

## INVESTMENT IN FORESTRY AND THE ROLE OF BANKS IN ITS ASSURANCE IN LATVIA

Evija Greģe–Staltmane

Forest Faculty, Latvia University of Agriculture. Dobeles street 41, LV – 3001,  
Jelgava, Latvia. E-mail: evija\_g2002@yahoo.com

UDC 630.6

Received: 12 April 2010  
Accepted: 24 February 2011

### ***Abstract***

The role of investing for each country's welfare is obvious. The international capital may come into a country's economics through international investments, different funds, and also through banks. To enable forestry to progress successfully and be competitive, some regular and stable investments are needed for its development. For the banks in Latvia, forestry has not been the priority sector in recent years. Understanding the special role of bank loans in forestry, in November 2009, a social research was carried out on the basis of a questionnaire in order to understand the attitude of the Latvian banks towards the forest land as a loan. The research revealed the strong and the weak sides of forestry, as well as some possible opportunities and threats in Latvia from the point of view of the banks. The results of the survey showed that banks consider forestry to be a very risky sector and they do not plan to deal with it in the near future.

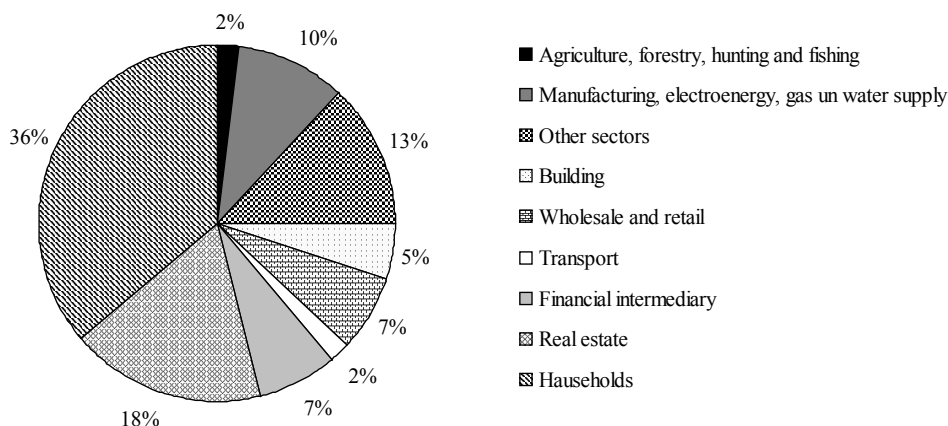
**Key words:** banks, investments, forest value, forestry.

### **Introduction**

After the Latvian banking crisis in 1995, a stable and competitive financial market has developed in Latvia. According to the annual report of the Bank of Latvia (2009), until the end of 2008, 21 banks and six branches of foreign banks were registered in the Republic of Latvia.

In 2008, the global financial crisis led to a significant deterioration of the financing opportunities and conditions including for the Latvian banks, prompting them to tighten their lending standards. The decrease in the banks' solvency negatively influenced the entrepreneurs, limiting the external financial resources for them. The liquidity squeeze on the global

financial markets, economic imbalances and economic downturn had a detrimental effect on the investors' confidence, which reduced loan refinancing opportunities for the Latvian banks and induced deposit outflows from those banks (Annual report of the Bank of Latvia 2009). As a consequence, the banks faced a significantly higher liquidity and financing risks. In 2009, no improvements could be observed in the banking sector because the banks "fixed" the losses by making reserves for doubtful projects and had strict credit terms and high interest rates. Currently, the banks are providing the loans for companies with a high export potential or with an effective internal market.



**Fig. 1. Distribution of loans balance granted to residents of the Latvian commercial banks by economic sectors at the end of 2007 (Dubra 2009).**

A very niggardly data is available about the amount and number of granted loans. Figure 1 shows that at the end of the year 2007, agriculture, forestry, hunting and fishing had made 2% of the total amount of granted loans. This suggests that crediting of these sectors is poorly developed and so far has not been a top priority for the Latvian banks.

In order to understand the attitude of banks towards forestry in general and forest land as a pledge, there was a need to conduct a survey of the Latvian banks.

## Materials and Methods

For situation analysis, a social research methodology based on a thirteen-question survey was applied. Primary data was collected in November, 2009. The main objectives of the survey were: to clarify whether a forest is a sufficient loan for a bank; to determine why banks reluctantly take a growing forest

as a pledge and to obtain information what conditions should be met in order to take a forest as a pledge.

Although the questionnaire was sent to 21 banks, in this research participated 15 banks. The answers of the banking survey reflect the assessment of the banks' leading specialists. Many banks which are niche banks with a specific activity, for example, a bank which has never issued credits in Latvia and is working with non-residents, mostly with corporate clients in Russia, refused to participate in the survey as they do not deal with forest crediting.

The collected data was counted and summarized in an EXCEL table. The scientific methods of induction and deduction were used.

## Results and Discussion

To the first question whether a forest is sufficient as a pledge for the bank, the

majority of the respondents answered – partly or only together with additional guarantees, 2 respondents considered a forest to be a sufficient pledge, but 2 respondents answered negatively. From the responses of the thirteen credit specialists a conclusion can be drawn that banks do not consider a growing forest to be a sufficient pledge. Such standpoint substantially hinders the Latvian forest owners from developing their own farms and entrepreneurship. In order to understand why banks are reluctant to take a growing forest as a pledge, several options were offered in the questionnaire. One third of the respondents checked off a number of variants. Overall, the impossibility of controlling the economic processes in the forest was mentioned as the main factor, risks associated with forestry – the second most important factor, whereas one third of the respondents considered that banking professionals are not enough qualified in forestry, but 3 respondents indicated that there are no professional forest appraisers. Banks consider a forest to be an asset which is difficult to realize and which requires specific knowledge.

According to the Daily Business newspaper, banks' position has not changed since the year 2006, forest is not sufficient as a pledge for a bank because the Latvian forest owners are working with mature stands (Ķirsons and Mārtiņa 2006). As to the financing coppices, the assessment of a forest creates a problem – many forest plots are being owned with different age structure, which, if selected for pledge, all should be appraised, but assessment

costs are relatively high. At the same time, there are relatively few appraisers who would undertake to evaluate a forest stand, but the banks, for their part, lack expertise in checking the assessment. For the forest owners the incoming cash flow is often formed only from the sale of trees, and during the time the trees are growing there is practically no income, therefore it is impossible to pay even the interest payments.

The third question in the questionnaire was an open-search question (with no options for the answers) where respondents were asked to define the conditions which should be met so that a forest could be taken as a pledge. On the whole, five main requirements necessary for the banks could be distinguished: 1) experts are needed who can adequately evaluate a forest; 2) credit specialists should have an understanding and experience in forestry; 3) banks should understand the forest industry and its markets; 4) a control is necessary over the conservation of the forest stand value, 5) banks should comprehend risks and risk mitigation techniques. From the banks' point of view, the main problem is that a bank can not control the harvesting of a forest. Accordingly, there is a possibility that timber is harvested and sold, but the earned means are not shifted for repayment of the credit under the previously signed agreement.

The results of the responses to the fourth question demonstrate that the forestry industry is connected with a high risk: 10 banks indicated the risk was high, but 5 banks – the risk was average.

The task of the fifth question was to rank risks by their importance: mark the most significant risk as 1, and the least important – as 6. Disasters (forest fires, wind falls, etc.) were assessed as the most significant risk, fluctuations in timber price – the second most important risk, and inflation was considered as the least important risk. The following risks were ranged practically at the same level, with a two-vote difference: government decisions (prohibitions, tax increases, etc.), poor forest management, and insect and disease damage. The fact that disasters were placed first points out the banks' poor awareness of the forest risks in Latvia.

Seven banks out of 15 answered the question about forest appraisers in Latvia, saying that appraisers are "a small number and with doubtful evaluation methods", 4 banks answered that "there is no information that forests are being evaluated", one bank considered that "there is a sufficient number of appraisers and they are professional", but three banks marked off "other". On the whole, the survey suggests that banks have limited information about forest appraisers in Latvia; moreover, they are not regarded as competent in this field.

To the question how large amount of credit could be assigned against the forest assessment, one bank answered – not more than 10–20%, seven banks said – 50%, two banks – 60%, one bank – 70%, and also one bank – from 50 to 70%. The rest three banks did not give concrete answers. The responses show that 11 banks believe that the optimal forest estate crediting amount is

50–70%, but 47% of respondents estimate it at only 50%.

In assessing how large the discount rate should be in forest evaluation, 7 respondents considered that 10%, but 12% and more would be suitable for forest assets, which probably might be related to perceptions of high risks. Only 5 respondents would apply a 5–6% discount rate. Such a distribution of the respondents' replies is connected with the fact that, on one hand, the forest is considered to be a stable long-term investment, but, on the other hand, fluctuations in prices and unstable profit figures in forestry during the previous periods in Latvia make banks increase the discount rate.

Regarding the question about forest insurance, 8 banks or 53% of the total number of respondents were convinced they could do it, 4 banks answered it was not possible to do, but 3 respondents either lacked information on forest insurance or they were not informed about the terms of insurance. A conclusion can be drawn that the banking sector is not yet fully aware of such a service, which is logical if banks have not had some previous experience of forest crediting.

The next question was whether the banks have had granted money against a forest estate as a pledge. Nine banks said they have had done it, 4 banks have had not done it, 1 bank has had issued money only against the land, but 1 bank did not wish to disclose the information. Only 9 banks stated the amount of credit for forestry out of the total number of loans, which ranged within 1–3%. This confirms the credit

amounts issued in the year 2007 (as illustrated in Figure 1), as well as the fact that banks are not yet ready to grant credits against forest estates in Latvia although more than half of the country's territory is covered with forests.

To the question whether the banks were planning to improve forest credit- ing, the majority of banks (12) or 80%

answered with certainty that they did not intend to develop forest crediting in the near future. Only three banks were planning to develop it and deal with it; they confirmed they were currently improving competence in this sector.

In response to the twelfth question, what type of business is forestry in the bank's opinion, only 1 bank considered it to be an unprofitable business,

**Table 1. Forestry SWOT from the point of view of the Latvian banks in 2009.**

<p><b>Strengths:</b></p> <ul style="list-style-type: none"> <li>- there will always be a demand for wood; prices might rise in the coming decades;</li> <li>- many educated professionals;</li> <li>- large areas of forests – Latvia's national treasure;</li> <li>- a developed industry;</li> <li>- a liquid asset;</li> <li>- a well-developed export of wood and its products; the industry plays an important role in balancing the country's trade balance and in developing the production;</li> <li>- favourable climate and geographical position (close to the realization markets);</li> <li>- a renewable resource;</li> <li>- the forest – a source of income, possesses a cyclical nature (sell, replant).</li> </ul>	<p><b>Weaknesses:</b></p> <ul style="list-style-type: none"> <li>- easily destroyable, subject to disasters;</li> <li>- poor forest management;</li> <li>- a lot of risks that cannot be operatively controlled;</li> <li>- changes in government decisions;</li> <li>- reduction of the valuable timber;</li> <li>- seasonality;</li> <li>- a relatively small part of the value added of the end-product is created in Latvia;</li> <li>- high dependence on the unfixed exchange rates in many export markets;</li> <li>- fluctuations in prices;</li> <li>- undeveloped long-term forest management culture;</li> <li>- fragmentation of forestries;</li> <li>- absence of strong forest co-operations;</li> <li>- slow turnover of money, which may take tens of years.</li> </ul>
<p><b>Opportunities:</b></p> <ul style="list-style-type: none"> <li>- the forest is "green gold" – the resource should be developed;</li> <li>- invest in forest areas in order to have a better assortment;</li> <li>- increase in timber prices in the market;</li> <li>- extensive use of wood;</li> <li>- biological growth of timber;</li> <li>- define a clear national policy for the forest sector and set it as a priority acquiring and producing industry; recovery of export markets;</li> <li>- positive decisions of the government, grants;</li> <li>- increase the value added acquired from forest products;</li> <li>- consolidation of the managed areas;</li> <li>- plenty of unused, cheap land and old traditions.</li> </ul>	<p><b>Threats:</b></p> <ul style="list-style-type: none"> <li>- harvested more than re-established;</li> <li>- global shocks and disasters;</li> <li>- increase of the performance of Russia's protectionist policy, which would increase foreign investing in industrial objects in Russia and would reduce the demand for/prices of Latvian timber;</li> <li>- weakness of the export market;</li> <li>- further adverse fluctuations in currency exchange rates in the export markets;</li> <li>- public policy and tax system – unfavourable for the sector;</li> <li>- fluctuating prices of logs (in comparison with Scandinavia);</li> <li>- growth of grey economy.</li> </ul>

2 banks – a perspective business, but 1 bank said that forestry as a business should be further developed.

The banking specialists were also asked to point out weaknesses and strengths, as well as opportunities and threats in forestry; their answers are reflected in Table 1.

Most of the banks are looking favourably on the forest sector because it is export capable, has a significant base of local raw materials, and generally is put in order, but the sensitivity to economic cycles and the uncertainty of the state policy regarding the forestry sector are considered to be the main disadvantages.

The banks' monetary support is very important for the successful future development of a company. Therefore forestry associations, the Latvian government and the Ministry of Agriculture of Latvia should provide some greater support to forestry in order to make it more attractive for the Latvian banks.

## Conclusion

Crediting the forest owners is poorly developed and so far has not been a priority for the Latvian banks. The banks' granted credit amount to forestry does not exceed 3% of the total amount of issued credits. Banks

have an uncertain attitude towards a forest as a good pledge since they have not enough practice and there is a fear of risks. Banks consider forestry to be a very risky sector and they do not plan to deal with it in the near future. Reconciliation between the requirements of the banks and those of the forest owners should be continued thus stimulating the crediting of the forest owners.

## Acknowledgements

The research was carried out within the frames of PhD studies at the Latvia University of Agriculture (LLU) and ESF project "Support for doctoral studies program of LLU", contract № 04.4-08/EF2.D3.19/.

## References

- Bank of Latvia 2009. Bank of Latvia: Annual Report 2008. Riga. 131 p.
- Dubra E. 2009. Latvijas ekonomikas konkurētspēja un investīciju nozīme tās veicināšanā [Competitiveness of Latvian economy and significance of investment for its promotion]. Rīga: Latvijas Universitāte. 166 p. (in Latvian).
- Kirsons M., Mārtiņa I. 2006. Bremzes izaugsmei [Brakes for development]. Dienas Bizness № 2928: 2 (in Latvian).