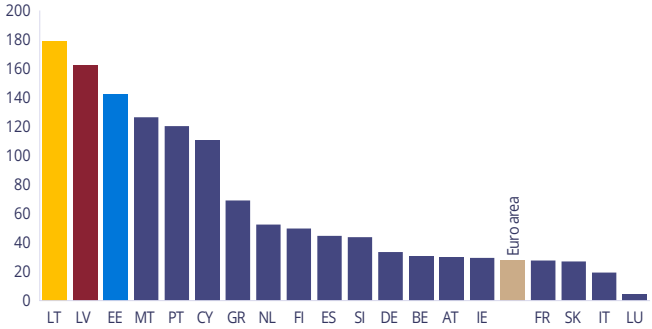


Sources: CSB, SRS, Latvijas Banka's calculations.

Although the financial situation of companies has improved significantly since the global financial crisis, lenders continue to apply relatively tight lending conditions, including high collateral requirements. In 2024, the average collateral value for loans granted to non-financial corporations in Latvia stood at 162% of the loan amount. The situation is similar in Lithuania and Estonia, whereas in the rest of the euro area, lenders' collateral requirements are much lower on average, standing at only 28% of the loan amount (Chart 3.8).

Chart 3.8

Average collateral value for new loans issued to non-financial corporations in euro area countries in 2024
(% of the loan amount)



Sources: AnaCredit, Latvijas Banka's calculations.

Latvia and Lithuania also have by far the largest share of loans with very high collateral values (Chart 3.9). Approximately one third of all loans granted to non-financial corporations in Latvia and Lithuania in 2024 had a collateral value of at least twice the loan amount. Although the practice of requiring such high collateral has become less common in both countries over the past few years (Chart 3.10), it remains considerably more prevalent than in other euro area countries.

Chart 3.9

Breakdown of collateral value for new loans issued to non-financial corporations in euro area countries in 2024
(% of the loan amount)

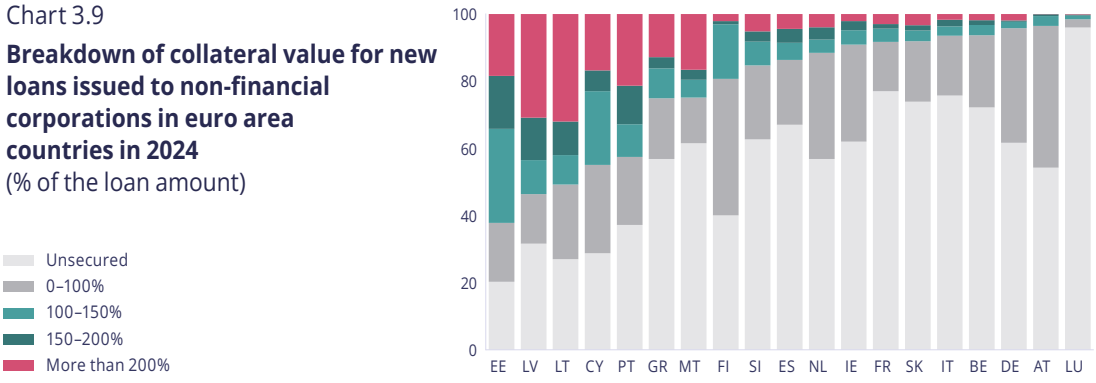
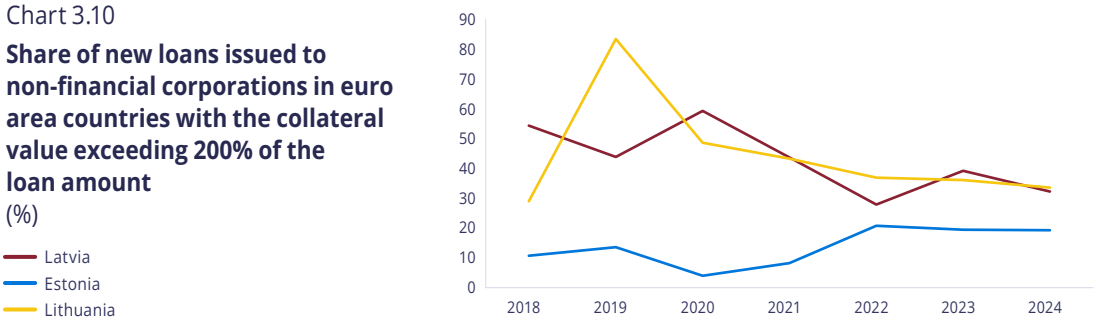


Chart 3.10

Share of new loans issued to non-financial corporations in euro area countries with the collateral value exceeding 200% of the loan amount
(%)

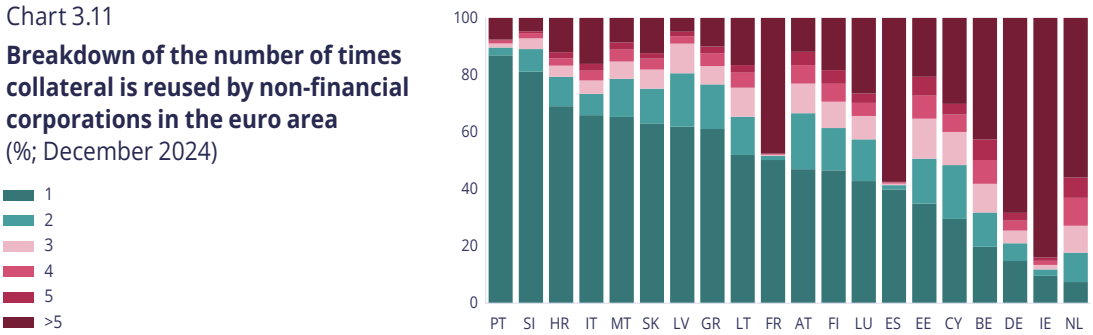


Sources: AnaCredit, Latvijas Banka's calculations.

In Latvia, loans are also more frequently secured with multiple collaterals than in other euro area countries. Moreover, this practice is not due to the reuse of the same collateral for different loans. In Latvia, almost two thirds of the collateral used for loans is dedicated to a single loan (Chart 3.11). In most other euro area countries, the use of a single collateral for multiple loans is much more common.

Chart 3.11

Breakdown of the number of times collateral is reused by non-financial corporations in the euro area
(%; December 2024)



Sources: AnaCredit, Latvijas Banka's calculations.

The stringent collateral requirements in Latvia may be due to differences in loan structures and borrower profiles. To assess the significance of these factors, a regression analysis was performed:

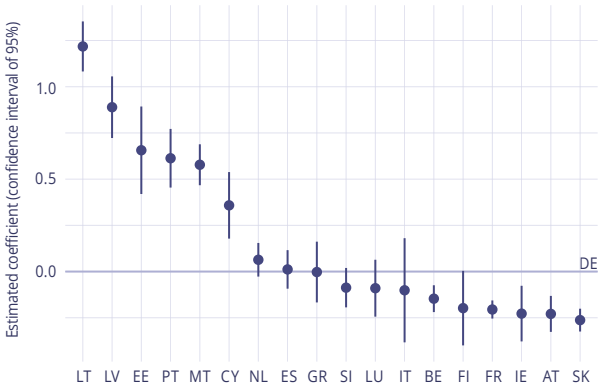
$$\frac{N}{K_{i,c}} = \partial_j X_{j,i,c} + \mu_c + \varepsilon_{i,c},$$

where $\frac{N}{K_{i,c}}$ is the collateral-to-loan ratio for loan i originated in country c, and $X_{j,i,c}$ represents the set of factors $\boldsymbol{j}$ that may affect the collateral amount, including the sector and size of the company, as well as the type and maturity of the loan. ∂_j are the regression coefficients of the relevant variables, $\varepsilon_{i,c}$, is the regression error, while μ_c represents the estimated country effect, which shows how the collateral-to-loan ratio for identical loans varies across countries.

The estimated country effect confirms that lenders' collateral requirements in Latvia are among the strictest in the euro area (Chart 3.12), surpassed only by Lithuania. The estimated coefficient indicates that the collateral requirements for a company in Latvia will be about 100 percentage points of the loan amount higher than those for comparable companies with similar needs in Slovenia, Germany, the Netherlands, and most other euro area countries. For example, if companies in these countries are required to provide collateral amounting to 50% of the loan amount, the requirement in Latvia would be 150%.

Chart 3.12

Estimated country effect
(impact on the collateral-to-loan ratio in 2024; in percentage points)

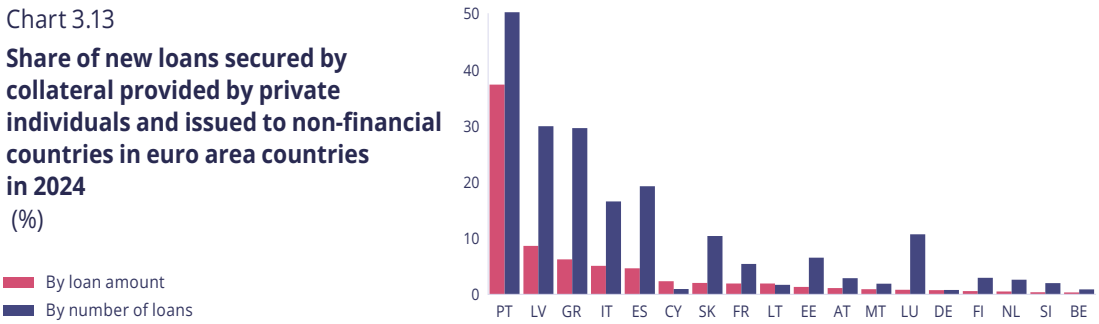


Sources: AnaCredit, Latvijas Banka's calculations.
Note. The fixed effects of the countries are normalised vis-à-vis Germany (German effect = 0); the coefficients for the other countries indicate deviations from Germany.

In Latvia, it is also relatively common to use collateral provided by private individuals (e.g. owners or managers). In 2024, around 30% of loans (by number) and 9% of loans (by volume) granted to non-financial corporations were secured by collateral provided by private individuals (Chart 3.13). This practice is much less common in Lithuania and Estonia. Only a few southern European countries (Portugal, Greece, Italy, and Spain) have a high share of loans secured by collateral provided by private individuals, the use of which is regulated by law. In these countries, such collateral is often the primary – and sometimes the only – form of security, fully covering the loan only in some cases.

Chart 3.13

Share of new loans secured by collateral provided by private individuals and issued to non-financial countries in euro area countries in 2024
(%)



Sources: AnaCredit, Latvijas Banka's calculations.

Requiring private individuals (e.g. owners or board members) to provide collateral for corporate loans is an important factor limiting lending. Essentially, this practice links the risks associated with business activity to the assets of a private individual, thereby undermining the principle of limited liability.

In 2024, almost all credit institutions in Latvia issued corporate loans secured by collateral provided by private individuals, although the prevalence of such loans varies widely among lenders. For some credit institutions, these loans represent as much as 20–50% of all loans (by volume) granted to non-financial corporations, while for the majority, they do not exceed 10%.

Collateral provided by private individuals is much more common for loans granted to relatively small companies (Chart 3.14). For small and very small companies (micro-companies), 23% and 13% of all loans granted in 2024 were secured by collateral provided by private individuals, while only 2% of loans were secured for large companies. Small and medium-sized companies also had, on average, higher overall collateral coverage than large companies (Chart 3.15).

Chart 3.14

Share of new loans secured by collateral provided by private individuals and issued to non-financial corporations in Latvia in 2024
(%; by company size)

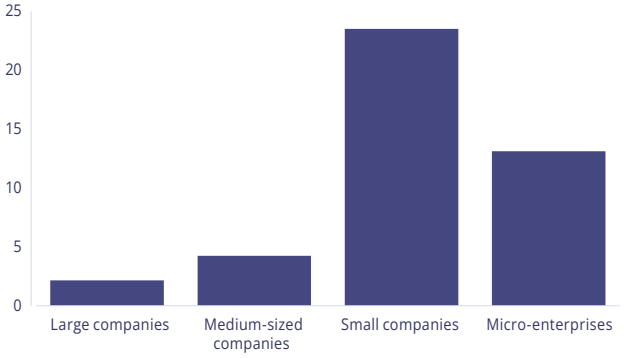
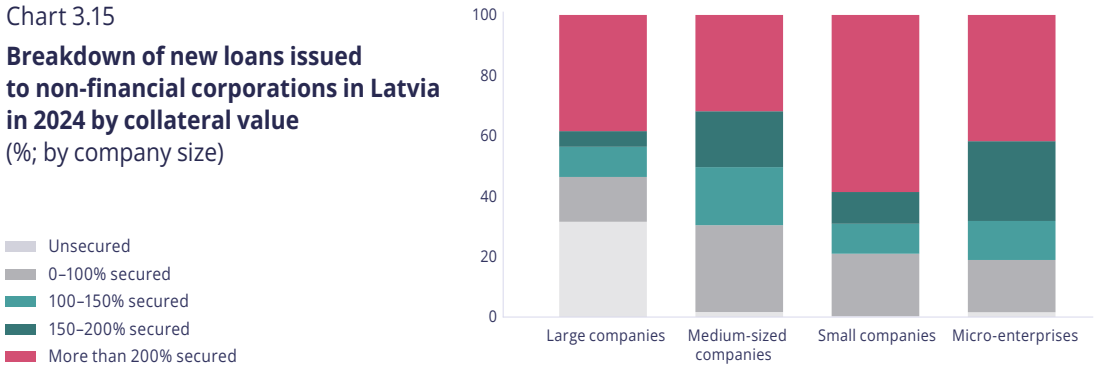


Chart 3.15

Breakdown of new loans issued to non-financial corporations in Latvia in 2024 by collateral value
(%; by company size)



Sources: AnaCredit, Latvijas Banka's calculations.

Therefore, it can be concluded that, in Latvia, despite improvements in the financial situation of companies, lenders' collateral requirements remain very strict. This limits lending activity in the corporate segment. Business surveys provide further evidence of this. The results of a business survey conducted by Latvijas

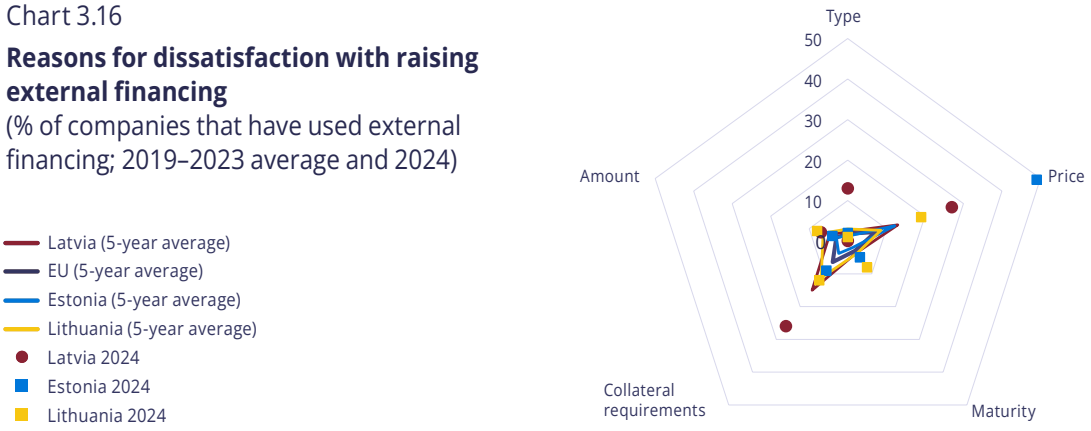
Banka in 2025 show that lenders' collateral requirements are not only one of the most common reasons for loan refusals, but also a reason why companies in need of external financing do not apply for loans.

Moreover, even among companies that have been able to attract external financing, collateral requirements are one of the main sources of dissatisfaction. A survey conducted by the European Investment Bank shows that, in Latvia, 26% of companies that obtained external financing were dissatisfied with the lender's collateral requirements (Chart 3.16). In Lithuania and Estonia, the shares of such companies were 12% and 9% respectively.

Chart 3.16

Reasons for dissatisfaction with raising external financing

(% of companies that have used external financing; 2019–2023 average and 2024)



Source: EIB Investment Survey Country Overview.

Solutions to steer collateral requirements towards a healthy balance should therefore be supported, both by protecting creditors from losses resulting from borrower insolvency and by avoiding the discouragement of financially healthy companies from seeking loans.

One possible solution is for public authorities to provide an independent assessment of a company's financial situation, which could serve as a reference for creditors and the companies themselves regarding their financial health. This could reduce the caution exercised by companies when applying for loans. For lenders, it would also lower the administrative costs associated with granting a loan. In other euro area countries, this function is performed by the national central banks. For example, the Deutsche Bundesbank offers companies a free assessment that includes a comparison of final credit ratings and financial indicators within the relevant sector. Such an analysis is often not feasible for companies, especially SMEs, using their own resources. Even for large companies, obtaining an independent and comparable external credit rating is a complex and costly process.[9]

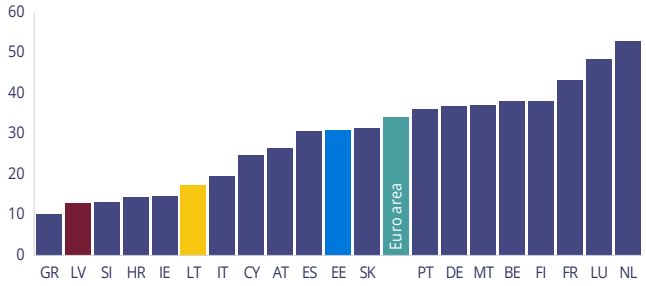
[9] It is important to note that the central bank credit rating system cannot be used for calculating the capital adequacy of commercial banks and therefore does not replace Internal Ratings-Based (IRB) approaches to credit risk assessment or the assessments made by credit rating agencies.

4. Financial health of households and demand for external financing

In Latvia, housing lending is the second lowest in euro area countries. In the second quarter of 2025, outstanding housing loans (mortgage loans and unsecured housing loans) issued to Latvian households was just shy of 13% of GDP (Chart 4.1). In Lithuania and Estonia, housing lending was much more active – 17% and 31% of GDP, respectively, while the euro area average was almost three times higher.

Chart 4.1

Outstanding housing loans to households in euro area countries Q2 2025
(% of GDP)



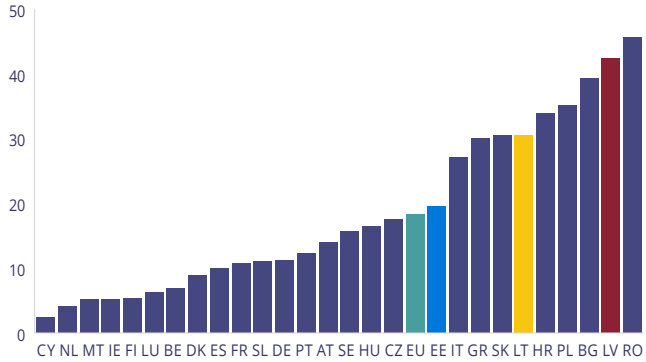
Sources: ECB Balance Sheet Items (BSI), Eurostat.

The comparatively low level of outstanding housing loans in Latvia provides evidence of several structural deficiencies, including a rigid loan financing mechanism (see Chapter 2).[10] In Latvia, the number of financial intermediaries that would allow borrowers to more proactively learn about their options and compare the offerings of various lenders is minimal (for more detail on the loan market architecture, see here). However, slow housing lending in Latvia is also attributable to the structure of the housing market, including a comparatively small size and the modest quality of housing.

Latvia has one of the highest overcrowding levels in the EU, ranking second, just behind Romania (Chart 4.2). Approximately 40% of the Latvian population live in housing that is considered overcrowded.[11] Moreover, this phenomenon affects not only socially vulnerable groups – high rates are also observed among the working age population and even quite well-off households (Charts 4.3 and 4.4).

Chart 4.2

Share of inhabitants living in overcrowded homes, excluding single person households, 2024
(%; all inhabitants)



[10] In Latvia, regions exhibit significant differences in financing activity. It is expected that in the near future these divergences will shrink due to the launch of the Altum programme "Loans for the purchase of housing in regions".

[11] A home is considered overcrowded if the household does not have: at least one room for the household; one room for each couple living in the household; one room for each person aged 18 years and older; one room per two same gender persons aged 12 to 17; one room for each person aged 12 to 17 who is not a part of the above categories; one room per two children younger than 12.

Chart 4.3

Share of inhabitants living in overcrowded homes, excluding single person households, 2024
(%; inhabitants aged 18 to 64)

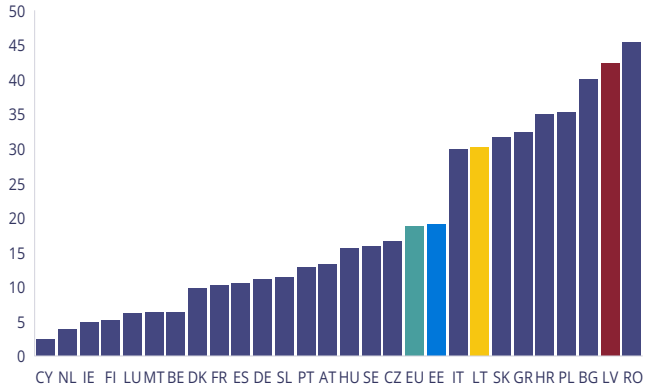
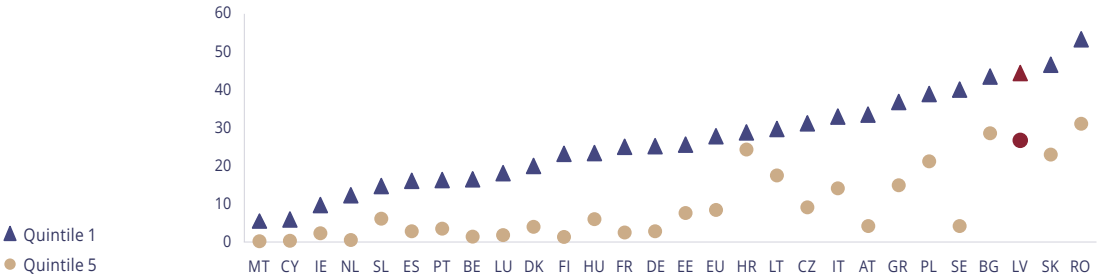


Chart 4.4

Share of inhabitants living in overcrowded homes, excluding single person households, 2024
(%; by income quintile)



Source: Eurostat.

Other indicators also confirm that residential units in Latvia are much smaller than the EU average. The number of rooms per inhabitant of Latvia is approximately a third smaller than the EU average (Chart 4.5); the average size of dwellings is also significantly smaller (Chart 4.6). In 2023, the average floor space of a dwelling in the EU was approximately 103 m^2 and had 1.7 rooms per inhabitant. While in Latvia, the average floor space of a dwelling was 81 m^2 and had 1.2 rooms per inhabitant.

Chart 4.5

Average number of rooms per household member, 2023

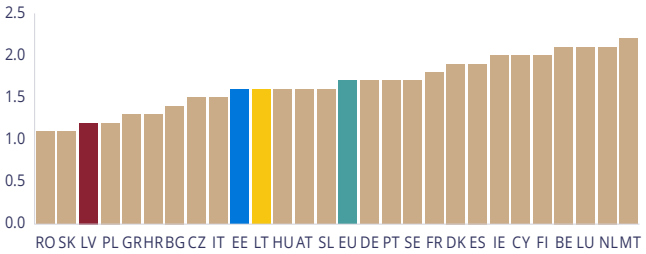
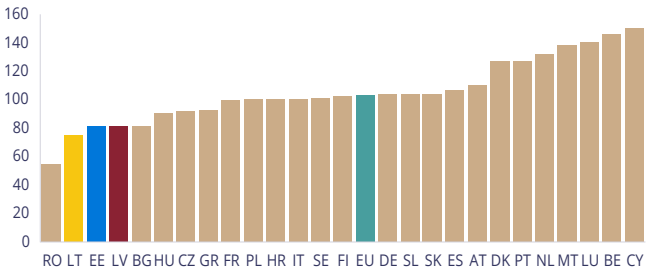


Chart 4.6

Average home size, 2023
(m^2)



Source: Eurostat.

These differences from the rest of the EU can be observed across all income groups – irrespective of their income level, on average, inhabitants of Latvia live in smaller living spaces than the rest of the EU. When it comes to households that have purchased or built their living space by taking a mortgage loan, Latvia

also significantly lags behind the EU average. In 2023, the average size of a living unit for persons with a mortgage loan in Latvia was 95.6 m², while in the EU – 126.2 m² (Charts 4.7 and 4.8).

Chart 4.7

Average housing floor space for inhabitants with a mortgage loan, 2023
(m²)

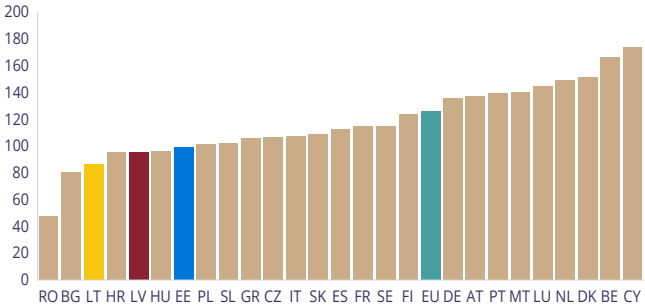
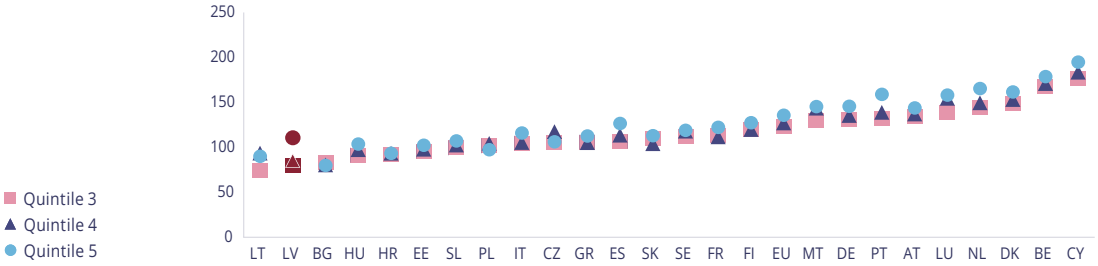


Chart 4.8

Average housing floor space for inhabitants with a mortgage loan, 2023
(m²; by income quintile)



Source: Eurostat.

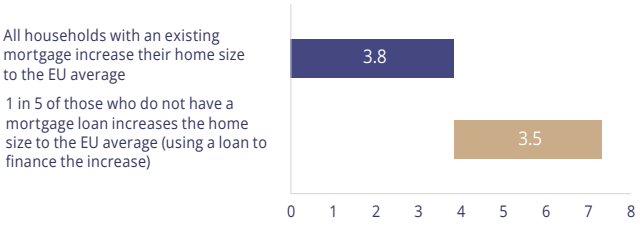
Most probably, the small size of dwellings is attributable to the structure of the housing stock and the large share of residential units built during the Soviet occupation. However, the price of mortgage loans also significantly affects the size of available housing. According to the calculations of Latvijas Banka, reduction of the mortgage rate by 1 percentage point for the average income group increases the maximum affordable space in a new building by approximately 6 m², while in standard design buildings the increase reaches 18 m².

Since joining the euro area in 2014, mortgage rates in Latvia have been 1–2 percentage points higher than in the euro area on average. This fundamentally limited the maximum value of a mortgage, and, as a result, the size of a residential unit. In the near future, the situation could improve as a result of lower markups and extended refinancing options (see Chapter 1) that give some households an opportunity to increase the size of their living space.

A transition to a larger average living space in Latvia would also be reflected in higher mortgage lending activity. Simplified calculations demonstrate that if all mortgage borrowers in Latvia increased the size of their dwelling to the average EU level, the total outstanding mortgage loans would increase by approximately one third, or 4% of GDP (Chart 4.9). Moreover, if only one in five inhabitants who currently do not have a mortgage loan would take the same action, outstanding mortgage loans would increase by at least another 3.5% of GDP.

Chart 4.9

Estimates of the increase in outstanding mortgage loans in Latvia in various scenarios
(% of GDP)



Sources: Eurostat, calculations of Latvijas Banka.
Note. A simplified assumption was made, i.e. the costs of increasing the floor space by one square metre equals the outstanding mortgage loans per one square metre. Thus, the results of the analysis are on the conservative side.

Significant improvements can also be achieved by modernising current residential units. In Latvia, approximately 80% of all dwellings with district heating were constructed before 2000, with most having yet to be renovated or retrofitted to improve energy efficiency (Chart 4.10). In these buildings, heat consumption is 3.5 times higher than the acceptable threshold for new buildings (Chart 4.11). As a result, their inhabitants have much higher heating costs, undermining their living conditions and creating an additional financial burden.

Chart 4.10

Housing structure in Latvia
(% of all residential units receiving heat from an external supplier)

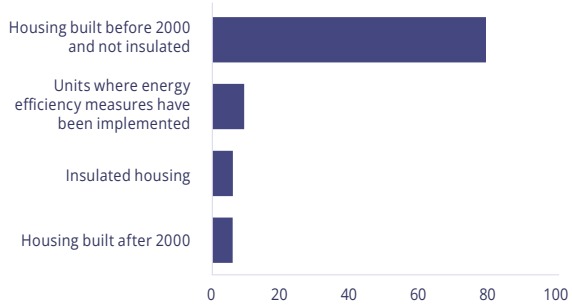
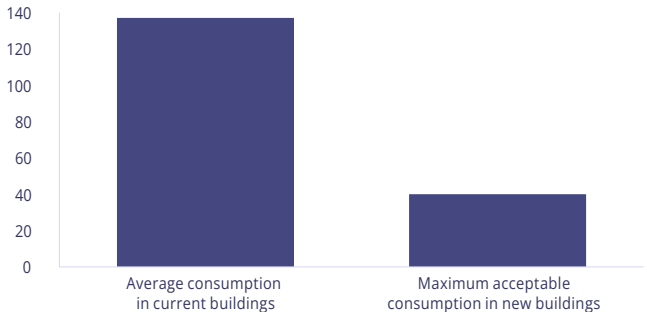


Chart 4.11

Current and acceptable heat consumption in residential blocks
(kWh/m^2 year)



Sources: CSB, Latvijas Banka's calculations.

Several solutions that contribute to improved energy efficiency in these units are currently being implemented. One of the most important is the insulation programme for residential blocks administered by Altum and available since 2016. This programme is financed by the EU Recovery and Resilience Facility – the co-financing rate is 40–50% of the renovation costs. The financing is available for buildings, where more than half of the apartment owners agree to renovate, do not have large utility debts, and have a potential of cutting heat consumption by at least 30%.

With this programme, residents can not only significantly reduce their heating costs but also improve the quality of their homes and living comfort. However, irrespective of state support, residents still incur costs for the renovation: in 2023, the average cost per square metre after state support amounted to EUR 161, which the participants of the programme generally covered with loans. Thus, the economic benefit of the renovation is at least partially offset by financial commitments.

However, calculations by Latvijas Banka (Box 2) demonstrate that the benefits of renovations are statistically much higher than the related costs. Assuming that the benefits (e.g. lower heating costs, renovated façades, etc.) and costs (e.g. loan payments) are fully included in the real estate market prices, it can be concluded that apartments in renovated buildings are on average 9–10% more expensive than similar apartments in buildings that have not undergone renovations. Moreover, a positive correlation between the amount of energy efficiency gains and the higher value of apartments can also be observed – in buildings where heat consumption has been cut by more than 60%, apartment prices are 19.1% higher than in similar apartments in unrenovated buildings.

Box 2 Does the insulation of buildings increase the real estate value?

Using data from the Altum database, which contains information on buildings in Latvia renovated for energy efficiency purposes, and data from the NĪTIS database, which records real estate market transactions, it is possible to assess the impact of building insulation on market prices of corresponding apartments. A regression analysis is used to compare the transaction price of otherwise almost identical apartments in renovated and unrenovated buildings, making it possible to assess the value increase resulting from a building's renovation.

$$ln(y_i) = \beta_0 + \theta r_i + \sum_{j=1}^{7} \beta_j factor(X_{j,i}) + \varepsilon_i$$

where:

- y_i – transaction price of the apartment i per m², in EUR;
- r_i – binary variable equal to 1, if the apartment i is located in a renovated building, otherwise 0;
- X_j – vector j of other factors inherent to the apartment i (number of rooms, the floor on which the apartment is located, the year and quarter of the transaction, the postal code, the number of floors in the building where the apartment is located, the decade the building was commissioned).

The regression coefficient θ shows the difference (in %) in prices of apartments in renovated buildings and the prices of otherwise identical apartments in unrenovated buildings. The analysis only includes transactions with apartments in standard design apartment blocks commissioned from 1950 to 1999.

The results indicate that apartment prices in renovated buildings are on average 10.4% higher than the prices of otherwise identical apartments in unrenovated buildings (Column 1, Table 4.1). Moreover, the higher the increase in the energy efficiency of the building, the higher the increase in price (Column 2). For example, in buildings where heat consumption decreased by at least 60% after the renovation, the price of apartments per square metre is 19.1% higher than the price of apartments in unrenovated buildings.

In addition to changes in the real estate prices, the owners of apartments in renovated buildings also benefit from reduced heating bills. However, the renovation is also not free and, quite often, results in higher management costs. To account for these additional benefits and costs, the present value of savings from lower heating bills are also included in the apartment prices, and the present value of loan payments are subtracted from them. The results (Column 3) demonstrate that, having taken into account these considerations, the renovation of a building increases the value for apartment owners by 9.3%.

Table 4.1 **Impact of renovation on real estate prices. Results of a regression analysis**

	(1)	(2)	(3)
Renovation	0.104*** (0.014)		0.093*** (0.014)
Reduction in heat consumption (30–45%)		0.075*** (0.019)	
Reduction in heat consumption (45–60%)		0.133*** (0.021)	
Reduction in heat consumption (>60%)		0.191*** (0.065)	
Number of observations	40 829	40 829	40 829

Sources: Calculations of Altum, NĪTIS, and Latvijas Banka.
Notes. *p<0.1; **p<0.05; ***p<0.01

The financial gains of renovation are affected both by construction costs, and the level of heating costs. The higher the heating costs, the higher the financial benefit to homeowners from energy efficiency gains, and the higher the market value of apartments in renovated buildings. This is confirmed by the calculations of Latvijas Banka: the price difference between the renovated and unrenovated real estate increased after

the dramatic increase of energy prices in 2021. At the same time, as construction costs increase, the relative appeal of apartments in renovated buildings decrease, as higher loan payments cut into the net gains.

As construction costs continue to increase, while the heating costs stabilise, the financial gains from building insulation decrease. In such circumstances, the policy instruments in place become ever more important. Currently, they focus on cutting construction costs – calculations by Latvijas Banka indicate that without state co-financing, the impact of building insulation on real estate pricing would be close to zero. Other solutions include facilitating insulation by increasing alternative costs that the residents incur, when buildings are poorly insulated, e.g. by linking the real estate tax rate to the energy performance of the building.

5. Conclusions

Financing activity in Latvia in 2024 and 2025 exhibits important signs of recovery – the amount of loans issued to both companies and households has increased, with the growth rate exceeding the GDP growth rate. At the same time, lending rates have also decreased not only due to lower EURIBOR rates, but also due to smaller markups, in particular in the mortgage segment. As a result of proposals submitted by Latvijas Banka and statutory amendments, refinancing mortgage loans has become significantly easier, improving the chances of borrowers to improve loan conditions and contributing to competition among lenders.

Irrespective of the positive dynamics, the lending level in Latvia is still significantly lagging behind the euro area average. To ensure sustained recovery, additional solutions that support financial intermediation and improve financing availability in all sectors of the economy are needed.

To facilitate the development of housing lending, the arrival of new market participants and the development of alternative financing sources are key. Extending refinancing opportunities helps to create a more competitive environment; however, the limited ability to secure financing for a reasonable price prevent many lenders from more active financing. To mitigate this problem, one solution is to expand the securitisation opportunities for mortgage loans in Latvia. Given that most Latvian lenders have relatively small mortgage portfolios, the involvement of public authorities to organise and coordinate the issuance of mortgage-backed securities is key.

Though the amount of issued corporate loans is increasing, borrowing conditions have not significantly improved. Unlike in the household segment, the markup rates have not noticeably decreased. To facilitate customer mobility and reduce lending segmentation, Latvijas Banka, in cooperation with the Ministry of Finance, has prepared a regulatory draft to limit commissions for the early repayment of loans.

Corporate lending is also hampered by the high collateral requirements of lenders, which significantly hinder corporate development and undermine competition in the lending market. To remove these barriers, a more balanced approach to collateral requirements should be promoted, as it would protect both the interests of lenders and business development. A potential solution is for public authorities to provide an independent assessment of the financial situation of companies – this could be a useful reference source for both lenders and companies on their financial health. This measure could enhance corporate awareness of available opportunities and stimulate loan applications, while also lowering the administrative burden for lenders.