Moody's Investors Service Ltd

CREDIT OPINION

MORTGAGE AND LAND BANK OF LATVIA

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 to the existence of guarantees from the Government of Latvia, 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. On 14 September 2007, Moody's changed the outlook on the A2 long-term foreign currency deposit rating to stable from positive. This rating action was prompted by the recent change in outlook to stable from positive on Latvia's A2 foreign currency deposit ceiling due to worsening economic imbalances and signs that economy might be overheating. Mortgage and Land Bank of Latvia's foreign currency deposit rating remains constrained by the country ceiling for foreign currency deposits.

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 Events

On 14 September 2007, Moody's changed the outlook on the A2 long-term foreign currency deposit rating of Mortgage and Land Bank of Latvia to stable from positive. This rating action was prompted by the recent change in outlook to stable from positive on Latvia's A2 foreign currency deposit ceiling, which was itself prompted by worsening macroeconomic imbalances that have eroded the upside potential for the sovereign ratings of the country in the foreseeable future. In addition, persistently high inflation makes Latvia's accession to European Monetary Union (EMU) unlikely within the next several years.

Recent Results

At H1 2007, Mortgage and Land Bank of Latvia had total assets of LVL786 million (€1.13 billion) compared to LVL698 million at the end of 2006. Growth in lending is still very high although it has slowed down from the previous year - loans to customers increased by 20% in the first six months of 2007. The bank recorded net profit of LVL3.65 million (€5.24 million) in H1 2007, an increase of 60% from H1 2006. Finally,

the Tier 1 ratio stood at 10.21% at year-end 2006. Measured by total assets, Mortgage and Land Bank of Latvia was the eight largest bank in Latvia at H1 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). As at 31 August 2007, the bank had market shares of 4.1% in retail mortgage loans and 2.7% in mortgage loans in total. 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. Moody's also understands that 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.

We are, however, cautious about the increase in related-party lending although consisting mainly of loans to subsidiaries of the bank (excluding the government of the Republic of Latvia), which represented 10% of total lending at year-end 2006 versus 8.5% at year-end 2005. Credit risk concentration is also one of the challenges as the 20 largest corporate loans represent over 400% of pre-provision income. 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. In particular, Moody's notes Mortgage and Land Bank of Latvia's recent syndicated loan agreements, a three-year €177.5 million syndicated loan concluded with 15 European banks in September 2007 and a five-year LVL13 million (€18 million) syndicated club loan with Japanese investors. In July 2007, the bank received a €30 million loan from German development bank KfW to be provided to SME projects. The co-operation with KfW has continued since 2000. We also note that the Republic of Latvia is providing guarantees as regards to borrowings from KfW and the European Investment Bank for the purposes of SME lending and from the Council of Europe Development Bank and the Nordic Investment Bank for housing development lending. 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 30 June 2007 the bank had issued mortgage bonds amounting to LVL56.6 million, which accounts for about 7% 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. Currently the maximum total open currency position is limited to LVL4.8 million representing 8% of the bank's 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) with an average duration ranging from 1 to 2.5 years. As of year-end 2006 these represented 7.5% of total assets.

Regulatory and Operating Environment

Please refer to Moody's forthcoming Banking System Outlook for Latvia.

Quantitative Rating Factors

Profitability
Trend: Neutral

In the first half of 2007 net income increased by 60% from the previous year to LVL3.65 million. The bank's recurring earning power (pre-provision income % risk-weighted assets) decreased to 1.79% in 2006 from 2.06% in 2005 due to a deterioration in loan quality and more intense competition in the Latvian lending market. In 2005 profit growth was also influenced by income accruing from the revaluation of investment properties as well as operating lease income.

Net interest income continues to account for the bulk of operating income (68% in H1 2007, 67% in 2006), which is also a factor behind the decrease in risk-weighted profitability. We note that net fee and commission income represent only around 10% of operating income and the growth has been slower than in net interest income so it only partially mitigates the effects of the ongoing decline in interest margins. The net interest margin in H1 2007 and in 2006 stood at 3.14% compared to 3.48% in 2005.

Liquidity
Trend: Neutral

The liquidity position of Mortgage and Land Bank of Latvia is solid. The liquidity ratio, defined as liquid assets to total assets, increased to 24% at H1 2006 from 13% at year-end 2005. The bank is mainly and increasingly funded by interbank funds, which account for almost half of its total funding, while other market funding, which consists mainly of mortgage bonds, represented around 7% of total funding at H1 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 41.5% of overall refinancing requirements at H1 2007 from 45.6% in 2006 and 52.8% 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).

However, declining interest rates dampen the prospect of further significant increases in deposit-based funding. This places greater pressure on the bank to develop and attract alternative funding sources. Moody's views the bank's efforts to widen its investor base geographically as a positive development.

Capital Adequacy
Trend: Neutral

Capitalisation levels are satisfactory, reflected by the bank's capital ratio of 13.3% as at 31 December 2006 (16.7%: 2005). In this regard it is also worthwhile noting that the ratio is well above the minimum capital requirement for banks, which has been 8% since

January 2005. 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. The future implementation of Basel II requirements is not expected to impact the capital cost of the bank.

Efficiency
Trend: Neutral

Expense growth has been relatively contained compared with previous years, resulting in an improvement in the bank's cost-to-income ratio to 63% in the first half of 2007 from 66% in the end of 2006. Despite the progress, the indicator remains comparatively high reflecting the bank's ongoing investment in its branch network and technology platform. Further infrastructural investment requirements are likely to place pressure on the bank's efficiency indicators in the short-to-medium term. We also note that wage-related expenses have increased rapidly by 43% year-on-year in H1 2007 compared to 32% in 2006 and are likely to constrain efficiency improvement going forward.

Asset Quality
Trend: Neutral

Similar to other Baltic banks, Mortgage and Land Bank of Latvia has experienced rapid loan growth in recent years (ca. 20% in H1 2007, 31% in 2006). Ongoing rapid growth could lead to a less seasoned portfolio, whilst rising house prices in Latvia could place affordability in regard to the bank's mortgage loan book under pressure. 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 0.81% as at December 2006 (0.96% as at 31 December 2005). We however express our cautiousness concerning the concentration of the bank's corporate lending on the real estate sector.

As of December 2006, commercial loans represented 40% of the loan portfolio, mortgage loans 33%, development loans (agricultural, rural and SME) 12% and consumer loans 10%. 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) is 75%.

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