Moody's Investors Service

Global Credit Research
Credit Opinion
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Credit Opinion: Mortgage and Land Bank of Latvia

Mortgage and Land Bank of Latvia

Riga, Latvia

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A2/P-1
Bank Financial Strength	D-
Covered Bonds	A1

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Key Indicators

Mortgage and Land Bank of Latvia

	[1]2007	2006	2005	2004	2003	Avg.
Total assets (LVL billion)	0.93	0.70	0.46	0.31	0.23	[2]40.05
Total assets (EUR billion)	1.33	1.00	0.66	0.45	0.35	--
Total capital (LVL billion)	0.08	0.07	0.07	0.04	0.03	[2]24.21
Return on average assets	0.81	1.04	1.21	0.77	0.78	0.92
Recurring earnings power [3]	1.36	1.45	1.77	1.49	1.60	1.53
Net interest margin	3.05	3.14	3.48	3.74	4.52	3.59
Cost/income ratio (%)	65.70	66.15	65.91	75.71	75.77	69.85
Problem loans % gross loans	0.89	0.87	0.96	0.53	0.60	0.77
Tier 1 ratio (%)	9.10	10.21	13.07	9.24	11.66	10.66

[1] As of December 31. [2] Compound annual growth rate. [3] Preprovision income % average assets

Opinion

SUMMARY RATING RATIONALE

In accordance with Moody's rating methodology for government-related issuers (GRIs), we assign A2/Prime-1 foreign currency deposit ratings to Mortgage and Land Bank of Latvia (Hipoteku Banka). The current ratings reflect the following inputs: (i) a Baseline Credit Assessment (BCA) of 11-13 (on a scale of 1 to 21, where 1 represents the lowest credit risk), (ii) the A2 local currency rating of the Latvian government, (iii) high dependence and (iv) high support.

The BCA of 11-13 is underpinned by the bank's good asset quality (notwithstanding rapid growth in loans), consistent profitability and sound funding profile. It additionally reflects Mortgage and Land Bank of Latvia's narrow franchise and revenue mix and the fact that the bank operates in a maturing banking market that is sensitive to external shocks.

We also assign a D- bank financial strength rating (BFSR) to the bank. The rationale for this rating mirrors that for the BCA.

High support reflects the fact that the bank is wholly owned by the Latvian government (Finance Ministry of Latvia) and consequently the expectation that state support would be forthcoming if necessary. State support has also been demonstrated in the form of capital injections. In addition, there is a State guarantee to four loans, for which the bank makes a yearly payment. We also note that the government decided in October 2006 not to privatise the bank but to gradually turn it into a development bank, an action that could also be viewed as a sign of support.

Credit Strengths

- The state ownership and consequent support

- Sound asset quality despite rapidly growing loan portfolio

- Good financial fundamentals based on consistent profitability and good liquidity

- Leading role in mortgage bond issuance in Latvia, with positive implications for the bank's funding profile

Credit Challenges

- Operating in a maturing environment that is sensitive to external shocks

- Ongoing rapid growth in lending could lead to a relatively unseasoned loan book

- Narrow franchise and revenue mix

- Low cost efficiency

Rating Outlook

All of Mortgage and Land Bank of Latvia's ratings have a stable outlook.

What Could Change the Rating - Up

The long-term deposit rating is constrained from any further upgrade by the foreign currency deposit ceiling of Latvia. A further strengthening of the franchise as well as an ongoing demonstration of sound financial fundamentals could exert upward pressure on the bank's BFSR.

What Could Change the Rating - Down

A downward revision of Latvia's local currency deposit ceiling due to the worsening of macroeconomic imbalances and heightened uncertainties about the capacity of the banking system in conjunction with a perceived diminution in state support would negatively impact the deposit ratings of Mortgage and Land Bank of Latvia. A weakening of the Latvian property sector and consequent deterioration in the bank's asset quality and franchise would have negative implications for the bank's BFSR.

Recent Results

At end-March 2008, Mortgage and Land Bank of Latvia had total assets of LVL940 million (EUR1.3 billion) compared to LVL928 million at end-2007. Growth in lending remains high - gross loans to customers increased by 23% in the first three months of 2008. The bank reported net profit of LVL1.3 million (EUR1.9 million) in the first quarter, a decrease of 31% from the same period in 2007. The decrease was mainly due to increased operating costs. The capital adequacy ratio stood at 8.8% at end-March 2008, down from 9.9% at end-2007. Measured by total assets, Mortgage and Land Bank of Latvia was the eight largest bank in Latvia in 2007.

DETAILED RATING CONSIDERATIONS

Detailed considerations for Mortgage and Land Bank of Latvia's currently assigned ratings are as follows:

Qualitative Rating Factors

Franchise Value

Trend: Neutral

Mortgage and Land Bank of Latvia was established as a state-owned commercial bank in 1993 to promote economic development in Latvia. Therefore the bank is primarily involved in the provision of mortgage loans and loans to small- and medium-sized enterprises (SMEs). In January 2008, the bank had market shares of 4.5% in lending and 2.8% in deposits. The services are provided through 30 branches and nine sub-branches in Latvia.

The bank is planning to open a few more branches in the near future.

In October 2006 the Cabinet of Ministers approved the transformation of Mortgage and Land Bank of Latvia to a full-scale development bank and declined to privatise the bank. The bank will gradually expand its operations to areas supporting Latvia's economic development that will supplement commercial banks' offerings including funding establishment and development of SMEs, financing innovations and crediting government support measures for farming and rural development. As part of its mandate the bank has been recently implementing programmes to support Latvian entrepreneurs including training, consultation and financial support.

Moreover, Mortgage and Land Bank of Latvia has been focusing on developing its retail banking services via a number of initiatives, including the establishment of additional branches, expanding its ATM network in cooperation with other Latvian banks and offering its services via Latvian credit unions. The bank has been actively focusing on upgrading its payment card and settlement services offering. Nevertheless, the bank's retail service offering is limited and as such will continue to face competitive pressure from larger financial institutions, in particular Hansabanka and SEB Unibanka and also from the smaller domestic banks.

Risk Positioning

Trend: Neutral

Mortgage and Land Bank of Latvia's market risk is low, reflected by the bank's limited trading position, largely conducted on behalf of the institution's customer base. The bank (similar to other Latvian financial institutions) has implemented policies in order to be in compliance with the most recent legislation for the prevention of money-laundering and financing terrorism. The bank is also in the process of implementing a Basel II compliant internal rating classification system.

Moody's views positively decreased related-party lending (consisting mainly of loans to subsidiaries of the bank excluding the government of the Republic of Latvia), which represented 6.2% of total lending at end-February 2008 versus 6.1% at year-end 2007 and down from 8.7% in 2006. Credit risk concentration is also one of the challenges as the 20 largest corporate loans represent nearly 30% of total loans. In addition, real estate companies dominate the largest exposures.

Mortgage and Land Bank of Latvia's liquidity management is adequate. The bank has demonstrated its ability to attract interbank funding to support its lending programmes to SMEs and housing. The issuance of mortgage covered bonds (rated A1 by Moody's) provides an additional source for funding diversification. Mortgage and Land Bank of Latvia's covered bonds are issued only in Latvia and investors are mainly domestic pension funds and mutual funds. As at end 2007 the bank had mortgage bonds outstanding LVL37 million, which accounts for less than 5% of the total funding.

In general, funding currencies of the bank corresponds to assets and currency risk is limited. However, the overall currency position of the bank is short in foreign currencies and mainly in euros, due to the increasing amount of foreign funding. We also note that the customers are increasingly borrowing in euros (particularly in view of the EMU accession) in order to avail themselves of lower interest rates. The Latvian supervisory authority set up limits on the banks' currency positions in April 2007 and after that Mortgage and Land Bank of Latvia has tightened its internal limits. As of end-February the bank's total open currency position represented less than 3% of equity (while the legal limit is +/- 10% of equity). The currency position in mainly in euros.

Trading and investment portfolios of the bank consist mainly of Latvian and non-OECD government and corporate bonds (mainly financial institutions

Regulatory Environment

For a discussion of the regulatory environment, please see Moody's latest Banking System Outlook on Latvia, published in November 2007.

Operating Environment

Trend: Neutral

This factor is common to all Latvian banks. EU membership is expected to continue benefiting Latvia in a number of ways, not least in terms of structural funding, foreign direct investment and broader export opportunities, as well as the reduction and eventual elimination of foreign currency transfer risk. Consequently, improvements in wage levels, employment opportunities and financial services have to some extent led to greater demand for banking products. In this regard, Moody's also notes positively governmental pension reforms designed to promote long-term savings.

However, the credit standing of banks operating in Latvia and the Baltic region remains constrained by the less mature operating environment in which their business is performed. Latvia's annual inflation rate surged to 16.8%

in March 2008, presenting an ongoing problem; it continues to restrict the country's entry to European Monetary Union (EMU) and could cause some instability.

Economic growth in Latvia averaged about 9% between 2001 and 2007 but has been rapidly declining in 2008. Demand for credit has noticeably cooled, and housing prices have started to decline. At this point in time, it is still too early to tell how the imbalances will be rectified. Moody's continues to believe that a "soft landing" is the most likely outcome to the current business cycle, followed by moderate growth over the medium term. However, the downside risks to the macroeconomic outlook have increased materially.

Quantitative Rating Factors

Profitability

Trend: Neutral

In 2007 net income increased by 8.5% from the previous year to LVL6.5 million. The bank's recurring earning power (pre-provision income % risk-weighted assets) improved to 2.7% in 2007 from 1.8% in 2006 largely due to strong net interest income.

Net interest income continues to account for the major part of operating income (70% in 2007, 67% in 2006). We note that net fee and commission income represent only less than 7% of operating income and the growth has been slower than in net interest income so it only partially mitigates the effects of the gradual decline in interest margins. Overall, the net interest margin has decreased to 3.1% in 2007 compared to 3.1% in 2006 and 3.5% in 2005.

Liquidity

Trend: Neutral

The liquidity position of Mortgage and Land Bank of Latvia is solid. The liquidity ratio, defined as average liquid assets to total assets, has steadily increased to 25% in 2007 from 21% in 2006, and 13% at year-end 2005. The bank is mainly funded by interbank funds, which on average account for 53% of its total funding, while other market funding, which consists mainly of mortgage bonds, represented less than 7% of total funding in 2007.

Although Mortgage and Land Bank of Latvia has succeeded in growing its non-bank deposit base in nominal terms, deposit-based funding declined to 38% of total funding in 2007 from 46% in 2006 and 53% in 2004. We view favourably the fact that the vast majority of depositors are Latvian residents (in contrast to the non-resident status of some of its banking competitors' deposit bases, which are more vulnerable to external shocks). Declining interest rates reduce the prospect of further significant increases in deposit-based funding. This places greater pressure on the bank to develop and attract alternative funding sources.

Capital Adequacy

Trend: Weakening

Capitalisation levels are satisfactory, reflected by the bank's capital ratio of 8.8% as at end-March 2008 (13.0%: 2006). Although capitalisation levels have declined over the past couple of years the ratio remains above the minimum capital requirement of 8%. In the past Mortgage and Land Bank of Latvia has relied substantially on its owner for capital support and, to a lesser extent, for internal capital growth.

Efficiency

Trend: Neutral

Despite strong growth expense growth has been relatively contained, resulting in a relatively stable cost-to-income ratio. The bank's cost-to-income ratio stood at 66% at end-2007, virtually unchanged from the levels in 2006 and 2005. However, the efficiency ratio remains comparatively high reflecting the bank's investments in its branch network and technology platform. We also note that personnel expenses have increased rapidly by around 30% both in 2007 and 2006 and are likely to constrain efficiency improvement going forward.

Asset Quality

Trend: Neutral

In line with other Baltic banks, Mortgage and Land Bank of Latvia has experienced rapid loan growth in recent years (34% in 2007, 31% in 2006 and 43% in 2005). Continued rapid growth could lead to a less seasoned portfolio, while concerns over the development of real estate prices could place additional pressure on the bank's mortgage loan book. Moody's also notes the existence of a number of large individual exposures in the bank's loan portfolio.

Concerns are mitigated by the fact that Mortgage and Land Bank of Latvia's loan book remains diversified by borrowers, whilst non-performing loans as a proportion of total loans remained fairly contained at 0.9% as at December 2007 (0.9% as at 31 December 2006). We however express our cautiousness concerning the concentration of the bank's corporate lending on the real estate sector.

As of end-February 2007, commercial loans represented 44% of the loan portfolio, mortgage loans 38%, development loans (agricultural, rural and SME) 12% and consumer loans 6%. Mortgage lending is fairly evenly split in terms of residential and commercial mortgage lending (albeit with a slightly higher weighting in terms of the latter). The maximum Loan-to-Value (LTV) for commercial loans is 75% and for consumer loans 90%. In February 2008, the average LTV ratio of the loans exceeding LVL 0.5 million was 85%.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Credit Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.