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Latvia economy briefing:

Proposal of Hypothecary Credit Interest Rate Reduction in Latvia

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Proposal of Hypothecary Credit Interest Rate Reduction in Latvia

Summary

Over the past five years, Latvia has experienced a significant 7% increase in hypothecary credit interest rates, greatly affecting its housing sector. This rise has burdened homeowners and curtailed housing market growth, leading to calls for a re-evaluation of these rates. In response, the Parliamentary Budget and Finance Committee has proposed a 50% discount on these rates for a year. While some government representatives support this broad relief, concerns have been raised by the Latvian Financial Sector Association and the Latvian Central Bank about potential constitutional risks. They suggest more targeted interventions to assist specific borrower groups in need. President Rinkevics emphasizes the gravity of the situation, advocating a balanced approach and not yielding to potential threats from the financial sector. As Latvia grapples with these challenges, its decisions will serve as a significant benchmark for other nations facing similar economic predicaments.

Introduction

Over the past five years, Latvia has seen a pronounced 7% increase in hypothecary credit interest rates, reshaping its economic milieu in significant ways. This surge has not only overshadowed the global average but also cast a profound impact on the nation's housing sector, a cornerstone of economic well-being. For the average Latvian homeowner, this escalation translates to an additional financial burden of thousands of euros over the lifespan of a mortgage, constraining their financial flexibility and dampening the aspirations of potential homeowners. Furthermore, this rise potentially curtails the growth trajectory of Latvia's housing market, intertwining with broader economic repercussions. With such tangible concerns echoing across the spectrum, from individual households to national economic strategists, there is an intensifying call for a systematic re-evaluation of these escalated rates. This article seeks to unpack the current scenario, proposing a strategic reduction in hypothecary credit interest rates and outlining its potential ripple effects across Latvia's economic canvas.

I The Proposal

On 3 October 2023, the Parliamentary Budget and Finance (Tax) Committee reached a preliminary agreement to implement a 50% discount on hypothecary credit interest rates for a one-year duration.

The Budget Committee has scheduled a vote on the draft law designed to protect the borrowers of hypothecary credits. However, the exact text of the proposed legislation remains undrafted, and no consensus has been achieved on whether it will be a separate law or amendments to existing legislation.

Janis Reirs, the Committee's chairman, elucidated that the 50% discount could be applied to the consolidated interest rate of the hypothecary credit, which comprises the "Euribor" rates and interest rates applied by the banks.

Mr. Reirs highlighted the critical demographic of borrowers being between the ages of 30 to 45, corresponding to the most productive age group. These individuals significantly contribute to the nation's Gross Domestic Product (GDP) and revenue streams. The proposed support aims to temporarily alleviate their financial burdens. Reirs stated, *"We want to set this support for a limited period. We'll evaluate the situation after one year."*

To address potential challenges from the European Central Bank possibly raising interest rates and the persistence of a high "Euribor" rate, the Committee proposed the one-year discount. Furthermore, the Committee suggests that this support should only apply to those borrowers whose maximum credit balance does not exceed 250,000 euros. Reirs emphasized the necessity of applying this support to standard loans without delays and ensuring that the received support does not affect the borrowers' reputation negatively.

The Ministry of Finance (FM) pointed out in a Committee session that the 250,000-euro support threshold would cover 97.6% of hypothecary credits by amount and 99.8% by count. However, FM suggests a more targeted approach and raises concerns about possible state over-intervention in the market, which could adversely impact the market and future investments.

There is a growing debate on the potential constitutional risks associated with such an intervention, primarily focusing on lenders' rights to private property and the risks of potential litigation with international investors. Adviser to the Minister of Justice acknowledged these rights but also emphasized the legitimate objectives of the law: protecting consumers and ensuring societal welfare, which might outweigh the rights of credit providers.

In response to potential objections from credit institutions, Reirs argued that similar arguments have been presented during other crises, namely that "banks will leave the market" and "banks will not lend". Reirs added, *"We are in a free market – if some banks leave, others will take their place."*.

II "Unjustified Financial Sector Extortion"

In response to proposed regulations by the Latvian government and the Parliament to reduce interest payments on loans issued by commercial banks, there has been significant pushback from banking representatives. The Latvian Financial Sector Association cautioned in a discussion on Latvian Radio that the banks could challenge these legal norms in the Constitutional Court. It noted that reducing interest payments across the board would likely not withstand a constitutional test, as it would breach principles of legal certainty and non-intervention in pricing policy. The Association further emphasized that banks are currently individually addressing issues with housing loans and are witnessing a "dramatic" increase in customer interest in interest rate reductions in September compared to August.

The Latvian Central Bank (Latvijas Banka) has also weighed in on the topic. Head of the Monetary Policy board of the bank, revealed that while the country has issued over 130,000 housing loans, the dire situation lies with approximately 13% of borrowers who recently took out their loans and whose total incomes barely met the loan conditions. For these borrowers, the interest payment exceeds 40% of their total income. He supported interest payment reduction, but emphasized that this aid should be well-targeted, as a universal reduction would pose significant constitutional risks.

Prime Minister Evika Silina conveyed a vision wherein the ideal approach to resolving the borrowers' situation would be for the credit institutions themselves to offer their clients temporary relief on interest payments, especially during times of high "Euribor" rates. By doing this, banks would sidestep legal disputes. Ms. Silina hinted that one bank has already informed the government about its readiness to offer a temporary interest rate reduction of 1% for compliant clients, without disclosing the specific bank. The Prime Minister expressed her anticipation for other banks to follow suit, suggesting that potential legal restrictions might not apply to banks that proactively offer such initiatives.

In turn, Latvian President Edgars Rinkevics articulated his assertive stance concerning the emergent financial distress faced by mortgage borrowers, predominantly attributed to the escalating Euribor rates. The President emphasized the indispensable need for efficacious measures to alleviate these borrowers' fiscal hardships.

Drawing parallels with the financial turmoil between 2008 and 2010, Mr. Rinkevics highlighted that during that epoch, individuals besieged by economic constraints emigrated en masse. He accentuated that both the state and the financial sector were complicit in exacerbating the then crisis. Presently, the nation's socio-economic fabric is perceived to be so delicately interwoven that even the departure of a solitary family or a handful, he underscored, culminates in considerable perturbations.

President Rinkevics critically addressed threats emanating from the financial sector, where the latter contemplates litigation if the government enforces any curbs on their payments. Dismissing such threats as "unfounded blackmail," he expressed sanguinity that the legislative body, Parliament, would enact requisite resolutions to address the situation. Demonstrating his resoluteness, he avowed that if any entity wished to initiate legal proceedings, they are welcome to do so.

Meanwhile, providing a perspective from the central bank, Deputy President of the Bank of Latvia echoed the sentiment that tailored assistance for specific borrower groups is certainly imperative. However, she emphasized the precision in targeting this assistance to ensure it reaches the most necessitous segments. From the Bank of Latvia's viewpoint, the financial aid should ideally be sourced from the banking sector's profits, either through a tax on bank income or other mechanisms, thus obviating any strains on the national treasury.

Conclusions

Considering the escalating hypothecary credit interest rates in Latvia, the government's proactive proposition to implement a 50% discount on these rates for a year has incited a plethora of responses. While there is a consensus on the necessity to alleviate the financial burden on homeowners, especially amidst high "Euribor" rates, the approach remains a subject of contention. The government, exemplified by Reirs and Silina, promotes a temporary universal reduction, albeit with certain thresholds and considerations, in a bid to buttress the financially stretched demographic that substantially contributes to the national GDP. However, voices from the Latvian Financial Sector Association and the Latvian Central Bank underscore the potential constitutional risks of such an expansive measure, advocating instead for more targeted interventions. The latter stance is further reinforced by President Rinkevics, who, while underscoring the gravity of the situation, echoes the need for a judicious approach without capitulating to threats from the financial sector. The unfolding debate underscores the complex interplay between economic relief, constitutional propriety, and the overarching goal of national welfare. As Latvia navigates this quagmire, the outcome will undoubtedly serve as a pivotal reference for similar global economic challenges.

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