# MORTGAGE AND LAND BANK
# OF LATVIA

## Condensed Consolidated and Bank Financial Statements
## for the year ended 31 December 2009
## (unaudited)

**MORTGAGE AND LAND BANK OF LATVIA**
**MANAGEMENT REPORT**

**12 months of 2009**

The year 2009 has been a year of significant decisions and development for the SJSC "Mortgage and Land bank of Latvia". With the concept on transformation of the Mortgage bank into development bank, approved by the Cabinet of Ministers, another significant step has been made last year into the direction of formation of development bank, so essential for the state of Latvia.

Under the tough present economic conditions, the Mortgage bank continued lending to Latvian enterprises within industries essential for the national economy as determined by the state, augmenting the range of traditional services offered by commercial banks. An essential fact is that the proportion of state aid framework programmes in the total portfolio of the Mortgage bank has grown from 12 to 39% in 2009. With the risk of granted loans rising as a result of influence of the overall economic situation, the Mortgage bank in 2009 has built provisions for doubtful loans of 74.2 million lats, while the equity capital of the bank has been increased by 72.8 million lats. In last year, the Mortgage bank also repaid a considerable amount of syndicated loans and accrued funds for of next loan repayment. The performed changes in operational structure comply with the transformation of the Mortgage bank into development bank.

We can boast an increase of the number of clients in the Mortgage bank both in sectors of legal and private entities under the conditions of economic recession. The volume of term deposits has also grown, as well as the Mortgage bank's market share in deposits sector, which serves as proof to the high level of clients' loyalty to the bank.

We are going to proceed increasing the implementation volumes of promotional programmes further in 2010, financing entrepreneurs and stimulating the development of Latvian national economy. We are also going to further improve the quality of the bank's services and maintain high standard of customer service.

**Global economic situation and its stabilization prospective**

The International Monetary Fund estimates that global economy in 2009 might have decreased by 1.1%, but in 2010 the world's economy might grow by 3.1%. After the deep recession of the global economy the economic growth has become positive, as the extensive measures implemented by countries have contributed to demand and reduced the uncertainty and the probability of systemic risks occurrence on financial markets.

The IMF forecasts that economies of European development countries would grow by 1.8% in 2010, compared to the 5.0% drop in 2009.

A quarterly decline of the Gross National Product (GDP) by 17.7% was registered in the 4$^{th}$ quarter of 2009 in Latvia (data of the Central Bureau of Statistics), indicating the proximity of the economy to its lowest point. Reduction of the GDP by 2-4% in 2010 is forecasted.

The factors, most closely related to the decrease of economic activity, are:

- decline in dominant industries of economy, which saw the greatest upsurge in previous years and are internal demand oriented: retail, construction, financial services, tourism, catering services etc.;
- drop of industrial output in 12 months of 2009, compared to the respective period of 2008, by 16%;
- the material reduction of Latvian national budget expenditures and raise in tax rates that will mark further decrease of the domestic demand also in 2010;
- unemployment level, that reached 16% in December of 2009 (in December of the previous year – 7%). The unemployment level might reach 20% in the first half of 2010, though the employment growth might restart only with resumption of economy growth, expected to occur in the second half of 2010;
- amassing of risks in the financial system of Latvia – the volume of non-performing loans on the rise, doubtful loans require building of provisions, substantial losses of banking operations, as well as the necessity to repay external loans. Credit resources have also become substantially more expensive. Thus the credit resources available to economy keep decreasing.

There are several factors indicating to stabilization and formation of preconditions for a balanced development of economy in the future:

- stabilization of exports ratios – dynamics of exports structure in major groups of goods by months indicate that, after a significant drop of export in 2008, 2009 brings the first early signs of rehabilitation. With economic growth resuming the swing in other countries of the European Union, being the primary export market for Latvia, a gradual increase of exports may be expected, which would allow the Latvian economy to recover. Where until now the ratio of exports to GDP has been within boundaries of 35-45%, then, with industries of domestic demand diminishing due to the restructuring of economy, in year 2010 exports might already seize the dominant position in economy, exceeding 50% of the GDP;
- improvement of foreign trade, greatly affected by the traditionally stabile balance of services trading, as well as rapid fall of imports, with the internal consumption shrinking;
- improvement of Latvia's balance of payments – the balance of the current account has been positive through all months of 2009. Current account surplus might be expected also further on, though it may fluctuate depending on losses of direct investment companies, reflecting as positive revenues account;

- halt of inflation growth and stabilization of consumer prices. Annual deflation was registered in October, for the first time in the history of the re-established Latvia. In December of 2009 if compared to December of 2008, consumer prices shrunk by 1.2%. The limited purchasing capacity of consumers will be the major driver for prices to drop further on. Therefore the deflation will continue throughout 2010, the contraction of prices hanging on the level of 3-5% by annual profile;
- reduction of labour force costs, substantially affected by unemployment growth and zooming supply of free hands. This circumstance will have a propulsive effect on the competitiveness of Latvian enterprises on the international market;
- actual effective rates of the lats approaching the nominal rates – the decrease of consumer prices manufacturers' expenses will narrow the gap between the actual and nominal rates of the lats.

**Financial sector and its tendencies**

On 31 December 2009, the banking services in Latvia are provided by 21 banks and six branches of foreign banks. The SJSC "Mortgage and Land bank of Latvia" is operating as the only 100% state-owned commercial bank.

In 2009, by unaudited data, the assets of the banks operating in Latvia have decreased by 7%, reaching 21.7 billion lats at the end of December, the volume of loan portfolio decreased by 7%, deposits (including the transit funds) – by 2%, and the capital and reserves of the banks – by 6%. In 2009, the unaudited losses of banks reached 773 million lats mostly due to accumulation of provisions for non-performing loans.

The lending of banks to the private sector still receded, driven by the cautious lending policies of banks due to the complex economic situation, as well as the low demand in sector of households as well as the sector of non-finance companies. But for all that, the total drop of the lending volume (by 7%) may not be regarded as steep, considering the high level of risk in economy, the necessity of banks to build provisions and restructure loans.

The credit resources available to Latvian commercial banks on the financial market substantially shrunk in 2009, along with the capacities of banks to refinance long-term interbank borrowings, and reduction of deposits also diminished the supply of money. Although euro deposits in 2009 have increased, the deposits in lats and US dollars have considerably dropped.

The decreasing growth of Latvian economy and price increase of credit resources has affected the loan portfolio quality of Latvian commercial banks, which has considerably deteriorated over the last year. At the end of 2009, the performing (non-overdue) loan portfolio of the banking sector reached 74.5%. Recovery options of problem loans are becoming more and more complicated, as a result of which the volume of write-off loans in the financial sector is growing.

The reserve requirements imposed by the Bank of Latvia have not changed in 2009: for bank liabilities exceeding 2 years – 3%, for all other liabilities included in the reserve base – 5%.

The US Federal Reserve system has maintained the dollar basic interest rate at its historically lowest mark during 2009 (0.25%). the European Central Bank reduced the euro basic interest rate – from 2.5% to 1.0%, and the Bank of Latvia has also reduced the lats basic interest rate from 6% to 4%, as a result of which this period saw a decrease of the average interest rate for loans issued by Latvian commercial banks. The average interest rate for private borrowers (in lats) decreased from 17.48% (December 2008) to 12.15% (December 2009), while for legal entities the decrease for the corresponding period was from 13.44% to 6.74%. The average interest rates for legal entities (in foreign currencies) decreased from 6.72% (December 2008) to 4.20% (December 2009), and for private borrowers – from 7.48% to 5.79%. In light of the activities of foreign central banks, targeted to boost the economies, interest rates for loans in foreign currencies would still remain lower than the rates for loans in lats, an essential factor for clients when selecting the loan currency.

**Financial results**

To the contrary of the trend in the banking sector, the volume of unaudited gross assets of the Mortgage Bank in 2009 increased by 4.4 million lats reaching 967 million lats (market share – 4.5%). Due to the global deterioration of the economic situation, with the risk of granted loans rising, Mortgage bank has accumulated the provisions for doubtful assets in the amount of 74.2 million lats during 2009. The unaudited losses of the Bank for 2009 were 54.1 million lats, and the retained earnings of the bank for previous years were 12 million lats.

In 2009, the gross loans' portfolio of the Mortgage Bank has decreased by 24.1 million lats or 3%, reaching 707.5 million lats (market share – 4.6%).

The volume of deposits (including the transit funds) with the Mortgage Bank in 2009 has increased by 22.3 million lats or by 8% to 326.8 million lats (market share – 3.4%).

The Bank in 2009 repaid syndicated loans and other interbank long-term loans of 215.2 million euro (151.3 million lats). In 2010, syndicated and other interbank long-term loans will be defrayed by 149 million lats.

In January 2009 the equity capital of the Bank was increased by 29.5 million lats. On 20 November 2009, the shareholder of the Mortgage Bank upon approval from the European Commission (decision no. NN60/2009) increased the equity capital of the Bank by 43.29 million lats. Thus the total volume of the paid-up share capital reached 121.32 million lats. The capital adequacy ratio of the Bank was 12.8% on 31.12.2009, which considerably exceeds the statutory minimum of 8% as directed by the Law on Credit Institutions.

Increase of the equity capital of the Mortgage Bank was included in the law on 2010 national budget (Article 12). Pursuant to that, the equity capital of the bank is to be increased by 70.2 million lats, with the state taking over liabilities of the Mortgage bank towards the Nordic Investment bank (NIB) and investing the respective amount into the equity capital of the bank. The recapitalization shall be conducted at the end of 1st quarter of 2010 according to the Bank's action plan. These funds shall be used for lending under the Programme for improvement of competitiveness of businesses. It means that these funds will remain with the bank after repayment of the granted loans, and the Mortgage bank would further use them for funding of Latvian entrepreneurs under the Programme for improvement of competitiveness of businesses.

In February 2009 the Mortgage Bank and Privatisation Agency concluded a share purchase agreement on sale of shares of Parex Bank owned by Mortgage Bank to Privatisation Agency.

At the beginning of 2009 the international rating agencies started gradual downgrade of the credit ratings of Latvia. *Standard & Poor's Rating Services* and *Fitch Ratings* downgraded Latvia's sovereign credit ratings to BB+ that was a speculative rating, noting that the downgrading reflected the worsening of the economic situation faster than anticipated. *Moody's Investors Service Ltd* downgraded the sovereign rating on Latvia to the lowest investment grade rating *Baa3*. The Mortgage Bank is 100% owned by state and its rating may not exceed Latvia's sovereign rating. For this reason *Moody's Investors Service Ltd* lowered the credit ratings of the Mortgage Bank along with the downgrading of the sovereign rating. The Bank is assigned the following ratings:

- long-term foreign currency deposits – ***Baa3***,
- short-term foreign currency deposits – ***P3***,
- financial strength rating – ***E+***,
- rating of mortgage bonds – ***Baa2***,

which are investment grade ratings.

At the end of 2009, the Mortgage Bank serviced its clients in 27 branch offices, located in Riga as well as in each district centre of Latvia, and 8 sub-branches in various regions of the country. While maintaining the mission to provide banking services to the population as accessible and convenient as possible, the Mortgage Bank conducted optimization of the bank's branch and sub-branch network in 2009: the status of Valka branch and Smiltene sub-branch were changed, Sigulda sub-branch of Ūnija branch and the sub-branch of Liepāja branch were closed, while Balvi and Ludza branches were transformed into sub-branches. These reorganizations allowed to achieve higher efficiency and reduce costs.

We are happy to declare that Preiļi Branch office was among the top ten most praised places of good service in the Pan-Latvian campaign "Praise good service!".

Proceeding with expansion of its ATM network, the Mortgage Bank installed 17 new ATMs in 2009, with the total ATM network of the Mortgage Bank thus expanding to 72 ATMs. The customers of Mortgage Bank can withdraw cash without commission fee being applied also in the network of "friendly ATMs" (Rietumu banka, Latvia Krājbanka, SEB banka, Parex banka), the total of 633 ATMs across Latvia.

**Course of development bank operations, implementation of state aid programmes**

On 3 December 2009, the concept "Transformation of the "State Joint-stock company "Mortgage and Land bank of Latvia" into Development bank" was accepted by the Cabinet of Ministers decree No.820. The goal of the concept was to select the optimum options for transformation of the Mortgage bank into development bank, by reducing transactions of commercial bank and channelling the bank's operations into directions currently crucial for the national economy.

In line with the decided by the Cabinet of Ministers, favour was granted to the concept model, encompassing formation of the development bank on the fundaments of the Mortgage bank and gradual phasing out of commercial banking functions until the deadline of 31 December 2013. According to the favoured model of the concept, the bank continues implementation of the existing state aid programmes, in cooperation with line ministries develops new promotional programmes, the start of implementation of which is decided by the Government.

The Mortgage bank gradually reduces the volume of the bank's commercial loan portfolio. In the area of commercial activity, the bank has already stopped lending to new clients and grants commercial loans only to existing clients, according to the present loan volume, and for restructuring of the existing loans of the bank's current commercial clients.

The Mortgage bank in 2009 continued implementation of promotional programmes, where aid is provided to certain groups of entrepreneurs and population as tasked by the government:

- Programme for improvement of the competitiveness of businesses;
- Microlending programme;
- Start programme "Support to Self-employment and Business Start-ups".

*Programme for improvement of the competitiveness of businesses*

On 17 February 2009, with the aim to boost entrepreneurship in Latvia, the Cabinet of Ministers passed Regulations No. 164 on lending to improve the competitiveness of businesses. As directed by these Regulations, the Mortgage Bank shall grant investment and working capital loans to small, medium and large entrepreneurs. In May, the Mortgage Bank received the first 50 million euro (35.1 million lats) for implementation of this programme from the Nordic Investment Bank (NIB), and the remaining 50 million euro (35.1 million lats) got transferred in July.

On 10 March 2009, the Cabinet adopted regulations No 238 regarding Activity 2.2.1.4 "Loans for Improvement of Competitiveness of Businesses" of the Supplement of Action Programme "Business and Innovations" that prescribe establishment of the Loan Fund as a separate financial resources unit in the Mortgage Bank for lending to the entrepreneurs under Cabinet Regulations No 164 (regarding loans for raising of competitiveness of businesses). The Loan Fund consists of the public financing in the amount of 61.6 million euro (43.3 million lats) and financing of the Mortgage Bank – 21.6 million euro (15.2 million lats). Lending from the Loan Fund was initiated in May of this year. 101.6 million lats had been granted under the competitiveness improvement programme by the end of December 2009, including 29.5 million lats from the Loan Fund.

*Microlending programme*

In the first quarter of this year, in accordance with the Cabinet Decree No 752 dated 2 December 2008, the Mortgage Bank commenced implementation of the Small and Medium Enterprises Microlending Programme granting microloans up to 3 thousand lats. The total financing volume of the programme is 564.8 thousand lats. By the end of December, the Mortgage Bank had granted microloans for the total amount of 404 thousand lats.

*Programme "Support to Self-employment and Business Start-ups"*

In compliance with the Cabinet of Ministers Regulations No 293, passed on 31 March 2009, "On Action Programme "Human Resources and Employment" supplement 1.3.1.2. activity "Support to Self-employment and Business Start-ups"", in August the Mortgage Bank initiated implementation of the Start programme, which provides training in business fundaments to business start-ups as well as consultations in preparing a business plan. In case of a positive decision of a lending committee, the participant of the programme receives a loan and grants for implementation of the project described in the business plan. By the end of December, 483 applicants had applied for consultations and training and training was started at the end of December; 106 business plans had been submitted to the bank, 51 of which was considered in credit committee and 29 were granted loans in the total amount of 565 thsd LVL and grants of 133 thsd LVL.

In 2010, the Bank is planning to launch an SME growth lending programme to stimulate the development of micro, small and medium entrepreneurs and farmers' unions in accordance with the Cabinet of Ministers regulations No.1065 of 15.09.2009. The aim of the programme is to improve the access to funding of entrepreneurs registered in Latvia, to revive and stimulate the development of Latvian national economy. For implementation of the programme, the Mortgage bank has signed a 100 million euro loan agreement with the European Investment bank on 2 October 2009, which will become valid after the state guarantee agreement is signed.

Nourishing the traditions launched in previous years, the Mortgage Bank closely cooperates with Latvian regions – in spring of 2009 the Bank signed co-operation agreements with the leaders of all five regional funds established in Latvia (funds of Valmiera, Talsi, Alūksne, Liepāja and Lielvārde), as well as councils of Limbaži, Ogre and Ērgļi regions, and Jūrkalne parish council on organisation of project tender. The Bank supports the best projects promoting activity and self-initiative of the local population in improving their surrounding environment submitted to tenders organized by the funds. 129 projects got implemented in cooperation with the Regional funds. Meanwhile, in cooperation with the Riga Technical University, the project "Good practice" was organized, providing students of engineering sciences with one-month of field practice during summer in client companies of the Mortgage Bank and other industry leaders in Latvia.

**MORTGAGE AND LAND BANK OF LATVIA**
**THE SUPERVISORY COUNCIL AND BOARD OF DIRECTORS OF THE BANK**

**Supervisory Council (at 31 December 2009)**

| | |
|---|---|
| Baiba Bāne | Chairman of the Council |
| Dāvids Tauriņš | Deputy Chairman of the Council |
| Baiba Brigmane | Member of the Council |

During the reporting period, the following Council members resigned: Ms. Iveta Strautiņa, Mr. Jānis Šnore and Mr. Matīss Markuss. Ms. Baiba Brigmane was appointed as Council members.

**Board of Directors (at 31 December 2009)**

| | |
|---|---|
| Rolands Paņko | Chairman of the Board |
| Jēkabs Krieviņš | Deputy Chairman of the Board |
| Andris Riekstiņš | Member of the Board |
| Jānis Bērziņš | Member of the Board |

On 10 August 2009 Inesis Feiferis resigned from the Board.

In accordance with Council decision on 10 August 2009, Rolands Paņko has been elected the Chairman of the Board and Jēkabs Krieviņš has been elected the Deputy Chairman of the Board.

During the reporting period Aija Laicāne resigned from the Board and Jānis Bērziņš as was appointed as member of the Board.

## STATEMENT OF RESPONSIBILITY OF THE MANAGEMENT

Management is responsible for preparing financial statements from the books of prime entry of the Group and the Bank for each financial period that present fairly the state of affairs of the Group and the Bank as at the end of the financial period and the results of their operations and cash flows for that period according to the International Financial Reporting Standards as adopted by the European Union..

Management confirms that suitable accounting policies have been used and applied consistently and reasonable and prudent judgments and estimates have been made in the preparation of the condensed consolidated and bank financial statements for the period ended 31 December 2009. Management also confirms that applicable International Financial Reporting Standards as adopted in EU have been used in preparation of the financial statements and that these financial statements have been prepared on a going concern basis. Appropriate accounting policies have been applied on a consistent basis.

Management is responsible for keeping proper accounting records, for taking reasonable steps to safeguard the assets of the Group and the Bank and to prevent and detect fraud and other irregularities. Management is also responsible for managing the Bank in compliance with the Law on Credit Institutions, regulations of the Bank of Latvia and the Financial and Capital Market Commission as well as other legislation of the Republic of Latvia.

**INCOME STATEMENT**
(all amounts in thousands of Euro)

| | 2009 | | 2008 | |
|---|---|---|---|---|
| | **Group** | **Bank** | **Group** | **Bank** |
| Interest income | 78,219 | 75,406 | 94,061 | 90,418 |
| Interest expense | (43,326) | (42,744) | (63,937) | (62,698) |
| **Net interest income** | **34,893** | **32,662** | **30,124** | **27,720** |
| Fee and commission income | 6,047 | 5,570 | 5,821 | 5,700 |
| Fee and commission expense | (1,417) | (1,458) | (1,419) | (1,383) |
| **Net fee and commission income** | **4,630** | **4,112** | **4,402** | **4,317** |
| Dividend income | 7 | 74 | 18 | 1,157 |
| Net trading income | 8,773 | 8,991 | 3,068 | 3,108 |
| Other operating income | 9,383 | 7,196 | 6,783 | 4,895 |
| Staff costs | (13,695) | (12,198) | (14,368) | (12,799) |
| Administrative expenses | (12,268) | (10,962) | (13,021) | (11,545) |
| Depreciation and amortisation | (2,897) | (2,610) | (3,325) | (2,877) |
| Provision for impairment losses | (107,573) | (105,604) | (13,204) | (12,159) |
| **Profit before income tax** | **(78,747)** | **(78,339)** | **477** | **1,817** |
| Income tax expense | 1,329 | 1,431 | (219) | (100) |
| **Net profit for the period** | **(77,418)** | **(76,908)** | **258** | **1,717** |
| **Attributable to:** | | | | |
| Equity holders of the Bank | (77,434) | - | 255 | - |
| Minority interest | 16 | - | 3 | - |

**BALANCE SHEET**
(all amounts in thousands of Euro)

| | 31/12/09 | | 31/12/08 | |
|---|---|---|---|---|
| <u>**Assets**</u> | **Group** | **Bank** | **Group** | **Bank** |
| Cash and balances with Central Bank | 136,591 | 136,591 | 64,193 | 64,193 |
| Trading securities | 7,220 | 6,999 | 5,491 | 5,280 |
| Investment securities – held to maturity | 61,161 | 61,161 | 91,163 | 91,020 |
| Investment securities – available for sale | 70,990 | 70,990 | 37,416 | 37,416 |
| Due from credit institutions | 50,385 | 50,193 | 93,322 | 92,962 |
| Derivative financial instruments | 2,780 | 2,780 | 2,250 | 2,250 |
| Loans to customers | 900,224 | 909,928 | 1,056,320 | 1,033,823 |
| Investment properties | 1,659 | 1,659 | 2,598 | 2,598 |
| Investments in subsidiaries and associated undertakings | 398 | 2,174 | 421 | 1,278 |
| Intangible assets | 3,136 | 2,449 | 3,463 | 2,763 |
| Property and equipment | 10,723 | 9,812 | 12,389 | 10,868 |
| Current income tax assets | - | - | 1,632 | 1,429 |
| Other assets | 12,658 | 2,654 | 7,114 | 2,071 |
| Deferred expenses and accrued income | 942 | 757 | 1,022 | 802 |
| **Total assets** | **1,258,867** | **1,258,147** | **1,378,794** | **1,348,753** |
| | | | | |
| <u>**Liabilities**</u> | | | | |
| Due to credit institutions | 539,997 | 539,997 | 733,103 | 705,641 |
| Due to customers | 462,076 | 462,164 | 429,847 | 430,005 |
| Derivative financial instruments | 221 | 221 | 777 | 777 |
| Transit funds | 2,775 | 2,775 | 3,238 | 3,238 |
| Issued debt securities | 53,257 | 54,423 | 57,854 | 57,854 |
| Other liabilities | 38,986 | 38,182 | 18,616 | 17,613 |
| Deferred income and accrued expenses | 5,687 | 4,804 | 3,714 | 2,678 |
| Current income tax liabilities | 61 | 0 | - | - |
| Deferred tax liabilities | 38 | 0 | 1,431 | 1,431 |
| Subordinated liabilities | 44,236 | 44,236 | 44,236 | 44,236 |
| **Total liabilities** | **1,147,334** | **1,146,802** | **1,292,816** | **1,263,473** |
| | | | | |
| <u>**Shareholder's equity**</u> | | | | |
| Share capital | 172,624 | 172,624 | 69,028 | 69,028 |
| Reserve capital | 3,591 | 2,935 | 3,591 | 2,935 |
| Minority interest | 57 | - | 41 | - |
| Revaluation deficit on available for sale investments | (4,317) | (4,317) | (5,068) | (5,068) |
| Retained earnings | (60,422) | (59,897) | 18,386 | 18,385 |
| **Total shareholder's equity** | **111,533** | **111,345** | **85,978** | **85,280** |
| | | | | |
| **Total liabilities and shareholder's equity** | **1,258,867** | **1,258,147** | **1,378,794** | **1,348,753** |
| | | | | |
| <u>**Off balance sheet items**</u> | | | | |
| Contingent liabilities | 17,188 | 25,726 | 34,159 | 34,159 |
| Financial commitments | 46,865 | 78,726 | 42,325 | 56,060 |

**CONSOLIDATED STATEMENT OF CHANGES IN THE GROUP'S EQUITY**
(all amounts in thousands of Euro)

| | Attributable to equity holders | | | | | |
|---|---|---|---|---|---|---|
| | **Share Capital** | **Reserve capital** | **Revaluation deficit on available for sale investments** | **Retained earnings** | **Minority interest** | **Total equity** |
| **Balance as at 31 December 2007** | **69,028** | **3,591** | **(2,191)** | **20,492** | **-** | **90,920** |
| Distribution of profit – payment for use of state capital | - | - | - | (2,361) | - | **(2,361)** |
| Minority share of IPAS „Hipo fondi" on the date of acquisition | - | - | - | - | 38 | **38** |
| Net loss on available for sale investments | - | - | (2,877) | - | - | **(2,877)** |
| Profit for the period | - | - | - | 255 | 3 | **258** |
| **Balance as at 31 December 2008** | **69,028** | **3,591** | **(5,068)** | **18,386** | **41** | **85,978** |
| Distribution of profit – payment for use of state capital | - | - | - | (1,374) | - | **(1,374)** |
| Net profit on available for sale investments | - | - | 751 | - | - | **751** |
| Shares issued | 103,596 | - | - | - | **-** | **103,596** |
| Loss for the period | - | - | - | (77,434) | 16 | **(77,418)** |
| **Balance as at 31 December 2009** | **172,624** | **3,591** | **(4,317)** | **(60,422)** | **57** | **111,533** |

**STATEMENT OF CHANGES IN THE BANK'S SHAREHOLDER'S EQUITY**
(all amounts in thousands of Euro)

| | Share Capital | Reserve capital | Revaluation deficit on available for sale investments | Retained earnings | Total equity |
|---|---|---|---|---|---|
| **Balance as at 31 December 2007** | **69,028** | **2,935** | **(2,191)** | **19,028** | **88,800** |
| Distribution of profit – payment for use of state capital | - | - | - | (2,360) | **(2,360)** |
| Net loss on available for sale investments | - | - | (2,877) | - | **(2,877)** |
| Profit for the period | - | - | - | 1,717 | **1,717** |
| **Balance as at 31 December 2008** | **69,028** | **2,935** | **(5,068)** | **18,385** | **85,280** |
| Distribution of profit – payment for use of state capital | - | - | - | (1,374) | **(1,374)** |
| Net profit on available for sale investments | - | - | 751 | - | **751** |
| Shares issued | 103,596 | - | - | - | **103,596** |
| Loss for the period | - | - | - | (76,908) | **(76,908)** |
| **Balance as at 31 December 2009** | **172,624** | **2,935** | **(4,317)** | **(59,897)** | **111,345** |

**CASH FLOW STATEMENT**
(all amounts in thousands of Euro)

| | 2009 | | 2008 | |
|---|---|---|---|---|
| | **Group** | **Bank** | **Group** | **Bank** |
| **Cash flows from operating activities** | | | | |
| (Loss) / profit before taxation | (78,747) | (78,339) | 477 | 1,817 |
| Depreciation and amortization | 2,897 | 2,610 | 3,325 | 2,877 |
| Increase in provision for impairment losses | 94,446 | 94,176 | 10,309 | 9,506 |
| Profit from sale of property and equipment | (598) | 115 | (139) | (1) |
| **Increase in cash and cash equivalents from operating activities before changes in assets and liabilities** | 1,973 | 2,126 | 997 | 745 |
| | 80 | 46 | 132 | 178 |
| Decrease / (increase) in balances due from credit institutions | (3,344) | 1,724 | (8,401) | (6,669) |
| Decrease / (increase) in loans to customers | 19,815 | 20,013 | 2,186 | 2,254 |
| Decrease / (increase) in trading securities | **36,522** | **42,471** | **8,886** | **10,707** |
| (Decrease) / increase in balances due to credit institutions | | | | |
| (Decrease) / increase in balances due to customers | 43,075 | 43,075 | (13,261) | (13,261) |
| (Decrease) in transit funds | 64,783 | 32,877 | (113,520) | (101,089) |
| (Decrease) in debt securities issued | (1,753) | (1,743) | (840) | (629) |
| Increase / (decrease) in deferred income and accrued expenses | (200,725) | (173,726) | 18,782 | 3,783 |
| (Increase) in deferred expenses and accrued income | 32,230 | 32,160 | 28,420 | 27,972 |
| Decrease / (increase) in other assets | (464) | (464) | (425) | (425) |
| Increase in other liabilities | (4,597) | (3,431) | (16,838) | (16,838) |
| **Cash and cash equivalents generated from operating activities** | **(30,929)** | **(28,781)** | **(88,796)** | **(89,780)** |
| **Corporate income tax paid** | **(3)** | **-** | **(1,476)** | **(1,026)** |
| **Cash flows from investing activities** | | | | |
| Increase in investment securities | (6,089) | (6,232) | (35,616) | (35,474) |
| Purchases of property and equipment | (1,574) | (1,386) | (3,914) | (2,517) |
| Proceeds from property and equipment disposal | 1,268 | 31 | 518 | 60 |
| Proceeds from investments in associated entities disposal | 23 | - | 386 | 34 |
| Acquisition of investments in associated entities | - | (1,231) | (21) | - |
| **Cash and cash equivalents used in investing activities** | **(6,372)** | **(8,818)** | **(38,647)** | **(37,897)** |
| **Cash flows from financing activities** | | | | |
| Shares issued | 103,596 | 103,596 | - | - |
| Proceeds received from issuance of shares | - | - | 30,000 | 30,000 |
| Proceeds from subordinated debt | - | - | (4,695) | (4,495) |
| Dividend paid | (1,374) | (1,374) | (2,360) | (2,360) |
| **Cash and cash equivalents generated from financing activities** | **102,222** | **102,222** | **22,944** | **22,944** |
| **Increase in cash and cash equivalents** | 64,918 | 64,623 | (105,975) | (105,759) |
| Cash and cash equivalents at the beginning of the period | 81,753 | 81,856 | 187,728 | 187,615 |
| **Cash and cash equivalents at the end of the period** | **146,671** | **146,479** | **81,753** | **81,856** |

## GENERAL INFORMATION

The Mortgage and Land Bank of Latvia was established as a state-owned commercial bank on 19 March 1993 by the Government of Latvia based on the Decree No 140 adopted by the Cabinet of Ministers. The Bank was registered with the Register of Enterprises of the Republic of Latvia on 3 June 1993. According to the Commercial Law the Bank was registered in the Commercial Register on 14 July 2004.

The operations of the Bank are regulated by the law On Credit Institutions and other effective laws of the Republic of Latvia, the Statutes of the Bank, the instructions of the Bank of Latvia and Financial and Capital Market Commission, as well as the decrees and regulations of the Cabinet of Ministers of the Republic of Latvia. The Bank is under the jurisdiction of the Ministry of Finance of the Republic of Latvia that represents the interests of the shareholder on behalf of the Cabinet of Ministers and holds 100% of the Bank's shares.

## RISK MANAGEMENT

The Group and the Bank manages all the major risks affecting the operation of the Group and the Bank in accordance with the Risk Management Policy approved by the Council of the Bank. The Risk Management Policy stipulates and describes the aggregate of measures used to ensure that a possibility of suffering losses is minimized in the event the invested or receivable resources would not be repaid or recovered in due time or full amount or the Group or the Bank would suffer other losses or would not derive the planned profit. Risk management is an integral component of the internal control system of the Group and the Bank and the risk management system has been established taking into account the size and structure of the Group and the Bank, as well as the best advisable practice, incl. the guidelines of Basel bank supervisory committee.
In light of the changes occurring on global financial markets and economy, a number of major improvements were made to the risk management system of the Group and the Bank during the reporting period, thus allowing to identify the risks more precisely and timely and to determine their impact on the future operations of the Group and the Bank.

The Group and the Bank abides by the following principles in its risk management:

- while assuming the risks the Group and the Bank shall be capable of implementing the aims and assignments defined in its development strategy in a longer run;
- the Group and the Bank shall operate by maintaining an optimum balance between profitability and safeguarding against the risks, i.e. the profitability must be as large as possible, however, the Group and the Bank shall not be exposed to the risks;
- risk assessment and management shall be an integral component of the every-day functions of the Group and the Bank;
- In accordance with their authority and competence the employees of the Group and the Bank shall know a customer and understand fully the nature of each transaction (operation) to be able to identify and assess the risks associated with the transaction (operation) and find the best solution both for the customer and the Group or the Bank;
- the Group and the Bank shall assess the probable losses that it might incur by assuming the risks and avoid extraordinary losses in its operation;
- the Group and the Bank shall identify and assess the probable risks before launching of new products or services or entering new markets;
- where necessary, the Group and the Bank shall reduce the risk limits, sell the assets subject to the risk or even leave the respective markets should these be assessed as excessively risky.

In managing the risks the Group and the Bank apply various methods and instruments for measuring risks, set the limits and maintain the appropriate controls. All risk policies are approved by the Council.

### Credit Risk

The Group and the Bank is subject to the credit risk. The credit risk is the risk of the customer or co-operation partner not being able to or refusing to meet its liabilities towards the Group or the Bank in full amount and due time.
The Group and the Bank manages the credit risk according to the Credit Policy as well as internal regulations, procedures and instructions of credit operations.
The Credit Policy of the Bank describes and defines the principles for the management of the credit risk and it relates to all activities of the Group and the Bank involving credit risk – lending, financial market transactions (operations), intermediary activities on behalf of the clients and issue of guarantees to third parties.

**RISK MANAGEMENT** (continued)

Management process of credit risk within the Group and the Bank encompasses establishment of guidelines and limitations, granting of loans or setting limits to particular clients or groups of interrelated clients; administration, monitoring and evaluation of files of clients or interrelated client groups, as well as appropriate control of the process, operation of management information system and evaluation of the total efficiency of the process.

In establishment of guidelines and limitations, the Group and the Bank primarily follows the common strategy of the Group and the Bank, as well as their historic experience in credit risk management, which allows defining adequate limitations of concentration, as well as adequate assessment of creditworthiness and collateral, passing decisions in decision-making institutions of the appropriate level. As the common strategy of the Group and the Bank encompasses gradual transformation of the Bank into development bank, the risk stemming from implementation of framework funding programmes becomes an increasingly significant risk source for the Group and the Bank.

The Bank's Lending department bears the responsibility for daily credit risk management in lending operations, incl. when setting criteria of creditworthiness and collateral adequacy, while decisions about assuming credit risk within the set limits are made by branch, regional and the Central lending committees, or the Board of the Bank. The daily supervision and administration of loans is conducted on the basis of each individual borrower's risk grade and affiliation, determined by organizational structure of the Group and the Bank.

The Risk management committee conducts the integrated monitoring of credit risk, incl. credit risk concentration and loan portfolio quality, while the Risk management department bears the responsibility for analysis of credit risk concentration, setting of limits and their control, quality assessment of the loan portfolio and building of provisions, as well as daily management of credit risk in operations with financial instruments. At least once a year, stress testing of the loan portfolio and scenario analysis is conducted, that includes changes of various macro-environment affecting factors (drop of real estate property prices, households' income decrease, contingent changes in development of various industries of national economy, and similar) and demonstrates the eventual impact on the Group's and the Bank's profitability, loan portfolio quality, volume of provisions and level of capital adequacy.

The Group and the Bank manages credit risk concentrations according to the Risk Exposures Controlling Policy that stipulates the methods of analysis of the credit risk concentrations and its controlling instruments including limits on credit risk concentrations. Credit risk concentration is managed by measuring and setting limits on the following concentrations:

- ratio of large exposure concentration and own funds (internal limit - 400%, limit set by the Law on Credit Institutions – 800%), as of 31.12.2009 was 47.1% (as of 31.12.2008 – 78.6%);
- ratio of single client's (related clients' group) large exposure and own funds, which may not exceed 25%, as of 31.12.2009 was 20.7% (as of 31.12.2008 – 22.1%);
- ratio of risk exposures with persons related to the Bank and own funds, which may not exceed 15%, as of 31.12.2009 was 2.6% (as of 31.12.2008 – 3.8%).
- proportion of risk concentration in a single economic sector in the Bank's credit portfolio and own funds as of 31.12.2009 was 120.9% (as of 31.12.2008 – 172.6%);

Since the Bank's strategy is not focused on servicing the non-residents business, the proportion of the Bank's total claims to non-residents was small and as of 31.12.2009 was 7.1% (as 31.12.2008 – 8.9 %) of the Bank's total assets. The Group and the Bank manages the country risk that results from the lending operations to non-residents according to the Country Risk Management Policy.

Each of the structural units involved in credit risk management maintain an appropriate internal control, efficiency of which is responsibility of the Internal audit department.

The management of the Group and the Bank has performed calculation of losses on the basis of all the facts at its disposal, unbiased proofs of depreciation, and believes the calculations disclosed in the financial reports are reasonable, considering the available information. Nonetheless, having the present awareness, it might occur, as a result of the next year's actual events, differing from the assumptions, that the respective book values of assets and liabilities be corrected.

**RISK MANAGEMENT** (continued)

**Liquidity Risk**

The liquidity risk relates to the ability of the Group and the Bank to redeem the legally valid claims of its customers and other creditors in due time and secure that the increase of the anticipated claims presents reasonable costs.

The principles for management of liquidity risk are determined by the Liquidity Risk Management Policy and Business Continuity Plan for Liquidity Crisis Situation. The Bank maintains that the liquid assets do not fall below 30% (set by the FCMC) of its short-term liabilities at all times. The Assets and Liabilities Committee of the Bank stipulates the guidelines for liquidity risk management and controls compliance thereof, whereas the Treasury Department provides for daily management of the liquidity risk.

To evaluate the liquidity risk, the Bank uses the GAP method. The Bank has set liquidity net position limit in each significant currency and total liquidity net position limit as well as maximum deposit amount from a single depositor to control the liquidity risk. At least once a month, scenario analysis or stress testing is conducted, to reveal the impact of contingencies on liquidity of the Group and the Bank.

Compliance with the liquidity ratio (min – 30%) was 82.2% as of 31.12.2009 (as of 31.12.2008 – 60.4%).

**Foreign Currency Risk**

The foreign currency risk occurs due to the differences between the asset and liability positions of foreign currencies that, as a result of the fluctuations of the exchange rates, affect the cash flow and financial results of the Group and the Bank. The principles for the management of the foreign currency risk are outlined in the Currency Risk Management Policy of the Bank.

Monitoring of the foreign currency risk is conducted by the Assets and Liabilities Management Committee of the Bank, whereas the Treasury Department provides for daily management of the foreign currency risk.

The Group and the Bank maintains a cautious foreign currency risk management policy and controls the foreign currency risk by imposing limits on the open currency positions for each currency and all currencies together consolidating in lats and by complying with the open currency position limits established in the law On Credit Institutions.

**Interest Rate Risk**

The interest rate risk is related to the influence of the fluctuations of the market rates onto the interest income and expenses of the Group and the Bank. To assess the interest rate risk the Group and the Bank analyses the maturity structure of the assets and liabilities sensitive to the changes in interest rates and susceptibility of the maturity structure to the potential fluctuations of the interest rates on a regular basis. The Assets and Liabilities Management Committee monitors the interest rate risk, whereas the Treasury Department is responsible for the daily management of the interest rate risk. The Bank has set limit on changes in economic value of the Bank at 10% of own funds and limit on changes in net interest income at 2% of own funds which, respectively, were 7.63% as of 31.12.2009 (as of 31.12.2008 – 9.76%) and 0.43% (as of 31.12.2008 – 0.27%).

**Operational risk**

The operational risk results from intentional or unintentional deviations from the standards adopted in daily operation of the Group and the Bank, for example human mistake or fraud, disturbances in the operation of the information systems, insufficient control procedures or their ignorance. The Group and the Bank manages operational risk according to the Operational Risk Management Policy. Self-assessment method is used to measure the operational risk, whereas the Bank's operational risk information system is used to identify, analyse and control the operational risk, which registers and analyses occurrences of operational risk and calculates the scale of actual or potential losses. Structural units of the Group and the Bank are responsible for the management of the operational risk in the daily operations, but the Risk Management Committee supervises the operational risk. The Risk Management Department is responsible for implementation of the operational risk management in the Group and the Bank.

The Bank has implemented Business Continuity Plan that includes guidelines on actions to be taken by the Bank, its structural units and employees at occurrence of risks that can have substantial negative effect on the Bank's operations.

**RISK MANAGEMENT** (continued)

**Capital Adequacy**

Capital adequacy shows those capital resources of the Group and the Bank needed to cover the credit and market risks arising from asset-side and off-balance sheet positions and also against operational risks.

The Group and the Bank completely follows the requirements of Basel II in their capital adequacy evaluation process. The Group and the Bank uses the standardised approach to calculate minimum capital charge for credit and market risks and basic indicator approach – for operational risk.

As of 31.12.2009, the capital adequacy ratio of the Bank calculated according to the regulations of the Financial and Capital Market Commission were 12.8% (as of 31.12.2008 -9.6%) which exceeded the minimum of 8% for the ratio of the own capital and total of risk-weighted assets and off-balance sheet items.

**THE PERFORMANCE RATIOS OF THE BANK**

| Items | Accounting period | Previous accounting year |
|---|---|---|
| Return on equity (ROE) (%) | -65.02% | 1.93% |
| Return on assets (ROA) (%) | -5.60% | 0.14% |

**CONSOLIDATION GROUP**

| No | Name of commercial company | Code of place of registration, address of registration | Type of activity of commercial company * | Share of fixed capital (%) | Voting rights in commercial company (%) | Justification for including in the Group** |
|---|---|---|---|---|---|---|
| 1. | SIA „Hipotēku bankas nekustamā īpašuma aģentūra” | LV –Latvija 40003426895 | CKS | 100 | 100 | MS |
| 2. | SIA „Hipolīzings” | LV – Latvija 40003616329 | CFI | 100 | 100 | MS |
| 3. | SIA „Risku investīciju sabiedrība” | LV – Latvija 40003952445 | CFI | 100 | 100 | MS |
| 4. | IPS „Hipo fondi” | LV – Latvija 40003403040 | IPS | 83 | 83 | MS |
| 5. | SIA „Rīgas Centra namu pārvalde” | LV – Latvija 40003266805 | CKS | 100 | 100 | MS |
| 6. | KS "Mazo un vidējo komersantu atbalsta fonds" | LV – Latvija 40003681329 | CFI | 47.62 | 47.62 | KS |

* IPS – investment management company, CFI – other financial institution, CKS – other commercial company; ** MS – subsidiary; KS – joint venture.

**RATINGS ASSIGNED TO BANK BY RATING AGENCY MOODY`S INVESTORS SERVICE**

| Rating type | Ratings | Rating Approval date | Previous rating |
|---|---|---|---|
| For long-term foreign currency bank deposits | **Baa3** | 25.06.2009. | **Baa3** |
| For short-term foreign currency deposits | **P3** | 25.06.2009. | **P3** |
| The financial strength rating | **E+** | 25.06.2009. | **D-** |
| The rating of mortgage bonds issued | **Baa2** | 23.04.2009. | **A2** |

Moody`s Investors Service reports of the Bank may be found at: *www.hipo.lv*
Additional information on the ratings assigned (incl. Legend of ratings) may be found at: *www.moodys.com*

These condensed financial reports are to be viewed along with the Bank’s Annual Report for 2008.

Rolands Paņko
Chairman of the Board

Uvis Zemītis
Chief Accountant