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The Latvian Banking Crisis

Lessons Learned

Alex Fleming
Samuel Talley

Lessons from Latvia's banking crisis can be applied in other transition economies.

The World Bank
Europe and Central Asia
Country Department IV
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Summary findings

In the spring of 1995, Latvia experienced the largest banking crisis in the former Soviet Union to date, involving the loss of about 40 percent of the banking system's assets and liabilities. Fleming and Talley outline the Latvian authorities' strategy for developing the banking system and identify how and why it unraveled. They discuss the World Bank's role and the lessons to be learned from the crisis, including the following:

- Banking systems are exposed to stress in several major ways. Enterprises — the main borrowers — become subject to hard budget constraints (are cut off from government funds) and are privatized. Inflation declines so enterprises can't rely on rapidly increasing revenues to service bank debts. Economic reform tends to produce banking systems that are mainly privately owned — making them vulnerable to withdrawals, as the public does not assume that failing banks will be bailed out.
- The government must protect against this vulnerability by establishing a proper legal framework for banking, developing effective bank supervision and regulation, and implementing solid accounting, disclosure, and auditing standards. It must also develop effective ways to handle problem banks and to close insolvent banks promptly.
- For banks in the state sector to be a source of strength to the banking system, they must have strong effective management and be relatively free from political influence.
- "Outlier" banks — those expanding assets very quickly or offering particularly high deposit rates — should be subject to intense supervision.
- Four things must be done to prevent fraud, incompetent management, and excessive risk-taking: carefully screen those who want to get into banking; subject all banks to thorough, frequent onsite examinations and assign the best examiners to the largest banks; require annual audits of all banks by reputable auditing firms required to report significant irregularities to authorities; and act decisively when fraud or bank difficulties are detected or suspected.

This paper — a product of the Enterprise and Financial Sector Development Division, Europe and Central Asia, Country Department IV — is part of a larger effort in the region to distill the lessons of the first five years of transition. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Suzanne Coffey, room H6-298, telephone 202-473-2635, fax 202-522-0005, Internet address scoffey@worldbank.org. April 1996. (15 pages)

THE LATVIAN BANKING CRISIS: LESSONS LEARNED

by Alex Fleming and Samuel Talley[1]

February 1996

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THE LATVIAN BANKING CRISIS: LESSONS LEARNED

THE LATVIAN BANKING CRISIS: LESSONS LEARNED

By Alex Fleming and Samuel Talley[1]

Introduction

In the spring of 1995, Latvia experienced what has been the largest banking crisis in the Former Soviet Union (FSU) to date, involving the loss of about 40% of the assets and liabilities of the banking system. The crisis has had a traumatic affect on the banking system and on the public's confidence in banks at large. The real economic effect is gradually being felt and is being manifest in a slower rebound in production and economic growth than had been expected, and in a budget crisis with which it has become intricately woven. The political fall-out from the crisis has now been felt as the Latvian public, in the context of a general election at the end of September 1995, has reacted against the center parties that have been at the heart of power for the last three years by voting for parties at the left and right extremes of the political spectrum.

The purpose of this paper is to outline the Latvian authorities' strategy for developing the banking system and identify how and why this unraveled. In particular, the paper seeks to establish the causes of the banking crisis and describes how the authorities dealt with it. The role of the World Bank is also discussed while, in a concluding section, the broader lessons deriving from the Latvian experience are drawn out.

The Evolving Banking System and Government Strategy

In order to appreciate the nature of the banking crisis it is important to place it in the context of the evolving structure of the Latvian banking system and the authorities' strategy towards it. Some commentators have described Latvian strategy towards bank restructuring as completely market orientated or "big bang" in nature. This is not an entirely accurate description in many respects and it is important to distinguish policy towards the remnant of the state banking system from that towards the emerging private banking sector.

The remnant of the state banking system

When Latvia gained its independence in 1991, it was confronted with the same starting position as virtually all the other countries comprising the FSU. Specifically, it inherited branches of the same specialized Soviet banks as the other countries: the Savings Bank, the Industrial/Construction Bank, a Social Bank and an Agricultural Bank. These banks suddenly had their ties to, and guidance from, their former FSU-based head offices cut-off. Most of the FSU countries converted these branches into nationally-owned banks that continued their former specialization. However, with the exception of the Savings Bank, the Latvian Government decided to combine the 45 branches of these former Soviet banks and place them under the auspices of the Bank of Latvia.[2] This approach had its advantages and disadvantages. With regard to the advantages, it clearly allowed the Latvian Government to proceed on a bank restructuring strategy which had a very flexible departure point. It permitted the Government to consider a range of options: selling off all the branches to the emerging private sector; privatizing the branches individually or in groups; structuring one or more state banks; or a combination of these approaches. The disadvantage was that the Bank of Latvia did not play any type of governance role in the branches under its wing. Branch managers, therefore, felt no accountability towards the President of the Bank of Latvia or its directors. As a result, a significant amount of bad lending took place as branch managers followed a business-as-usual policy. An audit of the branches--undertaken with the support of the Swiss Government--determined that non-performing loans amounted to about Lat 25 million (US$50 million)[3].

In 1993, as the Government decided on a strategy for dealing with the remnant of the state banking sector, a dichotomy developed between its approach to enterprise privatization and that relating to the banking sector. The enterprise privatization began to grind to a halt, caught up in a bureaucratic process involving an unduly strong role for the line ministries that did not want to divest themselves of the enterprise "jewels". The bank privatization was, however, entrusted to a separate mechanism involving a Bank Privatization Committee comprising staff of the Ministry of Finance, Bank of Latvia, and Members of Parliament. This Committee had considerable latitude for decision making. In contrast to the enterprise privatization, decisions on dealing with the remnant were made very quickly.

It was decided to keep the Savings Bank in the public sector and submit it to considerable institutional development support (EU-Phare financed), and bring in new management prior to privatizing the bank in due course. The main remnant was dealt with in three ways. First, nine branches were sold to private commercial banks: one branch to Parex Bank; one to Olimpija Bank; and seven branches to Bank Baltija. Secondly, fifteen of the branches were consolidated into eight private banks and sold through offerings of shares. Finally, on September 28, 1993, the rump of 21 branches was structured into one state bank--the Universal Bank of Latvia, or Unibank--and subject to intense institutional development supported by the World Bank (Japanese grant), the Government of Switzerland, and the European Union (Phare). Most of the bad loans[4] were concentrated in the branches of this bank and these loans were taken off Unibank's books and replaced by Government bonds. The restructuring of this bank and its privatization is described more fully in Bereza and Fleming (forthcoming). One of the main reasons for constructing Unibank was to provide an insurance policy against catastrophic failures in the private banking sector.

The new commercial banks

Meanwhile, government policy towards the evolving commercial banking sector was driven primarily by Parliament's insistence that under the new market system any person or entity should have the right to establish a bank. As a result, the commercial banking law was very liberal on the establishment of banks. As in a number of other parts of the FSU, a plethora of banks emerged. By 1993 over sixty banks had been licensed. Some of them were pocket banks owned by state enterprises, some were purely private but were dedicated mainly to raising deposits to on-lend to the owners, and some were set up with specific functions in mind (Olympija Bank was set up to help finance the Latvian Olympic team). The incentive for establishing a bank was simply to gain access to a much cheaper source of funding than going to existing banking institutions. All of these private or quasi-private banks were allowed to develop with little supervision from the Bank of Latvia initially.

As can be seen from Table 1 below, the size of the new commercial banking sector in relation to the remainder of the state banking sector grew very rapidly over the period 1992-94. The number of new commercial banks grew to 59 by the end of December, 1993 while their new branches increased sharply. Between December 1992 and December 1994, the new commercial banking sector share of total assets grew from 47% to 85%. Credits granted by the banking system grew sharply over this period, with the new commercial banks accounting for 89% of the total by the end of 1994, from only 23% two years earlier.[5] By contrast, the portion of the banking system's capital held by the new commercial banks remained relatively constant over the 1992-1994 period, although the aggregate amount grew by a factor of 15.

The rise of Bank Baltija

Among the private banks that developed very quickly in 1993 and 1994 was Bank Baltija. It began very modestly but then grew substantially both in terms of assets and branches. Its assets grew from about US$25 million in January 1993, to US$242 million in January 1994, and then to almost US$500 million by early 1995. Bank Baltija became the largest Latvian commercial bank in terms of assets, own capital and deposit funding by 1994. The bank's own capital grew from about US$1 million in early 1993 to US$20 million in January 1994 and to US$44 million in January 1995. The bank had 37 branches and 49 offices throughout Latvia with 1,300 employees in total. In April 1995, when the banking crisis began, the bank had total deposits of US$392 million and a loan portfolio of US$283 million.

The bank's ownership was unclear from the beginning, but the perception was that it was largely Russian backed. There were nine main shareholders of the bank who owned 91% of total shares. Roughly 59% of the Bank Baltija shares were owned by the family of Alexander Lavent, Chairman of the bank's Supervisory Board (among Lavent's companies, several are Russian dominated and registered off-shore).

Bank Baltija adopted, from its inception, a strategy for development that was very different from other banks in Latvia. Its goal was to develop a large network of branches and to become a retail bank in competition with the Savings Bank. It offered very high interest rates on local currency (Latvian Lat) deposits--90% for one year deposits during 1993--at a time when other banks were offering significantly lower deposit rates (18%-52%). By way of comparison, the Savings Bank was offering deposit rates of just 14-20%. As a result, many households switched deposits from the Savings Bank. Some first time depositors were also attracted to Baltija. By the end of 1994 Baltija had some 200,000 personal accounts. Bank Baltija was at the core of the banking crisis that was to emerge in the Spring of 1995.

Table 1. STRUCTURE OF LATVIAN FINANCIAL SYSTEM, 1992-1994

Bank	Former branches of Bank of Latvia* (state-owned)	Savings Bank (state-owned)	New Commercial Banks**	TOTAL
Number of Banks				
Dec. 92	1	1	50	52
Dec. 93	1	1	59	61
Dec. 94	1	1	55	57
Number of Branches				
Dec. 92	49	37	18	104
Dec. 93	21	35	82	138
Dec. 94	21	35	n/a	n/a
Assets, % of total				
Dec. 92	39	14	47	US$610 million
Dec. 93	15	12	73	US$964 million
Dec. 94	8	7	85	US$2146 million
Credits, % of total				
Dec. 92	70	7	23	US$230 million
Dec. 93	20	6	74	US$546 million
Dec. 94	7	4	89	US$730 million
Capital, % of total				
Dec. 92	12	3	85	US$22 million
Dec. 93	10	2	88	US$122 million
Dec. 94	7	6	87	US$336 million

* Figures for December, 1992 represent former branches of the Bank of Latvia that were overseen by the Bank Privatization committee. Figures for December 1993 and December 1994, reflect the operations of the Universal Bank (Unibank) of Latvia. The number of Unibank's branches increased in August-September, 1995 as it took over branches of Bank Baltija and purchased other small commercial banks. The Bank of Latvia had issued licenses to 27 branches of Unibank as of 11/17/95.

** This category includes: (i) the Latvian Investment Bank which is now 35% state-owned with the balance being held by EBRD (35%), Finnfund (10%), Swedfund (10%), and DEG (10%); and (ii) the Latvian Mortgage and Land Bank, which is state-owned.

The Crisis and its Causes

Manifestations of the crisis

The banking crisis in Latvia came to a head towards the end of March 1995,[6] precipitated in part by the insistence of the Bank of Latvia that all banks should prepare and present to its Banking Supervision Department financial statements that had been audited on the basis of International Accounting Standards. It was the failure of Bank Baltija to present such accounts, or indeed to give its auditors--Coopers and Lybrand--full access to needed documentation for the audit of 1994 financials that set off a chain of events leading to the bank's declaration of insolvency. But Bank Baltija was not the only bank involved in the crisis at this stage. Other banks included Latvian Deposit Bank, Centra Bank and Olimpija Bank, all middle-sized banks that were eventually declared insolvent. See Table 2 below. A number of smaller banks also experienced difficulty.[7] In all, about 40% of banking system assets and liabilities were compromised, totaling almost US$900 million.

The growing public perception that Bank Baltija was in difficulty led to a withdrawal of deposits from the bank, mostly by enterprises initially. Households were slower to grasp the gravity of the problem and so their withdrawals were more of a trickle than a classical run. The other banks that were involved in the crisis also experienced similar effects vis-à-vis their deposits. Large numbers of small deposit holders were caught when the banks' doors were closed. Yet there was no public panic in the capital, Riga. This development was to some extent treated by the public at large as just one further adversity in the painful process of transition. Some Bank Baltija depositors may, in any case, have been resigned to the fact that the high returns that they had earned on deposits was a premium that covered their subsequent losses.

The authorities' immediate response

The Bank of Latvia initially provided a modest amount of liquidity support for Bank Baltija. Large corporate names such as the Latvian Shipping Company[8]--as well as several major Latvian commercial banks--also provided direct liquidity

Table 2. RANKING OF TOP 20 BANKS (as of April 1, 1995)*

Name of Bank	Assets (US$ million)	Own Capital (US$ million)	Deposits (US$ million)	Loans (US$ million)
Bank Baltija**	496	53	392	283
Unibank	173	21	116	71
Riga Commercial Bank	170	19	124	71
Latvian Krajbanka	166	21	138	33
Parex Bank	163	13	106	85
Latvian Deposit Bank**	105	12	90	66
DLB	74	16	51	33
Zemes Banka	73	7	58	31
Centra Bank**	70	12	53	57
Rietumu Bank	63	5	37	4
Baltic Transit Bank	56	12	38	28
Olimpija**	55	13	43	36
Saules Bank	53	6	43	10
Naftas & Kimijas Bank	39	6	24	23
Latintrade Bank**	38	6	28	31
Latvian Creditbanik	37	7	26	25
Latvian Capital Bank	35	2	31	1
Sakaru Bank	34	4	24	15
Alejas Bank**	29	4	22	19
Kredo-Bank**	25	2	22	1

*) Source of information: Latvian Bankers Association (banks were ranked by assets).
**) Banks that collapsed in June-September, 1995.

support. Initially it was believed that Baltija's insolvency problem was of moderate size--on the order of $50 million--but as the accountants dug deeper into Baltija's financial operations, it became clear that the bank's negative net worth was as great as about $320 million or 7% of the expected 1995 GDP. The Bank of Latvia at this time refused to provide further liquidity support. The crisis had come to a head. Instead, the Bank of Latvia and government officials began protracted negotiations with the owners and management of Baltija. The owners and managers sought to stall for time by, among other things, suggesting a merger with the Latvian Deposit Bank and Centra Bank (these banks were also declared insolvent at a later stage) so that they could try to come up with a recapitalization plan. In retrospect, this provided a window of opportunity for managers and owners to undertake an asset stripping of the bank. See Box 1.

Of the roughly US$500 million in assets on Baltija's books when the crisis began, some US$260 million had disappeared by the time it was declared insolvent in July 1995. In addition, funds were blocked at Baltija's correspondent accounts with banks in Russia, Belarus and Ukraine.

Subsequently, the Bank of Latvia took over the management of the bank in the context of an Agreement drafted between the owners and management on the one side and the Bank of Latvia and Ministry of Finance on the other. Initially, this Agreement was used by the owners and managers to try to obtain concessions from the Government, on the principle that Baltija was too big to fail and that its fall would have significant political ramifications. Ultimately, as the depth of the problem became known, and following advice from the Bank and IMF, the Agreement was redrafted to give full control of the bank to the Bank of Latvia (Baltija's owners could regain control of the bank if they fully recapitalized it--an unlikely event given the degree of insolvency of the bank). So the Agreement served to provide the Bank of Latvia with the powers to run and dispose of Baltija despite the fact that the former lacked the power to formally intervene in the bank under the existing banking law.

General causes

It is not possible to identify one single cause of the banking crisis in Latvia. There are multiple causes running from a set of general factors relating

Box 1. The Bank Baltija Loan Portfolio and the Russian Intertek Bank

In late-April 1995, Bank Baltija allegedly sold more than half of its loan portfolio totaling Ls 80 million (US$ 160 million) to Intertek, a Russian bank located in Moscow. In return, Baltija was to receive Russian government bonds equal to 29 percent of the par value of the loans sold. The Russian bank, however, never delivered the bonds to Baltija.

Since Baltija was placed under administration, all efforts on the part of the administrator to cancel the loan sale agreement and have the loans returned to Baltija have been unsuccessful. In November, an Economic Court in Moscow declined for the third time to support Bank Baltija's claim on the loans, arguing that insufficient documentation had been provided to prove the existence of the loan agreement. Intertek has refused to confirm that a loan agreement was ever signed. Intertek has taken the position that all original documents on the loans had been returned to Baltija.

Intertek is a "pocket" bank that is owned by major companies participating in the Russian oil industry and provides service to Russian oil pumping (Siberia), oil refinery, and oil processing companies. The shareholders of Intertek are the largest of the Russian oil industry companies. The bank's largest shareholder is the Russian Ministry of Energy. There is also believed to be some cross-ownership between Baltija Bank and Intertek.

to the transitional phase through which the economy was passing to a number of causes quite specific to Bank Baltija.

The transitional process: There were a number of general factors at work that tended to create a vulnerability of Latvia to a banking crisis. Put at its simplest, the three major players in the banking system--the enterprise borrowers, the bankers and the banking supervisors--were all prone to mistakes as the economy made the transition from a command to a free market system. Enterprises made mistakes as they adapted production and other forms of economic activity to the new market signals, as well as to competition both internally and externally.[9] They chose projects that would sometimes fail, pulling their bankers down with them. Bankers meanwhile were still learning their trade. Bankers involved themselves in a wide range of activities, some of which proved to be loss-making.[10] A significant build-up in non-performing loans therefore took place across the banking sector and collections were inhibited by the lack of laws governing loan collateral. In Latvia, one manifestation of this was that commercial banks had to make provisions of about US$140 million at the end of 1994. In the first half of 1995, banks had to make further provisions of about US$86 million. The banking supervisors were also learning their trade. Supervisors throughout the world are invariably involved in a game of catch-up as they seek to keep up with innovations in the banks they supervise. Supervisors in Latvia--and indeed other parts of the FSU--are invariably further behind the quick-moving bankers than their Western counterparts. It is inevitable, therefore, that the joint vulnerabilities of the three players would lead to banking difficulties from time to time as the transition proceeded. This vulnerability to crises will likely continue until the real sector of the economy has essentially completed the transition and settled down to something like steady state. At the same time the susceptibility of bankers to make mistakes will persist until they have fully absorbed the lessons of earlier mistakes. At this juncture, the structure of the banking sector will stabilize so that the banking supervisors will be able to "catch up" to a degree. In short, the Latvian banking system was always likely to be susceptible to crises at this stage of its economic transition.

Corruption: In Latvia, as in other transitional economies, some banks were created--not primarily to service the banking needs of the public and establish solid business relationships that could serve the long run interests of the bank--but rather to achieve the "get rich quick" goals of owners and management. Rent-seeking activity of this type is characteristic of the transitional economies at this juncture. Such rent-seeking was encouraged by the loose legal and supervisory framework that governed banking in Latvia and other FSU countries during the first several years of the transition. In some cases, owners and managers primarily viewed the bank as a ready made source of financing for their own business interests, which often took the form of trade activities with parties located to the east. These owners and managers were encouraged to tap the bank's resources by knowledge that there were significant "loopholes" in the banking law pertaining to insider transactions. In other cases, owners and managers tried to achieve their short-run profit goals by taking excessive risks within the bank, often in the form of high risk lending, or by assuming large open foreign exchange positions. In these instances, the owners and managers were undoubtedly encouraged by knowledge that the supervisory authority was inexperienced, understaffed and lacked effective enforcement powers--a situation frequently found in the transitional economies.

Stabilization: In some countries--notably in Latin America--banking systems have become notably susceptible to crisis as stabilization takes hold. Tight monetary policies introduced as part of the stabilization program typically force up nominal interest rates and simultaneously reduce rates of inflation. This can create a strong movement from negative to positive real interest rates which has an impact on the ability of borrowers to repay loans. For much of the pre-crisis period in Latvia, market interest rates varied significantly between banks, making it difficult to measure the movement in real interest rates. Before stabilization took hold in 1992, inflation was running at over 500% and real interest rates were significantly negative. A cornerstone of Latvia's stabilization, however, was a very tight monetary policy. This was manifest in a reduction in interest rates that was not as sharp as the reduction in inflation. Subsequently, by mid-1993 (see attached charts) both real deposit and lending rates had become highly positive. The authorities pressed down on official interest rates, but market rates were quite sticky, reflecting in part the high interest rate strategy pursued by Bank Baltija, which had already attained a dominant position in the banking market (see section below on specific causes). Subsequently, as these special factors began to unwind real rates fell to more modest levels by year-end 1993. Despite a gradual fall in nominal interest rates through 1994 and into 1995 the rate of inflation fell further still, leading to a further temporary rise in real interest rates. The lasting effects of the high real interest rates in 1993, coupled with the temporary upturn in real rates in 1994, may well have had an adverse effect on borrowers through their reduced ability to service loans from local revenues that would have grown less quickly in nominal terms. This could have lead to a general deterioration in loan portfolio quality.

Confidence and rumors: Another factor that made Latvian private banks vulnerable to crisis was the uncertainty that depositors had about whether they would be bailed out by Government in the event of a difficulty arising. This was particularly the case with enterprises or other entities that had deposits and showed some agility in moving them. Even unfounded rumors can lead to difficulties for specific banks in these circumstances. In the later stages of the crisis, two of the largest private banks experienced such withdrawals, but were able to subsequently recover from the loss.

Specific causes

There were a number of specific causes relevant to the Latvian situation. All of them were applicable to the Baltija problem, with some also applicable to other banks.

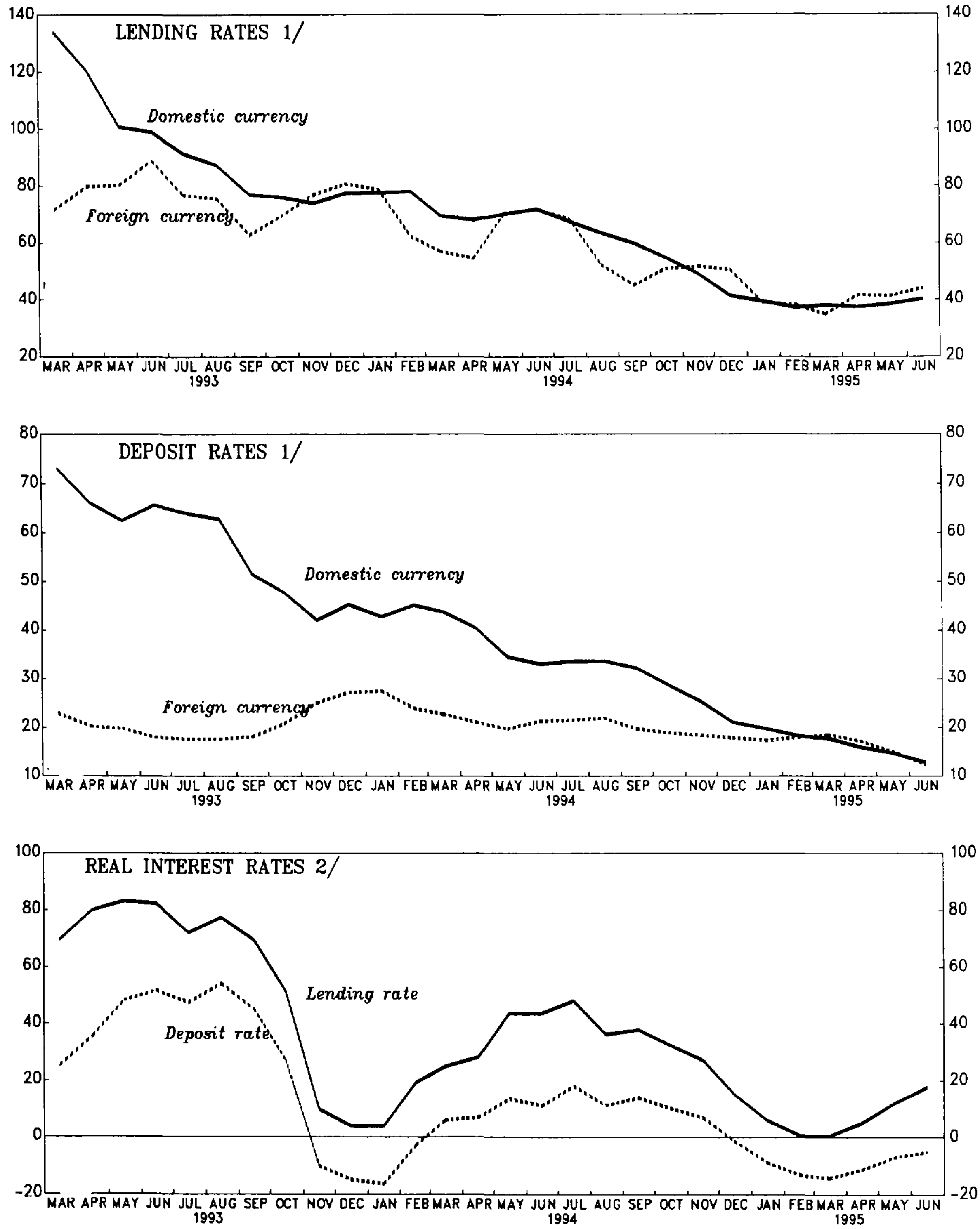
Trade financing: Latvia has a special position between East and West which makes it especially suitable for financing trade between the two areas. Special financing opportunities arose during 1993/4 on account of the fact that prices of metals and other commodities in Russia remained well below world market prices. Latvian banks were instrumental in financing East/West trade of this type. It was very profitable for both the traders and the banks, and the latter were able to charge high rates of interest on the financing. The existence of this type of high return opportunity encouraged several Latvian banks to become involved. The main difficulty came when Russian prices rose to near world levels and the financing opportunities began to dry up. This led to considerable pressure on banks to find other lending outlets. This put downward pressure on banks' profit margins as the banks scrambled to find equally profitable but riskier lending outlets.

Currency risk: There is evidence that Bank Baltija--and possibly other banks as well--followed a very high risk strategy in bidding for Lat deposits at very high interest rates. Convinced that the Lat would depreciate vis-à-vis the US dollar, Baltija repeatedly converted large volumes of Lats into US dollars and on-lent these dollars, thereby creating a large open forex position. As it turned out, the Lat appreciated considerably against the US dollar over the 1994/5 period. It is possible that Bank Baltija believed that by putting itself in a position where it dominated the banking system, any doubts about its own solvency would precipitate a fall in the Lat and thereby improve the bank's financial condition.[11]

Interest rate risk: A related explanation for Bank Baltija's strategy is associated with its ambition to become a major retail bank. Given that it was able to charge very high rates on its trade related lending, Baltija was in a position to offer very high deposit rates. This it did with a view to siphoning off depositors from other banks, particularly the Savings Bank. Queues formed as potential depositors, oblivious to the risks involved, opened accounts with Bank Baltija at a rate of 90 percent for one year deposits. Baltija management furthered this aggressive strategy by opening a significant number of branches around the country. But this strategy back-fired as market interest rates fell, exposing Baltija to significant net interest margin pressures.

Poor management: As it expanded aggressively, Bank Baltija also undertook many profligate expenditures, including throwing lavish

LATVIA
INTEREST RATES
(In percent per annum)



Sources: The Bank of Latvia; and staff estimates.
1/ Three-month moving average; credits and deposits of 3-6 months' maturity.
2/ Computed on the basis of the three-month moving average of the monthly inflation rate.

Box 2. Banking Stability Returns?

Structural changes: On November 15, 1995, the Latvian Economic Court decided to liquidate three banks: Olimpija, Kredo and Olti. On November 9, 1995, the Bank of Latvia also canceled the license of Riga International Bank because the bank was insolvent. The bank had no household deposits and its major creditors were Bank Baltija and the Savings Bank. On December 11, 1995, the Economic Court declared Bank Baltija bankrupt and ordered its liquidation. This action was based on the recommendation of Baltija's administrator, who concluded that the bank could not be rehabilitated. This recommendation was supported by the Bank of Latvia, the Ministry of Finance, and Ernst & Young, the auditing firm which had been assisting the administrator.

Banking System Data: The table below presents data on the size of the Latvian banking system for selected months from December 1994 through October 1995. The data includes, up to May 1995, all operating banks and those banks that were no longer operating, but whose licenses had not yet been canceled by the Bank of Latvia. This latter group of banks includes Bank Baltija, Deposit Bank and Centra Bank. After May 1995, the table only includes those banks which are actually operating in Latvia.

As indicated, the banking crisis resulted in a shrinkage in the size of the banking system during the late spring and early summer. However, since August, the total assets, total loans and total deposits of the system began to increase, suggesting that the banking system had begun to stabilize. The one negative was a continuing downtrend in the amount of bank capital until October.

While not shown in the table, there has also been a sharp shift in the composition of deposits from time and savings deposits to demand deposits. Between January and September, the amount of time and savings deposits fell from US$306 million to US$146 million, undoubtedly reflecting depositors' desires to maintain maximum flexibility when depositing in banks.

Latvian Commercial Banking System, 1994-1995

(Million US Dollars)

	1994	1995								
	Dec.	Mar.	Apr.	May*	May**	June	July	Aug.	Sept.	Oct.
Total Assets	2146	2106	2074	2088	1464	1400	1304	1378	1400	1434
Total Loans	730	746	756	764	524	470	426	440	430	424
Own Capital	336	326	312	316	262	248	260	250	242	256
Total Deposits	938	934	938	914	644	580	528	534	544	568
No. of Banks	57	(57)	(57)	(57)	53	47	44	44	39	39

*) From December 1994 to May 1995, data includes banks operating in Latvia, as well as those which are no longer operating but had not lost their license.
**) Banks actually operating in Latvia from May 1995 onwards.

parties for clients and government officials. This activity was apparently undertaken as a means of insuring itself politically against any future difficulties that it might encounter. In general, systems were not put in place to properly manage the bank, particularly, as noted above, in the area of risk management.

The Impact of the Banking Crisis

The Impact on the real economy

Data for the real sector of the economy suggests that the positive real growth expected for 1995--a target of 5%--is not attainable. The Latvian authorities have forecast that the banking crisis will "cost" up to 1.2% of GDP in 1995 and up to 2.2% of GDP in 1996. The increasing tightness in liquidity brought about by the loss of deposits means that much more modest growth will have taken place in 1995. It is likely that the adverse wealth effects, coupled with the general effect on economic confidence, will have subsequent negative effects on the economy. The outcome might have been even worse were it not for the buoyancy of the newly emerging private sector that has little linkage with the banking sector as either depositors or borrowers. In real terms, the money supply declined by 17% during the first five months of 1995. Inflation has abated on account of the liquidity tightness while nominal interest rates have begun to increase since the middle of 1995, leading to an upturn in real interest rates. The net international reserves of the Bank of Latvia declined from a peak of $466 million at the end of 1994 to $369 million at the end of June 1995 as the Bank of Latvia intervened to maintain the Lat's parity vis-à-vis the Special Drawing Right (SDR).

Impact on the budget

A severe budgetary crisis emerged in Latvia in 1995 and this has been exacerbated by the banking crisis in two ways. First, the lost liquidity of enterprises has reduced their ability to pay taxes. The budget deficit that had been expected to be US$80 million for the whole of 1995 has ballooned to about US$140 million, or about 3% of GDP. Second, the fall in liquidity of the banking sector at large, reflecting *inter-alia* the subsequent reduction in deposits as a result of the banking crisis, led to a fall in the demand for short-term Treasury paper on the part of banks. The outstanding stock of Treasury bills fell from a peak of about $115 million in early March to $50 million at the end of June 1995. Hence, the financing side of the budget also became more problematic.

The budget will also suffer because the Latvian Government has used the banking system extensively to allocate foreign credit lines with Government guarantees to the private sector. While it is not clear at this stage how much foreign credit has been channeled through now insolvent banks, the main difficulties have arisen with loans provided by the G-24 and IMF (Structural Transformation Facility). These loans were channeled through the banking system without a sound monitoring system in place for the banks and final users. This has meant that not only weak banks were used as intermediaries, but also funds were used for unauthorized purposes.[12]

Impact on other banks

It might have been anticipated that the banking crisis in the spring of 1995 would have spilled over onto the surviving banks, presenting them with potentially serious liquidity pressures. However, available data indicates that this did not happen initially. In fact, between the beginning of May and the beginning of July--the period when Bank Baltija was obviously failing and was then declared insolvent--the top ten banks in the system, in aggregate, had an increase in total deposits of 3.3 percent.

However, during the month of July--just when the Baltija crisis was stabilizing--two of the large banks began experiencing serious funding problems. Indeed, one of the banks sustained a decline in total assets of 26 percent, while the other had a 20 percent decline compared with the previous month. While complete information on these events is not available, the loss of funding in one case appears to have been related to the withdrawal of large interbank balances by Russian banks. In the other case, the bank seems to have been the victim of unsubstantiated rumors regarding its solvency, which reportedly led to the withdrawal of deposits by some major Western European corporate depositors.

The fact that there was not an even more widespread contamination of the banking sector can be attributed to the fact that the interbank market--a possible channel for contamination--accounted for only 6% of total bank liabilities (at end-April).

Another concern has been the withdrawal of deposits from the Savings Bank in recent months. This has taken place in the form of a trickle rather than a major run. In some cases depositors who had lost funds in insolvent banks had to draw down funds from their Savings Bank accounts to finance their immediate needs. The withdrawals also appear to be associated with a general fall in confidence in the banking system by household depositors. Whereas enterprise depositors must maintain a deposit balance in order to consummate transactions, the reaction of households facing uncertainty is to keep cash in either domestic or foreign currency.

A number of other banks, the stronger ones in the system, have consistently benefited from the difficulties elsewhere in the sector. Unibank, for instance, has consistently gained deposits.

The political impact

The results of the elections at the end of September have led to a rejection of the ruling centrist parties. It was the centrist parties that held the prime economic portfolios in recent coalition governments. It is these parties that were mostly associated with the banking collapse. The parties at the extremes of the political spectrum gained seats in the election, some of which had strongly criticized the Government's performance in handling the banking crisis. While the banking crisis may not have been the primary cause of a shift in voter sentiment, it was certainly a contributing factor and an element in political campaigns.

Dealing with the Aftermath

The Latvian Authorities have had to deal not only with the immediate management of the crisis but also with the crisis of confidence in the banking sector and the political fall-out from the crisis. Urgent changes in the legal, regulatory, supervisory and institutional framework have been made in recent months.

Depositor compensation

In order to rekindle confidence in the banking sector, the Government has decided to compensate household depositors who lost funds in the failed banks. The Government plans to set a compensation ceiling of US$1,000 per depositor. Given the budgetary constraints that the Government is now under, cash compensation will be limited to US$400 in the period from August 1995 to January 1996. In the subsequent three years depositors will receive US$200 additional per year. The Government is hoping to cover some of the cost of such compensation through the recoveries of assets of the failed banks. There must be some question, however, as to whether the Government could sustain this level of compensation, given the budgetary tightness, and in the absence of recoveries of assets from the failed banks.

New banking legislation

In response to the banking crisis, the Bank of Latvia developed three banking laws--a new commercial banking law, a law that would set up a bank rehabilitation/liquidation agency, and a law that would create a deposit insurance system. These actions were taken in an effort to rebuild shattered public confidence in the banking system and to strengthen the legal and institutional framework that underlies a banking system. Each of these three laws were temporarily adopted by the Government in July while the Parliament was out of session. However, each of these laws had to be introduced and enacted by the Parliament when the legislature reconvened.

The *commercial banking law* in Latvia was initially enacted in May 1992. This law was only six pages long and can probably best be described as a "bare bones first effort" to provide a legal framework for banking after independence was obtained in September 1991. The major deficiencies of the law included weak licensing requirements, restrictions on connected lending that could be easily circumvented, no limitations on a bank's investments in real estate and the shares of non-banking companies, no provisions governing the change of control of an existing bank, and inadequate authority for the Central Bank to close and liquidate a bank. But probably the most serious deficiency was the lack of an adequate range of enforcement powers for the Bank of Latvia, the supervisor of banks. Under the law, the Bank was limited to using "moral suasion", which may not be effective in some cases, and revoking a bank's license, which is a draconian supervisory action. The Bank of Latvia did not have "intermediate stage" enforcement powers--such as cease and desist authority, the power to remove bank management or the authority to fine banks--that are typically found in effective banking laws.

The new banking law that was drafted in the first half of 1995 was much more detailed and inclusive than the 1992 statute. Moreover, it substantially strengthened those provisions in the 1992 law that were particularly deficient. Most important, the proposal gave the Bank of Latvia a much broader range of enforcement powers for supervising the banking system, and plugged the loopholes in the 1992 law pertaining to connected lending.[13] In August 1995, the Parliament began a careful review of the law temporarily approved by the Government in July. After adopting a number of largely technical amendments, the Parliament enacted the proposed law in October.

The second law drafted by the Bank of Latvia in response to the emerging crisis was the *Law on Rehabilitation*. This law was designed: (1) to give the Government a permanent institutional mechanism for rehabilitating banks whose failure could have serious adverse effects on public confidence in the banking system and the functioning of the payments system; and (2) to improve the process of liquidating failed banks--a process that is widely viewed in Latvia and other countries of the FSU as being slow and ineffective. The proposed law called for the creation of a Banking Agency, an independent government organization that would handle both bank rehabilitations and bank liquidations.

In rehabilitating a bank, the Banking Agency would first try to arrange a private sector solution by having existing owners or new private sector entities carry out the rehabilitation. However, if a private sector solution is not possible, the Agency would consider undertaking the rehabilitation itself, if such an action were deemed to be essential and cost effective. The Banking Agency would be funded by contributions by the Government and the Bank of Latvia, as well as by periodic premium payments by all licensed banks. The Agency's ruling board would be composed largely of appointees of the Ministry of Finance and the Bank of Latvia.

The draft Law on Rehabilitations was adopted by the Government on a temporary basis in July, and subsequently submitted to the Parliament for permanent enactment. However, the Parliament to date has not enacted this proposal, perhaps reflecting the view that the Banking Agency is no longer critically needed, now that the banking crisis seems to have passed.

Box 3. World Bank Comments on the Law on Rehabilitation

In its comments on the draft law, the World Bank supported the concept of setting up a bank rehabilitation/liquidation agency. The Bank stated that there may be occasions in the future when the Government will have to take action to rehabilitate a major bank in order to prevent the loss of public confidence in the banking system and preserve essential banking services in the country. If so, it would be better for the Government to rely on an experienced organization operating under a predetermined set of rules than to carry out the rehabilitation on an ad hoc basis. Moreover, the Bank believed that having a single on-going organization carry out bank liquidations would be more effective than relying on the present system of liquidating banks through the court system.

However, the Bank recommended several important changes in the law. First, the Bank argued that the law should contain provisions that clearly set forth the criteria that the agency would employ in deciding whether or not to rehabilitate a failing bank. The Bank believed that Government-supported rehabilitations should be limited to only "essential" banks whose failure could have adverse systemic implications. Without having specific "essentiality criteria" in the law, the Bank was concerned that the agency might end up bailing out banks irrespective of their size or importance.

Second, the Bank expressed concern about the proposed funding of the agency. The Bank argued that, in principle, the agency's funding of bank rehabilitations should come entirely out of the Government budget. By contrast, the proposed law would have the funding come from three sources: (1) a capital contribution from the budget that was unspecified both with respect to amount and timing; (2) annual contributions from the Central Bank; and (3) periodic contributions by all banks. The Bank indicated that it realized that the government budget was under great pressure and that the Government may feel that it had no alternative but to rely to some extent on non-budgetary sources of funding. However, if this were done, the Bank urged that the Government "fix" the funding of the rehabilitation agency as soon as the budget would allow.

The third banking law drafted by the Bank of Latvia was the *Law on Compensation of Deposits*. This law would create a deposit insurance system that would protect individual depositors up to 500 Lats (the equivalent of $1,000) in the event of a bank failure. This law was designed to help restore the public's confidence in the banking system, reduce the likelihood of future bank runs, and minimize the adverse wealth effects of future bank failures. Like the other two proposed laws, the deposit insurance proposal was adopted by the Government in July. However, while subsequently introduced into the Parliament, the proposal has not yet been enacted.

Tighter supervision

The Bank of Latvia took much of the blame for the banking crisis as there were clearly weaknesses in the implementation of supervisory policy. The head of banking supervision was forced to resign and a restructuring of the Banking Supervision Department has taken place. The Bank of Latvia also has hired additional supervisory staff, has moved to tighten prudential regulations, and has required banks to establish internal control departments.

Moreover, the Bank of Latvia has made arrangements for external accounting firms to supplement the work of the Bank of Latvia's on-site examiners. This more intense supervision will focus on the "core" banks that are permitted to take household deposits. A number of additional banks have been forced to close with the result that at present there are only 39 banks permitted to operate. And of these, only 14 have full banking licenses permitting them to accept household deposits. The remaining 25 banks only have restricted licenses. Enforcement has been improved through an amendment to the Administrative code that has permitted the Bank of Latvia to impose fines on bank management for violations of prudential regulations.

The Role of the World Bank

During the period 1993-94, the Bank provided support to the Government in its efforts to deal with the remnant of the Soviet banking system. The Bank, in the context of preparing its Enterprise and Financial Sector Restructuring Project, worked closely with the Bank Privatization Committee on a bank restructuring strategy which focussed on what to do with the branches of the former Soviet specialized banks. One result of this was the structuring of Unibank and its subsequent path to privatization. Technical assistance was also provided to the Savings Bank (financed by EU-Phare).

Technical assistance was also marshaled to strengthen the infrastructure for banking, including bank supervision. In this area the IMF provided significant assistance, with support also provided by EU-Phare. The World Bank Project also provided

Box 4. World Bank Comments on the Law on Compensation of Deposits

In its comments to the Government and the Parliament, the Bank indicated that it could support a deposit insurance system that protected small depositors up to some modest level, so long as the system was properly funded and had other appropriate design features. However, the system proposed in the draft law had serious deficiencies and, therefore, could not be supported by the Bank in its current form. First, as with the proposed bank rehabilitation function, the Government's capital contribution was unspecified as to both amount and timing. Second, the insurer would be given <u>prior preference</u> over other creditors to proceeds from the liquidation of a failed bank. As a result, the insurer eventually should "come out whole" in almost all bank failures. However, by placing the insurer at the head of the line for liquidation proceeds, other creditors, including <u>uninsured depositors</u>, would be moved back in line and would end up in a worse position than if there were no deposit insurance system. Stated differently, the real effect of the proposed deposit insurance system would be to reallocate losses associated with bank failures <u>among depositors</u> -- from those depositors who are insured to those who are not. The Bank argued that this result would defeat one of the major objectives of a deposit insurance system -- to promote public confidence. This objective could only be attained if some depositors are protected while other depositors are left no worse off.

inter-alia institutional development support for other commercial banks that met prudential requirements, as part of the establishment of the credit line for private enterprises. As part of this project, the Bank pressed for a strengthening of the legal framework for property rights, collateral and bankruptcy. These areas are foundational for the establishment of robust lending mechanisms within the banking system.

After the banking crisis broke, a new phase of assistance was initiated. In addition to providing advice to the Government on the three banking laws noted above, the Bank advised the Government on four other issues. The ***first*** involved the Government's negotiations with the management of Bank Baltija to recapitalize the bank, thereby restoring the bank to solvency.

The Bank advised the Government to cease these negotiations and promptly bring a petition to the courts to have the bank declared bankrupt. One reason for the Bank's advice was the belief that the management did not have either the intention or the resources to recapitalize the bank, given the depth of the insolvency. But even if the required capital could be raised, the Government, as a matter of principle, should not restore the bank to management that had grossly mismanaged and apparently defrauded the bank.

The ***second issue*** was whether the Government itself should attempt to recapitalize the bank, install new management, and then later on privatize the bank when it was fully rehabilitated. On this issue, the Bank advised the Government <u>not</u> to attempt a recapitalization. One reason was that the bank was known to be extremely insolvent, and "filling the hole" would place enormous pressures on a budget that was already under great strain. A second reason was that the <u>actual</u> hole in Baltija might turn out to be much larger than currently thought. In those cases where banks have been the victim of apparent fraud, it is not unusual to discover later on that there are large deposits and guarantees that have not been recorded on the bank's books. Given this possibility, Governments virtually never attempt to rehabilitate a bank involved in fraud.

The ***third issue*** on which the Bank provided advice related to the Bank of Latvia acting as a lender of last resort. In the spring of 1995, it became increasingly clear to the Bank that Latvia was going to have a major banking crisis--with the probable failure of four banks comprising about 40 percent of the system's assets. Moreover, it appeared that there was essentially nothing that the Government could do about the coming crisis--Bank Baltija could not be saved for the reasons listed above, and the other banks probably were not large and important enough to be worth trying to save. In this situation, the key policy objective was to make sure that the rest of the banking system would get through the crisis. The Bank believed that the size of the crisis and the great media attention being given to Bank Baltija would have a serious adverse effect on public confidence and might lead to significant deposit withdrawals from the remaining banks. If so, the key to holding the banking system together would be effective lender of last resort support by the Bank of Latvia. Accordingly, the Bank urged the Bank of Latvia to get prepared and be willing to supply needed liquidity support to all banks that were solvent and could provide required collateral.

The ***fourth area*** where the Bank provided advice was on methodologies for dealing with the compensation of depositors in the failed banks. The Prime Minister had publicly stated his intention to compensate household depositors in the failed banks. With this as a given, the Bank developed options for compensating depositors. This work was also supported by EU-Phare consultants who were instrumental in assisting with the implementation of the scheme.

During the crisis phase, the Bank also provided technical assistance through the use of the staff of its Technical Unit that had been originally set up to channel a credit line under the Enterprise and Financial Sector Restructuring Loan. Finally, the Bank acted as a catalyst for technical support from other donors.

Lessons Learned

There are five important lessons to be learned from the Latvian banking crisis--lessons that can be applied to other transitional economies.

The first lesson is that both the economies and the banking systems of transitional countries are inevitably exposed to major strains and stresses, at least during the first several years of the economic reform process. These cannot be avoided, given the enormous distortions built up in socialist economies over the years. Such distortions must be addressed if these countries are to achieve efficient resource allocation and rapid economic growth.

Banking systems are exposed to stress in several major ways. First, enterprises, which are the primarily borrowers from banks, become subject to hard budget constraints, thereby cutting off government funding that is critical to the servicing of their bank debt. As the reform process proceeds, these enterprises are privatized, thereby irretrievably cutting them off from any hope of financial support from the government. Second, the sharp decline in inflation that typically accompanies macroeconomic stabilization means that enterprises can no longer depend on rapidly increasing revenues to service their bank debts. Third, economic reform tends to produce banking systems that are primarily privately owned. This certainly has been the case in Latvia, Estonia and Russia. While the privatization of the banking system is clearly desirable from many perspectives, it makes the system more vulnerable to deposit withdrawals because the public does not presume that failing banks will be bailed out, as is usually the case with state-owned banks.

The second lesson follows from the first. If banking systems are exposed to stress, the government must take strong actions to protect against this vulnerability. One way to do this is to get the legal framework for banking in proper order, develop an effective bank supervision and regulation capacity (in order to constrain undue risk-taking by banks), and implement good bank accounting, disclosure and auditing standards (which will help to develop market discipline and supplement bank supervision in constraining undue bank risk-taking). Another government action is to develop effective mechanisms for handling problem banks and closing insolvent banks promptly. In Latvia, it was not just that Bank Baltija, the largest bank in the system, failed, but that when it was finally closed, it was so deeply insolvent that the Government essentially lost the option of bailing out this key bank in order to protect depositors and the payments system.

The third lesson relates to those banks that are still in the state sector and are awaiting privatization. At the time of a banking crisis, it is extremely helpful if these banks are able to serve as a source of strength to the banking system, as Unibank clearly did in Latvia. This result is possible only if the state banks have strong, effective management and are relatively free from political influence, particularly relating to their lending operations. It should be noted that Unibank had been undergoing extensive financial and operational rehabilitation for several years prior to the banking crisis in early 1995, with substantial help from foreign sources.

The fourth lesson is that the supervisory authorities in transitional economies should look carefully at banks which are "outliers" in the banking system. Banks that are expanding their assets or branch networks exceptionally quickly, or banks that are offering particularly high deposit rates, should be subject to intense supervision. Activity in specific banks which is outside the norm for the banking system as a whole may be an indicator of a problem in the bank concerned.

The fifth lesson is that fraud, managerial incompetence and excessive risk-taking can have devastating effects on a banking system, particularly if they occur in one of the largest banks. In banking, there are four primary ways to protect against these exposures. The first is to carefully screen those who want to get into banking. Second, all banks should be subject to frequent, thorough on-site examinations; and the best examiners should be allocated to the largest banks whose failure could have systemic implications. Third, all banks should be required to be audited annually by reputable auditing firms, and these firms should be required by law to immediately report any significant irregularities to the supervisory authorities. Fourth, when a bank gets into difficulty and there is a hint of fraud, the authorities should act decisively to deal with the bank and those responsible for the problem.

ENDNOTES

[1] Ms. Brigita Usakova and Mr. Roger Handberg of the World Bank Technical Unit in Riga, Latvia also made significant contributions to the paper. Helpful comments were also received from Lars Jeurling, Paul Siegelbaum, Alan Roe, and Lily Chu. Suzanne Coffey handled the production of the paper.

[2] The Government also decided to revive a state bank that had existed during Latvia's short period of independence between the two world wars. The Mortgage and Land Bank was established on March 19, 1993 by Government resolution, as a state commercial bank. The bank's initial shareholders' capital was Ls 100,000, or US$ 200,000 (100% held by the Government). The bank started to grant mortgage loans to Latvian farmers, entrepreneurs and private persons, mortgaging real estate and land in cities and rural areas, and to perform payment and credit transactions related to the privatization of state property (land, housing).

[3] All data in this article relating to Latvian Lat amounts are subsequently expressed in dollars at an exchange rate of US$2=Lat 1.

[4] The US$ 50 million in non-performing loans comprised about 40% of the assets of Unibank as of March 1994.

[5] Banking intermediation (defined as total deposit funding) stood at 21% of GDP in 1993 rising to 40% during the first six months of 1995.

[6] Although seven smaller banks had been declared insolvent in 1994: Lotta, Latvian Bank for Reconstruction and Development, Baltic Bank for Reconstruction and Development Kurzeme, Sigulda, Tautas and Top-banka.

[7] Other banks declared insolvent in 1995 were Latintrade, Latgale Commercial Bank, Liepajas Commercial Bank, Polarzviagzne Bank, Alejas Commercial Bank, Kredo Bank, Olti-Bank and Bauskas Bank.

[8] The Latvian Shipping Company and connected companies abroad have lent funds to Bank Baltija in an amount of Ls 23 million (US$46 million). These loans were secured by a mortgage on Baltija's loan portfolio, real estate, vehicles and intellectual property.

[9] The slow pace of privatization likely exacerbated this problem in Latvia.

[10] Bankers are hampered in transition economies by a lack of safe, short-term financial instruments in which to invest their liquidity. This makes them more likely to take risks in lending.

[11] This explanation for Bank Baltija's demise is contained in a paper by Hallagan (Big Bang Banking Reform: the Latvian Experience, July 1995).

[12] A lesson to be learned here is that in transitional economies it is important to structure very strong mechanisms for channeling credit through commercial banks to the private sector. Such mechanisms should involve the continuous monitoring of intermediary banks, focusing in particular on the establishment of monitorable goals for their capitalization, adherence to prudential ratios, risk management capabilities, etc. The focus, in the initial stages of implementing a credit line, should be on the strengthening of the intermediaries with less emphasis on targets for lending volume.

[13] The World Bank, in providing comments first to the Government and later to the Parliament, strongly supported the new banking law and urged its speedy enactment. The Bank argued that the new law represented a substantial improvement over the 1992 law, particularly in strengthening the Central Bank's enforcement powers.

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