



ANNUAL REPORT AND ACTIVITY REPORT 2011
OF THE FINANCIAL AND CAPITAL MARKET COMMISSION

CONTENT

I. Introduction	4
Chairman's Statement	4
Report of the Board	6
Strategy of the Commission's Activities	8
II. Commission's activities in 2011	32
Supervision	8
Self-Assessment of Compliance of the Regulations Governing the Activity of Latvian Banks and of the Banking Supervision Practice with Basel Core Principles	9
Banking Sector	9
Suspending the Activity of the JSC "Latvijas Krājbanka"	12
Cooperative Credit Unions	12
Payment Institutions and Electronic Money Institutions	12
Insurance Companies	12
Investment Management Companies and Investment Funds	13
Managers of Assets of the State Funded Pension Scheme	13
Private Pension Funds	14
Investment Service Providers	14
Issuers of the Financial Instruments Admitted to Trading on the Regulated Market	14
Trading in Financial Instruments	14
Security of Financial Services and Information Systems	15
Prevention Money Laundering	15
Licensing	16
Developing Regulatory Provisions	17
National Regulations	17
EU Regulations Adopted in 2011	19
Draft EU Regulations Discussed in 2011	19
Planned EU Initiatives in 2012	21
Financial Stability System	21
Deposit Guarantee Fund	21
Fund for the Protection of the Insured	23
Protection of the Customers of the Financial Instruments Market (Investors)	24
Financial Stability Fee	24
Cooperation	24
Cooperation at the National Level	24
International Cooperation	25
Customer Protection	29
Communication with General Public and Educating the Customers of the Financial Sector	30
Major Tasks in 2012	31
III. Governance and Structure of the Commission	32
Staff of the Commission	32
Structure of the Commission	36
Financing of the Activities of the Commission	37
Internal Audit and Quality Management	40
IV. Performance of the Participants of the Financial and Capital Market in 2011	41
Economic Development Trends in 2011	41
Bank Performance	41
Performance of Cooperative Credit Unions	46
Performance of Insurers	47
Performance of the Second and the Third Tier Pension System	51
Performance of Investment Management Companies and Investment Funds	53
Performance of Investment Firms	55
Performance of Payment Institutions and of Electronic Money Institutions	55

CHAIRMAN'S STATEMENT



A Year of Challenges

At the time of preparing this Report, the mission of the International Monetary Fund (IMF) had just finished its work and acknowledged that the fiscal policy in Latvia was balanced and national economy had recovered notably (in 2011, GDP increased by 5.5%). For the year ahead, our growth estimates are more moderate, even though the Latvian economy had been the fastest growing economy in the European Union (6.8%) for the second consecutive quarter. More rapid development of the labour market, improving solvency of households and increase in lending would be in line with that growth rate. However, this is not the case because uncertainty about future, external environment and solution of the euro area problems hinder the pace of these positive processes. Overall, year 2011 brought both good and also bad news.

The Latvian financial sector had regained its profitability. After the difficult years of the crisis, banks finished 2011 not only with a profit (excluding JSC "Latvijas Krājbanka" and JSC "Parex banka"), but also with a high capital adequacy ratio of 17.4%; it meant that our banks were ready to cover various risks in future as they had seriously strengthened their capital base: as of end-2008, banks had invested about half billion lats in their capital. In 2011, bank liquidity exceeded the regulatory requirement twofold and was 63.9% in December.

However, lending did not follow the pattern it should in a period of sound growth: the credit portfolio shrank by 8.1% or 1.2 billion lats. Overall in 2011, newly granted loans amounted to 1.5 billion lats, but about one tenth only was granted to households. Concerns about a possible second wave in the area of overdue loans had been partly justified. Even if the level of problem loans seemed to be lowering, the explanation was that, in 2011, a significant portion of such loans was written off as lost loans. These fluctuations evidenced the difficulties both businesses and private persons were experiencing to repay their debts. The financial structure of households in Latvia was still vulnerable, especially in winter. In 2011, 95 million lats of household debt were written off. The reasons were self-explanatory: persistently high level of unemployment, heating and fuel prices, significant tax burden; people were not able to recover after reaching the trough of the crisis while income was remaining at its previous level. The situation in the commercial activity sector was different: due to their improving solvency enterprises received the lion's share of newly issued loans. Our exporters were among the leaders in Europe. At the same time — was the situation sufficiently credible? Our major export markets were close neighbour countries: Estonia, Germany, Lithuania, Sweden and Russia. Some of them were already members of the euro area. In the case of forecasts of recession in the euro area proving correct, this would definitely affect the growth of the Latvian economy and also its financial sector.

Other market participants were also operating in an evidently challenging environment in the reporting year. The amount of the premiums written by insurance companies increased by nearly 20%, whereas the market in general was performing at a loss. Even if the volume of funds taken as deposits and issued as loans by credit unions increased, their profit was 10% less than in 2010 because of an increase of 32% in provisions for doubtful debts. Contributions by both employers and employees in private pension plans increased though the average profitability of these plans diminished and was negative, -2.7%. The assets of the investment plans used for the State-funded pension scheme investments increased by 5.8%, but the average profitability of these plans was negative, -1.9%.

Despite the relatively stable situation in 2011, the resilience of the Latvian financial sector was directly challenged again. The collapse of the old-state bank in Latvia, JSC "Latvijas Krājbanka", was highly unexpected. As a result of the operations by shareholders that are currently investigated by law

enforcement bodies (the funds held with correspondent accounts had been pledged), the Financial and Capital Market Commission (the Commission) had to suspend the activity of the bank in December 2011. Whilst paradoxical, there was, however, positive news in the crisis situation caused by the JSC "Latvijas Krājbanka": full repayment was ensured to 99.8% of depositors from the funds of the Deposit Guarantee Fund and of the Treasury, thereby enhancing confidence that the State does meet its liabilities. Funds in correspondent accounts were inspected in all banks and similar problems were not uncovered in any other bank.

The significant part of the business with non-residents was unfailingly a challenge for the Latvian financial institutions. In 2011, the share of non-resident deposits in total bank deposits was 47.2% (in 2010, it was 41.6%). Non-residents also received nearly one half of the newly issued loans. It was necessary to integrate more efficiently this valuable part of banking business in the Latvian financial sector, be aware of and mitigate the risks inherent to it. Since we were interested in attracting investments and additional capital, we had to assess asset quality and investor reputation to ensure that Latvia did not turn into an attractive destination for the "dirty" money of businesses from our neighbour countries. While being aware that non-resident deposits were subject to the State guarantee system, we had to develop possible solutions to ensure that this burden did not appear too heavy for Latvia at a certain stage. We had to use the changes in the EU financial supervisory framework to our advantage to ensure that, at the international level, Latvia's interests were properly represented and the needs of small open financial sectors taken into account while ensuring their development. These would be the challenges on our way to joining the euro area.

In Latvia, the general public had shown that it could learn a lesson from mistakes. If we wanted to follow the path of a reasonable growth, our choice should be the economic strategy of Western European countries, i.e., living within our means and assessing probable future risks in a timely manner. This required profound financial understanding at the level of each recipient of financial services.

The end of 2011 and the beginning of 2012 were also marked by personal challenges for me, as I accepted the position of Chairman of the Commission. The 100 days passed quickly. From the outset of my career at the Commission, one of my promises had been to ensure a more extensive explanatory work and educate people in financial issues in the long run. A knowledgeable person would not bow to the challenges of dubious financial pyramids and take another loan to repay a previous debt. In the area of finance, business is based on trust, and appropriate understanding that there is no need to be panicked by rumours is ensured by sufficient knowledge. We have to work together to avoid more "dark days" with queues at ATMs. Latvia is definitely not the only country having experienced them. After hearing about the possible leaving of the euro area, people in Greece withdrew 700 million euro from banks in one day. Therefore, in future the Commission's position will be driven by openness and information-sharing, and raising financial intelligence will be one of the directions of our activity within the new Communication strategy. A stable household that manages its risks is a cornerstone for long-term stability and development of the entire financial sector.

Challenges have been, are and will be a part of the modern world. Our task is to see them in good time and face them or use them skilfully to our advantage. Confidence about future is backed by good news that the Latvian financial sector, having survived throughout the previous challenges, is ready for a gradual and reasonable growth under favourable external conditions.

Kristaps Zakulis,
Chairman of the Commission



REPORT OF THE BOARD



Komisijas padome 2012. gada sākumā (no kreisās):
Ludmila Vojevoda, Kristaps Zakulis, Gvido Romeiko, Jānis Brazovskis, Jeļena Ļebedeva.

As of its establishment on 1 July 2001, the business of the Commission had been to develop regulations governing the activities of the Latvian financial and capital market and ensure the supervision of that market as well as protection of the interests of the customers of market participants. The Commission was a full-fledged and autonomous public institution managed by its Board. The funding for the Commission's activities was ensured by the payments made by the participants of the financial and capital market.

On 8 December 2011, following the submission of an application for voluntary resignation, Irēna Krūmane was released from the position of Chairwoman of the Commission. Jānis Placis, a member of the Board and Director of Supervision Department, also resigned but continued to perform as a member of the Board until appointment of a new member. Apart from these changes, the Board members in 2011 were the same as previously: Jānis Brazovskis, Deputy Chairman of the Commission, Gvido Romeiko, Director of the Legal and Licensing Department, and Ludmila Vojevoda, Director of Regulations and Statistics Department.

In the reporting year, 60 Board meetings were held (51 in 2010), during which 325 decisions were taken (346 in 2010), and 10 meetings of the Consultative Council of the Financial and Capital Market Commission were held during which 43 draft regulations that were binding on the financial and capital market were discussed (24 in 2010). The Consultative Council assessed and approved draft annual budget of the Commission for 2012 and the Commission's work programme for the forthcoming period.

In 2011, the Commission's experts developed or supplemented six laws and 33 Commission's regulations. Prior to their approval, all draft regulations were sent to the professional associations of market participants for comments.

In the reporting year, the strategy for the Commission's activities for 2012–2014 was developed with a view to ensure more efficient regulation and supervision of the financial sector to promote stability, competitiveness and development of the financial and capital market as well as to protect the interests of investors, depositors and the insured persons. Strategic goals for the next period were defined accordingly.

Overall in 2011, 88 on-site inspections of market participants were carried out (54 in 2010), of which 25 inspections were carried out in banks to assess in particular their capital adequacy, lending procedures and risk management functions, and six inspections were carried out in insurance companies. Within its inspections, the Commission performed 12 on-site audits of the security of information systems and about 140 off-site assessments of the security of information systems of market participants. To assess whether market participants complied with the requirements of the Law on the Prevention of Laundering the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing, the Commission carried out 17 on-site inspections in banks and one inspection in an investment firm in 2011. Overall in the reporting year, the Commission applied 38 sanctions to market participants (30 in 2010), including sanctions to JSC "Latvijas Krājbanka" whereby the bank's debit operations were initially restricted and later the activity of the banks was suspended. The amount of penalties imposed on market participants in 2011 totalled 248 500 lats (100 000 lats in 2010).

In 2011, 14 notifications for acquiring a qualifying holding were assessed. In four cases the Commission issued its consent for acquiring a qualifying holding in Latvian banks and in one case it took a decision to reject an application for acquiring a qualifying holding. In three cases approvals for acquiring a qualifying holding were issued to insurance companies. Investment firms submitted four notifications and in three cases approvals were issued for acquiring a qualifying holding. During the reporting year, in three cases permissions were issued for mandatory share buyout offers, in four cases approval was given to make a public offer of shares, and in one case a prospect for admitting shares to trading on the regulated market was assessed. In general,

the Licensing Division of the Commission assessed 77 cases of compliance of the officials of the participants of the financial and capital market with the regulatory requirements.

After the activity of JSC "Latvijas Krājbanka" was suspended because of the detected non-availability of deposits, the Commission had to ensure payment of the State-guaranteed compensation to the bank's depositors. The assets of the Deposit Guarantee Fund amounted to 149.9 million lats, whereas the amount of State-guaranteed compensations to 218 thousand depositors of JSC "Latvijas Krājbanka" was 335.6 million lats. The shortfall of 185.6 million lats was lent to the Deposit Guarantee Fund by the Republic of Latvia. Before the centralised payment of guaranteed compensations, the Commission used the assets of the Deposit Guarantee Fund to ensure that, already on the next day after the unavailability of deposits, the depositors of JSC "Latvijas Krājbanka" received up to 50 lats per day of the State-guaranteed compensation; the full amount of the State-guaranteed compensation was available as of the fifth business day after unavailability of deposits. As a result, due to the State guarantee system, 99.8% of depositors of JSC "Latvijas Krājbanka" were able to recover the full amount of their deposits.

With a view to providing complete information to general public about topical trends, in 2011, the Commission prepared 96 Statements to mass media (59 in 2010), of which 25 Statements were disseminated at the time when the activity of JSC "Latvijas Krājbanka" was suspended, guaranteed compensations paid and an administrator chosen. At the time of suspending the activity of JSC "Latvijas Krājbanka", specific explanations were provided to various customer groups. The staff of the Commission were re-deployed to ensure that the customers of JSC "Latvijas Krājbanka" received prompt consultations on the phone. Taking into account the experience in ensuring communication in the financial sector during a crisis and examples of other countries, the Commission's experts were tasked by the Prime Minister to develop a crisis communication plan for the financial sector and agree it with cooperation partners. The plan set out active cooperation among the Commission, the Bank of Latvia, the Ministry of Finance and the Office of the Prime Minister during crises and involvement of market participants and their professional associations, where necessary. The plan was approved on 2 February 2012 during the meeting of the Financial Sector Development Council.

As a continuation of the measures to educate the customers of market participants and in line with the concept developed in 2010, on 1 March 2011 an informative site *KLIENTU SKOLA* (Client School) was launched on the Commission's website (available in Latvian only at www.klientuskola.lv). The site had been developed to provide objective and clearly understandable information to customers about various financial services and particular attention had been paid to risk assessment. As of the launching of the site, the Commission's communication experts, in cooperation with supervision experts, had provided 49 e-mail consultations to the users of the site.

The internal audits carried out during the reporting year showed that the Commission's internal control system ensured completion of the Commission's tasks in line with its strategic goals and in compliance with the regulatory requirements. Overall, the assessed control processes were functioning well, but it was necessary to improve separate internal control processes for managing guarantee funds, performing security inspections of the information systems of market participants, developing data collection, processing and analysis system and communication process, as well as processes in the area of work safety and fire security. In 2011, the crisis situations in the banking sector uncovered failures in the implementation of the Commission's communication policy. Appropriate conclusions were made and immediate changes were introduced to the management of communication processes and the pro-active communication.

In 2011, the Commission received and scrutinised 317 applications about the participants of the financial and capital market and provided 695 explanations about the payment of the State guaranteed compensation to the customers of JSC "Latvijas Krājbanka".

In 2011, the Commission continued its consultations in the area of document management to the participants of the financial and capital market and also to other institutions in relation to electronic documents, introduction of a secure electronic signature and of electronic record-management system. On 2 November 2011, the Commission signed cooperation agreement with the Latvian National Archives "On cooperation in the pilot project in the framework of the Draft National Programme "Uniform Information System of State Archives" of the European Regional Development Fund (ERDF) and in document description".

STRATEGY OF THE COMMISSION'S ACTIVITIES

In 2011, the Commission developed a medium-term planning and management document "Strategy of the Activities of the Financial and Capital Market Commission for 2012–2014" (the Strategy). According to the Strategy, **the mission of the Commission's activity** is to efficiently regulate and supervise the operation of the financial and capital market and of its participants, promote stability, competitiveness and development of the financial and capital market and safeguard interests of investors, depositors and the insured persons.

In line with the Strategy, **the Commission's strategic goals** for the next period are as follows:

1. Develop effective regulatory framework that will promote development and competitiveness, ensure high standards of risk management and better quality and security of financial services.
2. Ensure that the market participants operating in Latvia are financially sound, professional and of good repute.
3. Ensure that the financial system is sound and regulation-compliant and promotes development.
4. Ensure an efficient administration of the financial stability fee.
5. Ensure systematic collection and analysis of statistical information as well as preparation of statistical reports, analytical materials and development forecasts of the sector.
6. Promote efficient cooperation with foreign supervisory authorities.
7. Enhance protection of customer interests within its own competence and also in cooperation with other institutions in Latvia.
8. Ensure information and education measures to the general public to promote both confidence in the sector and ability to comprehensively assess the risks associated with financial services as well as take informed decisions.
9. Constantly improve its own operating processes and increase efficiency and productivity of its operations.

The Strategy sets out **the main priorities of the Commission's activities**:

1. Ensure independent and autonomous supervision of the financial sector, enhance supervisory capacity and ensure adequate resources.
2. Continue regulatory reforms in the financial sector to correct the inconsistencies highlighted by the global crisis and introduce new tools aimed at ensuring financial stability in future (incl. Basel III, CRD IV, Insolvency II, European financial supervisory system).
3. Introduce reforms aimed at strengthening the supervisory framework that would notably improve the operative nature and efficiency of the preventive measures and ensure the possibility of immediate intervention in the activity of participants of the financial and capital market by taking the necessary measures.
4. Combat money laundering to ensure unfailing quality and security of financial services while strengthening cooperation with domestic and foreign law enforcement bodies.
5. Prepare for the forthcoming EU Presidency in 2015 by ensuring support to Latvia within its competence.
6. Improve understanding of the general public in Latvia about financial issues, including the operation of the financial sector and the services it provides, to ensure that customers have practical knowledge and are able to take prudent financial decisions in the long run.

II. COMMISSION'S ACTIVITIES IN 2011

SUPERVISION

As at the end of 2011, **334 participants of the financial and capital market** were subject to the Commission's supervision and their total assets were 22.7 billion lats (i.e., 147.8% of Latvia's GDP*) (see Table 1).

Table 1

Structure of the Market Participants Subject to the Supervision by the Commission

Market Participants	Assets, in million lats		Number of market participants	
	2010	2011	2010	2011
Banks and branches of foreign banks	21 974	20 926	21+8	22+9
Cooperative credit unions	12	13	34	33
Insurance companies and branches of foreign insurance companies	444	477	13+11	12+10
Private pension funds	1.8	1.9	7	7
Pension plans	112	120	21	21
Investment management companies	20	21	16	15
Investment funds	206	237	37	44
Investment plans of the State-funded pension scheme	830	880	27	27
Investment firms	3.7	3.6	7	6
Insurance brokerage companies			104	86
Payment institutions			16	33
Electronic money institutions				8
JSC "NASDAQ OMX Riga" (Stock Exchange)			1	1
Latvian Central Depository			1	1
Total	23 607	22 679	329	334

* Data source: <http://www.csb.gov.lv/en/statistikas-temas/gross-domestic-product-key-indicators-30517.html>.

Self-Assessment of Compliance of the Regulations Governing the Activity of Latvian Banks and of the Banking Supervisory Practice with Basel Core Principles

In 2011, the Commission carried out self-assessment about compliance of its supervisory practice and of regulatory requirements with Basel Core Principles.

During the preparation for the self-assessment, amendments to the Credit Institution Law were made whereby a bank's management board and supervisory board had to notify the Commission of any conditions, including suspicious and fraudulent transactions that were likely to materially affect the future operation of the bank or tarnish its reputation. As well, improvements were introduced to the organisation of the supervision process by amending the Manual for Assessing Banking Risks and a separate Manual for Off-site Supervision of Banks was prepared setting out, inter alia, the procedure for exchanging information and cooperation within colleges of supervisors.

In 2011, for the third consecutive year, the Latvian financial sector was operating in a volatile and unpredictable external and internal financial environment. On the one hand, the recovery and even slight development of the Latvian economy had a positive effect on bank performance indicators. In December, the IMF and the European Commission assistance programme was successfully completed thus improving the reputation of the Latvian sovereign in financial markets. On the other hand, these positive trends were short-lived because the solvency of enterprises and households was still fragile, their debt burden big and their demand for credits limited. As well, escalation of the sovereign debt crisis and deteriorating financial stability in the euro area in the second half of the reporting year threatened the growth of the Latvian economy and, consequently, increased the credit risk and profitability risk of the Latvian financial sector.

Banking Sector

Turmoil in the banking sector at the end of 2011 (insolvency of JSC "Latvijas Krājbanka" and rumours about problems of "Swedbank" JSC) had a temporary effect on the reputation risk of the banking system, but overall it did not have a significant or permanent influence. Bank performance indicators tended to stabilise for the second consecutive year (see chapter "Performance of the Participants of the Financial and Capital Market in 2011").

Responding to the contradictory developments in the financial system, the Commission continued strengthening the enhanced supervisory framework introduced in 2009 to carry out risk-focused and result-oriented supervisory measures and ensure the possibility of timely intervention in bank activities by taking the necessary measures to solve problems or reduce losses.

During 2011, banking supervision was based on interlinked methods: monitoring bank performance on the basis of financial Statement analysis and performing on-site inspections.

Significant structural changes were made in the Supervision Department. As a result of reorganising the Banking and Institutional Investors Division, three separate structural units were established: Monetary Financial Institutions Operations Analysis Division that is responsible for carrying out off-site supervision, Monetary Financial Institutions Risk Assessment Division that is responsible for carrying out on-site inspections, and Pension and Investment Funds Division. Moreover, a new function — supervision methodology — was established to ensure that the techniques used in supervision were improved on an ongoing basis and complied with EU requirements.

In 2011, the following priorities were determined in banking supervision:

- assess adequacy of the capital basis of Latvian banks;
- assess sufficiency and quality of liquidity maintenance and management;
- assess sufficiency of banks' work with problem loans and recognition of loan impairment losses in their Statements;
- assess the potential impact of banks' activity strategy on the structure and volume of risks.

Monitoring of Bank Performance Indicators

The Commission continued enhanced off-site monitoring of bank performance based on the analysis of banks' regular reports; it also received additional operative overviews and reports about bank activities:

- daily reports about deposit dynamics;
- reports about liabilities to related financial institutions;
- decisions by bank credit committees and management boards as well as internal audit reports about inspections;
- results of credit risk, liquidity risk and market risk stress tests.

As well in 2011, banks were required to draw up interim financial Statements for six months by 30 June 2011 and carry out their audit. These Statements enabled the Commission to have an independent third party conclusion about the financial situation of banks.

After the events at JSC "Latvijas Krājbanka", in order to stabilise the situation in the banking sector and boost customer confidence, the Commission required that all banks carried out extraordinary inspection of their correspondent accounts and involved sworn auditors. In each bank, the sworn auditors compared the bank's data with the data of the correspondent bank / custodian bank of the securities to verify all account balances and availability of relevant funds. The auditors did not uncover that the funds held in bank accounts in Latvia would be pledged without authorisation or appropriate disclosure in financial Statements as had been the case at JSC "Latvijas Krājbanka".

The Commission, together with the Bank of Latvia, continued to carry out regular stress tests of credit and liquidity risks. In respect of credit risk, stress tests were performed in view of macroeconomic forecasts, and results thereof were used to establish the possible losses in credit portfolios under assumed conservative scenarios of economic development and the ability of bank capital to absorb those losses. Liquidity risk stress tests were also carried out. Within those tests several behaviour scenarios of bank customers were analysed along with the bank's ability to ensure timely fulfilment of the legal claims of customers.

Where necessary, the Commission contacted banks to enquire about their plans to maintain the required level of capital adequacy and ensure liquidity in contingency.

For some years already, the Commission had been assessing bank risks by assigning a rating to each bank in view of the size of its risks and its risk management quality. The rating system had been a tool for the Commission to identify, analyse and assess the risks inherent to the operations of the institutions it supervised and to assess the quality and adequacy of the techniques a bank had been using to manage its risks and appropriateness of these techniques for the bank's size and complexity of its operations.

In accordance with the rating process, the Commission assigned to each institution, for supervisory purposes, a rating ranging from 1.0 to 4.0, where 1.0 was the highest assessment and 4.0 was the lowest. Supervision of an institution was planned in view of the rating: if an institution was assigned a high rating (the institution's activities were characterised by low risk and the risk management was sufficient), the required supervisory measures were minimal, whereas for an institution with a low rating (with high risks inherent to its operations and weak risk management) the supervisory control should be ongoing and enhanced.

In 2011, on the basis of the Commission's inspection results, the ratings of 11 banks were revised. Overall, at the end of the reporting year, banks were assigned the following ratings:

Rating scale	1-2	2.1-3	3.1-4
Number of banks	7	12	-

In 2011, the main banking risks were credit risk, liquidity risk, strategy and business risks. Particular attention was paid to bank strategies and profitability. In view of the sovereign debt crises escalating in some euro area Member States, the Commission focused on risks related to financial instruments, especially foreign debt securities.

Risks were analysed using both quantitative and qualitative information.

An important task was to strengthen confidence in the financial system by reducing the possibility to spread false information, stir doubt and disseminate rumours about potential problems of market participants. During supervision, the Commission assessed the publicly available quarterly reports of banks and information disclosed therein. The Commission established requirements that were aimed at increasing transparency of bank operations, promoting market discipline and providing timely comparable information to stakeholders about the bank's financial standing and performance.

In the reporting year, the Commission applied the following sanctions to banks as set out in the Credit Institution Law:

- penalties totalling 50 000 lats were imposed on two banks and a restriction on providing financial services was imposed on one bank for a failure to comply with the established regulatory requirements;
- a penalty of 132 000 lats was imposed on one bank for violations in the area of money laundering;
- a penalty of 1 000 lats was imposed on one bank and a warning was issued to one bank for a failure to comply with the requirement of the Credit Institution Law to report to the Commission;
- a penalty of 25 000 lats was imposed on one bank for inconsistencies in its risk management and internal control systems.

Within the framework of corrective measures, additional requirements were imposed on three banks in the area of credit risk.

Group Supervision

In 2011, the Commission's staff participated in the work of six colleges of supervisory authorities of credit institutions of Member States, and for the first time the Commission chaired one college as the responsible supervisory authority. Topical issues on the agenda of colleges were coordination of supervisory measures, internal capital adequacy assessment and risk profile assessment at a group level.

On-site Inspections in Credit Institutions

In the reporting year, the Commission carried out 25 inspections in banks and paid particular attention to assessing capital adequacy, lending process and also risk management functions: management of credit risk, operational risk, liquidity risk, strategy and business risks and the compliance control function. The detected weaknesses and inconsistencies were discussed with the managements of banks and plans were agreed to correct them.

Capital Adequacy

The Commission carried out enhanced assessment of the adequacy of bank provisions for expected losses. In 2011, corrections in the capital adequacy calculation were made in 10 banks. In addition to the minimum capital adequacy requirements banks assessed also their internal capital adequacy to establish the capital they actually needed in view of their risks. All banks concluded that their capital was sufficient to cover the risks inherent to their current operations and also ensured a sufficient capital buffer in the case of significantly adverse scenarios affecting their operations. An assessment was carried out in all banks as to their capital adequacy assessment process and compliance of their internal capital adequacy assessment process with the requirements of the Credit Institution Law.

Assessment results uncovered areas where banks needed improvements (the procedure whereby banks established the amount of capital needed to cover the material risks inherent to their current and planned operations, stress test techniques and the analysis of stress test results). The Commission continued a dialogue with several banks about their strategy and capital planning process.

During the assessment of bank capital adequacy the Commission paid particular attention to whether the capital adequacy was consistent with

further activity strategy of each bank and with the size of risks inherent to bank's planned operations as well as to the methods for managing these risks. When the Commission uncovered that banks had assumed unduly high risk, it, in line with the rights vested to it in accordance with the Credit Institution Law, imposed an obligation on 11 banks to maintain a higher level of own funds than the minimum capital requirements.

Credit Risk

Of all on-site inspections in banks in 2011, six inspections were carried out to assess quality of credit portfolios and credit risk management. These inspections covered 38.7% (a portfolio of 5.1 million lats) of the total credit portfolio of the banking sector. Particular attention was paid to timely recognition of loan impairment losses (adequacy of provisions) or to the amount of the capital correction made where the foreseen losses exceeded the volume of the provisions made. The quality of monitoring in respect of the real estate pledged for the benefit of banks was assessed where the results of that monitoring directly affected timely recognition of loan impairment losses.

With the quality of the credit portfolio deteriorating as of 2009, the volume of problem loans, including restructured loans, increased rapidly in banks' credit portfolios as banks, in order to promote repayment of problem loans, were actively restructuring their loans to reduce their expected loss and improve the solvency of borrowers.

In view of the large portion of overdue loans in the credit portfolio, during inspections particular attention was paid to the work by banks with overdue and problem loans, i.e., the justification for and efficiency of loan restructuring. As a result of inspections, the Commission required that banks additionally recognised loan impairment losses by making provisions or capital correction. Additional impairment was mainly uncovered in respect of the loans that depended on collateral.

To assess credit restructuring rules and their compliance with regulatory requirements, including the Commission's regulations, the Commission carried out off-site inspections of all banks. The Commission assessed the procedure developed and recorded by banks whereby they restructured loans, recognised impairment losses at the time of restructuring and further interest income, as well as the procedure whereby features of a problem loan were assigned to a loan or cancelled when making statistical reports to the Commission about the credit portfolio structure.

The Commission supported the activities of banks in the area of loan restructuring aimed at preserving the value of the loans whose quality had deteriorated. The Commission concluded that, overall, the internal procedures whereby banks established rules and basic principles that governed loan restructuring complied with regulatory requirements. After having assessed restructuring rules in banks, the Commission concluded that banks used methods and basic principles for loan restructuring depending on the size and structure of their credit portfolio, specific features of their lending and credit policy principles approved by the respective bank group. Banks had developed various restructuring programmes taking into account the category and the risk level of the borrower. At the same time, during on-site inspections in banks and while assessing banks' loan restructuring practice, the Commission uncovered cases when banks had made multiple amendments to a credit agreement (restructuring) without due analysis of the borrower's cash flow and by formally assessing the borrower's ability to regain solvency that would make repayment to the bank possible. The Commission required that banks improved their respective internal documents by introducing in them basic principles and conditions for further work with problem loans.

In view of the increase in the volume of newly issued loans to non-residents and the additional risks related with loans to non-residents, the crediting practice of non-residents was inspected, i.e., the criteria for issuing a loan, credit quality monitoring and the quality of the issued loans.

Liquidity Risk

Uncertainty in the global financial market was the reason why the Commission continued to pay attention to bank liquidity also in 2011. Banks whose main shareholders were banks and branches of other Member States that operate in Latvia played an important role in strengthening stability of the banking sector (the market share of such banks and branches in loans was 67.6%). At the outset of the crisis, they had injected notable volume of funds in their subsidiaries. As of 2009, the financing by parent banks had been in continuous decline and, to a certain extent, had been set off by investments in the share capital and the subordinated capital of their Latvian subsidiaries; this confirmed that banks of other Member States, especially of Scandinavian countries, that operated in Latvia were committed to keep their investments in Latvia and ensure that their subsidiaries comply with regulatory requirements for capital adequacy and liquidity.

In 2011, the Commission continued to receive daily information from banks about the dynamics of deposits that was used to exercise efficient control over changes in bank deposits and, where necessary, take timely corrective measures. The Commission also continued its enhanced supervision over the liquidity management quality of foreign bank subsidiaries at a group level as these banks mainly relied on the resources allocated to them by their parent banks. Therefore the Commission managed liquidity risk in the banking system in general and, where necessary, required that banks took preventive measures to improve their liquidity risk management.

Due to the events at JSC "Latvijas Krājbanka" and "Swedbank" JSC, at the end of 2011 the Commission required that banks carried out stress tests that would include a scenario "rapid outflow of deposits" and assessed their results, and, where necessary, amended or supplemented their "Activity Plan for Dealing with Liquidity Crisis".

Market Risk

In comparison with banks of other countries, Latvian banks did not have significant investments in financial instruments in 2011 (overall, shares and debt securities did not exceed 7.8% of bank assets).

Even though market risk was insignificant in the banking system in general, in view of the escalation of the sovereign debt crisis and weakening financial stability of some euro area Member States in the second half of the year, in 2011, the Commission continued to pay particular attention to banks' portfolios of financial instruments to ensure that banks were disclosing them prudently in their financial Statements and assessing the liquidity of their existing securities. In respect of the banks with notable investments in securities, the Commission inspected and assessed their securities portfolios. The

following criteria were used to inspect the structure of a bank's securities portfolio:

- country concentration in the portfolio;
- the share of sovereign T-bills in portfolios;
- distribution of securities across credit rating groups.

Risk Management Functions

When providing financial services banks had to ensure efficiency of every business unit or activity type, and also establish and efficiently implement the overall risk management function that was important for the bank's activities. In 2011, during bank inspections, the Commission paid more attention to the quality of managing each material risk. When assessing each risk management function, the size of each risk was assessed along with the effect of its changes on the bank's overall activity, as well as the efficiency of the bank's internal control system and of the management's work when identifying, measuring and managing each relevant risk. In particular, the Commission analysed whether banks were using the results of various scenarios and stress tests when managing their risks.

Suspending the Activity of JSC "Latvijas Krājbanka"

On 16 November 2011, the Commission was notified that, upon the initiative of the Bank of Lithuania, the Lithuanian government was taking over the shares of *AB Bankas SNORAS* and a shortfall of securities amounting to 204 million lats had been uncovered in that bank. On the same day, the Commission prepared an official letter to the Bank of Lithuania requesting it to submit a more detailed information about further actions of the Lithuanian State and their possible impact on the operations of JSC "Latvijas Krājbanka", and, as a matter of urgency, convened a meeting with the members of the management board of JSC "Latvijas Krājbanka" at its premises. The Commission received an official notification from the Bank of Lithuania to the effect that it had suspended the operations of *AB Bankas SNORAS* in payment systems, appointed a temporary administrator and the Lithuanian government had nationalised the shares of *AB Bankas SNORAS*.

Upon receipt of information about nationalisation of *AB Bankas SNORAS* in Lithuania, the ebbing of deposits increased in JSC "Latvijas Krājbanka"; consequently, during a meeting on 17 November 2011, in which the management board representatives of JSC "Latvijas Krājbanka" participated, the Board of the Commission resolved to establish restrictions on the settlement of liabilities of JSC "Latvijas Krājbanka" and appoint a group of Commission's proxies for the bank, as well as asked the bank to immediately transfer fund balances of its correspondent accounts to the banks of EU MS.

On 18 November 2011, the Commission uncovered that its instruction to transfer the fund balances of correspondent accounts could not be implemented because the funds of five correspondent bank accounts had been pledged (encumbered) for the benefit of third parties. Since the Commission considered that there were signs of a criminal offence in this, on 21 November 2011, it filed an application with the Prosecutor General Office and on the same day the Board of the Commission resolved to suspend the provision of financial services by JSC "Latvijas Krājbanka", suspend members of the executive board and of the supervisory board from their duties and appoint additional Commission's proxies for the bank.

Since the bank could not ensure settlement of creditor claims in full amount, the Board of the Commission convened an extraordinary meeting on 22 November 2011 and resolved that there was unavailability of deposits, and already on 24 November 2011 it signed an agreement with JSC "Citadele banka" about the payment of guaranteed compensations. The payment of guaranteed compensations to the customers of JSC "Latvijas Krājbanka" started on 29 November 2011.

In view of the shortfall of financial resources at the bank, on 1 December 2011, the Commission filed an application with Riga Regional Court for insolvency of JSC "Latvijas Krājbanka". On 16 December 2011, Riga Regional Court approved a commercial company of sworn auditors LLC "KPMG Baltics" and its authorised representative J. Ozoliņš as administrators of the insolvency proceedings of JSC "Latvijas Krājbanka". On 23 December 2011, Riga Regional Court declared JSC "Latvijas Krājbanka" insolvent.

Cooperative Credit Unions

In 2011, supervision was carried out by monitoring performance indicators that was based on the analysis of financial Statements and particular attention was paid to adequacy of the provisions made by credit unions for doubtful debts. During the reporting year, four on-site inspections were carried out aimed at assessing the financial standing of cooperative credit unions, their management work, asset quality, structure of income and expenses and compliance with regulatory requirements. The Commission imposed the following sanctions in respect of credit unions:

- a restriction on taking deposits was imposed on one credit union provided that its equity did not fall below 10%;
- a restriction on granting loans and taking deposits above a certain threshold was imposed on one credit union for failure to comply with certain requirements of Credit Union Law;
- a warning was issued to three credit unions for failure to comply with certain requirements of Credit Union Law.

Payment Institutions and Electronic Money Institutions

In 2011, supervision was carried out by monitoring performance indicators that was based on the analysis of financial Statements and particular attention was paid to the total volume of payments made by payment institutions and electronic money institutions and the average outstanding electronic money. During the reporting year, on-site inspections in payment institutions and electronic money institutions were not carried out.

Insurance Companies

In 2011, the Commission's staff performed six full-scope inspections in insurance companies, of which five were in non-life insurance companies and one in a life insurance company, and followed, on a regular basis, whether insurance companies complied with the requirements for the required solvency margin and the cover for technical provisions as established in the Law on Insurance Companies and Supervision Thereof. During the reporting year, no material violations of regulatory requirements were detected for which sanctions set out in the Law on Insurance Companies and Supervision Thereof should be imposed.

In 2011, one non-life insurance company and one life insurance company received permission to include in the calculation of available solvency margin 45% of the increase in the investment property value.

During the reporting year, the Commission's employees participated in five meetings of colleges of supervisory authorities of insurance and re-insurance companies of the countries of European Economic Area (EEA). The most topical issue in the work of these colleges was the development of an internal model for an insurance group or a reinsurance group and the expected approval of the model by the supervisory authorities of insurance and reinsurance of Member States in relation to the implementation of the requirements of the Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

Guarantee Fund of the Compulsory Civil Liability Insurance of Owners of Motor Vehicles

In 2011, the Commission performed an inspection of the guarantee fund administered by the society "Latvijas Transportlīdzekļu apdrošinātāju birojs" (Motor Insurers' Bureau of Latvia) as to compliance with the fund's establishment, accrual and administration procedures and notified the Ministry of Finance and the society itself about inspection results.

Insurance and Reinsurance Intermediaries

In 2011, the Commission's staff performed one off-site inspection to assess compliance with the requirement of the Activities of Insurance and Re-insurance Intermediaries Law about keeping the funds acquired from insurance and reinsurance mediation distinct from the funds of the insurance and reinsurance intermediary, and carried out eight thematic inspections to assess compliance of insurance and reinsurance intermediaries (legal persons) with the requirements of the above mentioned Law.

During the inspections in 2011, material violations of regulatory requirements were uncovered and the following sanctions were applied to insurance and reinsurance intermediaries (legal persons) in line with the Activities of Insurance and Reinsurance Intermediaries Law: in four cases an entry in the register of insurance and reinsurance intermediaries was cancelled, in three cases a penalty of 100 lats was imposed, in one case a penalty of 500 lats was imposed and in six cases a warning was issued about the violations of the requirements of the Activities of Insurance and Reinsurance Intermediaries Law.

Investment Management Companies and Investment Funds

In the reporting year, off-site supervision of investment management companies and investment funds was carried out to assess their financial standing, asset quality, structure of income and expenses and compliance with regulatory requirements.

As well, three on-site inspections of investment management companies were carried out. During each inspection, particular attention was paid to the established internal control system of the company and risk management by assessing appropriateness and applicability of the internal regulatory basis. As well, transparency of operations and compliance with the best practice principles were assessed as well as respecting customer interests.

The weaknesses and inconsistencies uncovered during the inspections were discussed with company management and action plans for necessary corrections were agreed to ensure successful functioning of the companies.

Since JSC "Latvijas Krājbanka" performed the function of a custodian bank of four investment funds, the managers of these funds had to select a new custodian bank and transfer all funds to the new bank within a reasonable time. Because JSC "Latvijas Krājbanka" could not perform its functions of a custodian bank, determining the unit value of investment funds was suspended while the funds were transferred to the new custodian bank. However, taking into account the legal requirement that assets of an investment fund must be kept distinct from the assets of the custodian bank, the transfer of assets of all investment funds could start without delay and, consequently, determining the unit value of investment funds and their repurchase were promptly re-started. Therefore the suspension of the activity of JSC "Latvijas Krājbanka" did not have a material impact on the investment fund sector.

Managers of Assets of the State-funded Pension Scheme

In the reporting year, off-site supervision of SFPS asset managers was performed to assess the asset quality of the investment plans they managed, the structure of income and expenses and their compliance with regulatory requirements.

In 2011, three on-site inspections of SFPS asset managers were carried out. Particular attention was paid to assessing the internal control system, compliance of functional division with the established organisational structure, the decision-making and implementation of management decisions, appropriateness and applicability of the internal regulatory basis and the established reporting system. Particular attention was paid to selecting providers of outsourced services and the use of those services by assessing the control systems established by asset managers to assess outsourced services. The performance of custodians was also assessed.

The weaknesses and failures uncovered during inspections were discussed with the management of the SFPS asset managers and action plans were agreed for the improvements needed to ensure successful functioning of asset managers.

During off-site inspections, the critical situation analysis submitted by SFPS asset managers for investment portfolio of each investment plan was assessed. The indicated risk drivers, scenarios and expected activities in the case of adverse scenarios were assessed.

Since JSC "Latvijas Krājbanka" was a custodian bank for six investment plans, in line with the effective regulations every SFPS asset manager was under an obligation to change the custodian bank, as soon as possible and with reasonable means, in respect of the functions that were previously performed by JSC "Latvijas Krājbanka" under the signed agreements of a custodian bank. An asset manager chose another custodian bank, signed an agreement of a custodian bank and, consequently, promptly transferred the assets to the new custodian in order to restore the asset management process in full amount as soon as possible. Therefore, in view of the special protection ensured to SFPS assets by law, these assets could be transferred to the

new custodian quickly and the suspension of the activity of JSC "Latvijas Krājbanka" did not have an adverse effect on the liabilities of SFPS investment plans; in the same vein, investment plan members did not have to engage in the process of changing the custodian bank and the asset manager ensured compliance with regulatory requirements.

Private Pension Funds

In the reporting year, off-site supervision of private pension funds was carried out to assess their financial standing, quality of pension plan assets, income and expenses structure and compliance with regulatory requirements.

As well, two on-site inspections were carried out in pension funds. During inspections, particular attention was paid to appropriateness and sustainability of the internal control system established by pension funds, and to the identification and management of material risks. Distribution of functions and compliance with the established organisational structure were analysed as well as the ability of the information exchange and reporting system to ensure sufficient and traceable information to internal and external users. Particular attention was paid to choosing providers of outsourced services and using such services by assessing the control systems for such services established by pension funds. The performance of both asset managers and asset holders was analysed. Particular attention was paid to the distribution of duties and responsibilities between the management board and the supervisory board to assess the ability of the pension fund's management body to ensure efficient daily functioning of the pension fund and feedback from shareholders.

The uncovered weaknesses and failures were discussed with the management of pension funds and action plans were agreed for the needed improvements to ensure successful functioning of pension funds.

During off-site inspections, the critical situation analysis submitted by pension funds for investment portfolio of each pension plan was also assessed. The indicated risk drivers, scenarios and intended actions in the case of adverse scenarios were assessed. According to pension funds, interest rate risk was an important risk driver because fixed income securities dominated investment portfolios; as well, risk of volatile market prices was important. Pension funds with significant investments in instruments denominated in foreign currency recognised currency fluctuation risk as a material risk. During off-site supervision in 2011, the performance of internal audit of private pension funds was assessed on the basis of the submitted internal audit plans and opinions.

Since JSC "Latvijas Krājbanka" was a custodian bank for five pension plans of a private pension fund, in line with the effective regulations a pension fund was under an obligation to change the custodian bank, as soon as possible and with reasonable means, in respect of the functions that were previously performed by JSC "Latvijas Krājbanka" under the signed agreements of a custodian bank. The pension fund chose another asset holder, signed an agreement of an asset holder and consequently transferred the assets to the new custodian in order to restore settlement in full amount as soon as possible. Therefore, in view of the special protection ensured to pension plan assets by law, the suspension of the activity of JSC "Latvijas Krājbanka" did not have an adverse effect on the performance of private pension funds and members did not have to engage in the process of changing the custodian bank.

Investment Service Providers

In 2011, seven inspections were carried out in banks (two planned and five targeted inspections) and four inspections were performed in investment firms (one planned and three targeted inspections). Targeted inspections were mainly carried out in response to customer complaints.

The Commission paid particular attention to the services to customers: information provided to customers about financial instruments and related risks, suitability and appropriateness of an investment service to customer's knowledge, experience, investment objective and financial ability to assume particular risk. The Commission also assessed the topicality of internal processes and documents of investment service providers and their compliance with regulatory requirements.

In the reporting year, in respect of the detected violations of legal provisions in the area of providing investment services, the Commission issued four administrative rulings: in one case it issued a warning to a market participant, in one case it imposed a penalty of 1000 lats, in one case it imposed a penalty of 27 000 lats for violation by the market participant of the requirements of the "Law on the Prevention of Laundering the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing" and in one case it imposed certain restrictions on a market participant to provide investment services and ancillary investment services.

Issuers of the Financial Instruments Admitted to Trading on the Regulated Market

At the end of the reporting year, JSC "NASDAQ OMX Riga" (Stock Exchange) was operating in Latvia as the only regulated market. At the end of the year, shares of 32 issuers were listed on the Stock Exchange. Listing of debt securities included six issuers for a total of 36 various debt securities: Latvian government debt securities (29), corporate debt securities and bonds (3) and mortgage bonds (4).

The Commission followed, on a regular basis, whether issuers disclosed information in a timely manner and in compliance with the requirements of the Law on the Financial Instruments Market. In 2011, in respect of the detected violations and after considering the essence of the violation, in eight cases the Commission required that issuers took measures to eliminate the weaknesses in disclosing mandatory information in future or publish corrected or additional information and instituted three administrative processes for violations in disclosing mandatory information, as a result of which respective administrative rulings were issued and a penalty of 1000, 2500 and 3000 lats was imposed.

One administrative case was instituted and a warning was issued to an issuer for failure to comply with the requirements of the Law on the Financial Instruments Market about preparing and maintaining a list of holders of inside information.

Trading in Financial Instruments

On the Stock Exchange as the regulated market in Latvia, a notable increase in share trading activity was evident in 2011. In comparison with 2010,

the total number of transactions in the share market increased by 10.07% and the number of traded shares increased by 55.49%, whereas total turnover in the share market in 2011 was 26.1 million lats, by 78.33% more than in 2010. At the end of 2011, the share market capitalisation of the Latvian Stock Exchange had decreased by 12.32% year-on-year, but when comparing the shares of 10 largest issuers with the peak turnover, the capitalisation of the 10 issuers had decreased by 3.57% year-on-year at the end of 2011.

To promote sound operation of the financial instruments market, the Commission monitored, on an ongoing basis, the trading in financial instruments by following and analysing the instructions submitted to the Stock Exchange and the transactions carried out therein to identify and prevent market manipulation and using inside information in transactions with financial instruments. The Commission carried out more than 10 enhanced inspections and in one case it sent information about a possible market manipulation to a law enforcement body for assessment.

The Commission inspected whether the persons listed as holders of inside information had complied with the Law on the Financial Instruments Market and notified the Commission of their transactions and whether it had been notified, in due course of that Law, about acquiring or disposing of a qualifying holding; in 2011, an administrative case was instituted in one case and a penalty of 2 500 lats was imposed on the respective person. In other cases when immaterial weaknesses or inaccuracies were detected, instead of instituting an administrative case, the Commission issued a warning to the persons to prevent re-occurrence of the weaknesses in future.

Security of Financial Services and Information Systems

Since all financial services depended on the operation and support of information systems, and this trend was on an increase, and also in view of the fact that both the complexity of services and the level of threat had been increasing, the Commission continued to monitor security of information systems.

In the reporting year, a revised regulation for security of information systems became effective; it is based on the risk management technique and enhancing informative feedback from all market participants. The regulation is in line with international practice and standards in the sector. It aims at ensuring that the services available to the customers of market participants via information systems are secure, sound, controllable and trustworthy.

Within its supervisory process, the Commission carried out 12 on-site audits of information system security and about 140 off-site assessments of the security of information systems of market participants.

Overall in the reporting year, particular attention was paid to the following aspects of information system security:

- secure authentication of users (customers) of remote services;
- managing security incidents of information systems.

For the next strategic planning period (2012–2014), the strategy for monitoring security of information systems was developed whereby regulations and supervision priorities were defined. According to the strategy, the regulations had to be topical, flexible, in line with the general practice and standards and only to the extent needed to ensure protection of interests of customers of market participants. Monitoring security of information systems should serve as a positive stimulus, be efficient and proactive.

During the payment of guaranteed compensations to the depositors of JSC “Latvijas Krājbanka”, the Commission’s IT experts ensured that the process was efficient and data of JSC “Latvijas Krājbanka” customers were safe (their truthfulness and unavailability to unauthorised persons).

Preventing Money Laundering

In the area of preventing money laundering, in 2011, the Commission’s representatives continued their participation in the activities of the EC Committee for the Prevention of Money Laundering and Terrorist Financing (CPMLTF), and in the work of 3L3 Task Force on Anti Money Laundering (AMLTF) of the three EU committees (Committee of European Banking Supervisors (CEBS), Committee of European Securities Regulators (CESR) and Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)). In the reporting year, the Commission’s representatives also participated in the work of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL).

To assess compliance of the participants of the financial and capital market with the requirements of the Law on the Prevention of Laundering the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing, in 2011, the Commission carried out 17 on-site inspections in banks and one inspection related to the supervision of an investment firm. As well, the Commission carried out three off-site inspections (assessment of procedures) in banks and five inspections in financial institutions, of which two were related to supervision of insurance intermediaries that provide life insurance services, and three with the supervision of investment management companies.

During those inspections, the Commission detected 12 cases when financial institutions and credit institutions had failed to comply with the requirements of the Law on the Prevention of Laundering the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing. In three cases a penalty was imposed for violations of the Law on the Prevention of Laundering the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing (of 5000, 25 000 and 100 000 lats).

During 2011, for information exchange purposes in respect of money laundering issues, the Commission received 12 requests for information from foreign supervisory authorities of the financial and capital market: three from the US, two from Estonia, two from Russia and two from the UK and one from each of Cyprus, Lithuania and Kyrgyzstan. The Commission sent four information requests to supervisory authorities of other countries: two to Cyprus, one to Estonia and one to Russia.

In accordance with the Commission’s register of unusual and suspicious financial transactions, eight reports were sent to the Financial Intelligence Unit (Office for the Prevention of Laundering of Proceeds Derived from Criminal Activity) in 2011.

LICENSING

	As at the beginning of 2011	As at the end of 2011	New market participants in 2011
Banks	21	22	1 ¹
Branches of banks of EU MS	10	9	-1 ²
Cooperative credit unions	34	33	-1 ³
Providers of banking services from European Economic Area (EEA)	255	269	+17
Insurance companies	13	12	-1 ⁴
Branches of insurance companies of EU MS	11	10	-1 ⁵
Providers of insurance services from EEA	437	462	+35
Investment management companies	16	15	-1 ⁶
Providers of investment management services from EEA	18	20	+2
Investment brokerage firms	7	6	-1 ⁷
Providers of investment brokerage services from EEA	1344	1512	+219
Agents attracted by investment service providers	1	0	-1
Agents from EEA attracted by investment service providers	14	19	+6
Private pension funds	7	7	0
Insurance firms	104	86 (22 entries were cancelled)	+4 ⁸
Insurance agents	560	621 (111 entries were cancelled)	+61
Providers of payment services from EEA	41	97	+56
Payment institutions (registered)	16	33	+15
Electronic money institutions (registered)	0	8	+12 ⁹
Electronic money institutions from EEA	13	16	+3

¹ Banks

JSC "Latvijas Krājbanka" was declared insolvent on 23 December 2011 and LLC "KPMG Baltics" was appointed an administrator of the bank. On 20 June 2011, a licence for the operation of a credit institution was issued to JSC "Rigensis Bank".

² Branches of banks of EU MS

The Latvian branch of AB Bankas SNORAS discontinued its operation in view of the fact that, on 7 December 2011, the licence for the operation of a credit institution that had been issued to AB Bankas SNORAS was cancelled.

³ Cooperative Credit Unions

On 5 May 2011, the licence of Rauna Kooperatīvā krājaizdevu sabiedrība (Cooperative Credit Union of Rauna) was cancelled.

⁴ Insurance Companies

On 4 February 2011, the licence for the provision of insurance that had been issued to IJSC (insurance joint-stock company) "ERGO Latvija dzīvība" was cancelled due to the reorganisation of the company.

⁵ Branches of Insurance Companies of EU MS

The Latvian branch of GF Försäkringsaktiebolag discontinued its operation in view of the fact that, on 4 April 2011, it was merged insurance joint-stock company "Gjensidige Baltic".

⁶ Investment Firms

On 14 January 2011, the licence for the provision of investment services and ancillary investment services that had been issued to limited liability company, investment firm "Maximus Capital Markets" was cancelled.

⁷ Investment Management Companies

On 9 December 2011, the licence of investment management joint-stock company "LKB Asset Management" was cancelled upon the company's request.

On 5 May 2011, the licence of investment management joint-stock company "Finasta Asset Management Latvia" was cancelled due to the company's decision to start its liquidation.

On 21 April 2011, a licence was issued to an investment management joint-stock company "M2M Asset Management".

⁸ Insurance Brokers

In 2011, the following insurance brokers were registered with the register of insurance and reinsurance intermediaries:

- LLC "DIRECT Latvia";
- LLC "GO Insurance Services";
- LLC "REGOR BROKERIS";
- LLC "UNIBROKKER".

⁹ Electronic Money Institutions

On 30 April 2011, amendments to the Law on Electronic Money and Payment Services became effective according to which the Commission grants a licence for the operation of an electronic money institution and registers electronic money institutions that, in accordance with Article 5.1 of the Law on Electronic Money and Payment Services do not need a licence.

In line with the procedure set out in regulations governing the operation of the participants of the financial and capital market, overall 14 notifications of acquiring a qualifying holding in banks, insurance companies and investment firms were assessed in 2011.

During the reporting year, banks submitted seven notifications. In four cases the Commission issued permission to acquire a qualifying holding in

Latvian banks and it took one decision to reject an application for acquiring a qualifying holding. Two administrative cases were dropped because applications for acquiring a qualifying holding were withdrawn.

Insurance companies submitted three notifications and permission for acquiring a qualifying holding was granted in three cases. Investment firms submitted four notifications and permission for acquiring a qualifying holding was granted in three cases; one administrative case was dropped because the application was withdrawn.

In the reporting year, in line with the procedure set out in the Credit Institution Law, the assessment process was started in respect of an application to receive a licence (permission) for the operation of a credit institution and one administrative case was dropped because the application was withdrawn.

In 2011, the assessment process was started in respect of an application to receive a licence for the operation of an electronic money institution and of an application to receive a licence for the provision of investment services.

The Commission assessed compliance of the submitted documents with the Law on the Financial Instruments Market and, in 2011, issued permission for mandatory share buyout offer in three cases, for making a public offer of shares in four cases and assessed one prospectus for admitting shares to trading on the regulated market.

Overall in 2011, the Licensing Division assessed compliance of 77 officials of the participants of the financial and capital market with regulatory provisions.

DEVELOPING REGULATORY PROVISIONS

National Regulations

In 2011, a number of legislative measures were undertaken for transposing EU regulatory requirements and improving the regulatory framework for the financial sector. Overall six laws and 33 Commission's regulations were developed or supplemented. Prior to their approval, all draft regulations were sent to the professional associations of market participants for comments.

Amendments to Laws

The Saeima approved amendments to the **Law on Investment Management Companies** whereby the requirements of Directives 2009/65/EC, 2010/44/EU and 2010/43/EU were introduced; the aim was to establish a level playing field in the EU by approximating competition conditions for investment management companies registered in MS and by revoking restrictions for the registration of open-end investment funds in other MS while ensuring a more efficient protection to fund investors. In parallel with amendments to the Law on Investment Management Companies whereby a new procedure for the operation of investment management companies and investment funds and supervision thereof was established, amendments were made to the **Law on the Financial and Capital Market Commission** whereby the section about the funding to ensure the Commission's supervisory function was revised.

Amendments to the **Payment Services Law** established new requirements for the registration and licensing of electronic money institutions as well as requirements governing their activities and supervision; as well, the title of the law was changed to **Law on Payment Services and Electronic Money**. As a result of the amendments, the rights of the subject "electronic money institution" that had previously been governed by the Credit Institution Law were extended so that in addition to issuing electronic money it could also provide payment services; as well, the requirements that had previously applied to payment institutions only in the area of payment services now applied also to electronic money institutions.

Amendments to the **Law on the Prevention of Laundering the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing** were in line with the requirements of Directive 2009/110/EC; they specified the definition of a financial institution and established cases when an electronic money institution was entitled not to carry out customer diligence; as well, the notion "providers of money transfers and transfer services" was replaced with a notion "payment institutions" in line with the terminology used in the Law on Payment Services and Electronic Money. The term "electronic money institution" was also incorporated in the law in line with the terminology used in the Law on Payment Services and Electronic Money.

Most Important New Regulatory Provisions and Amendments to Regulations

"**Regulations Governing the Activities of Payment Institutions and Electronic Money Institutions and Preparation of Reports**" established the assets in which a payment institution that in addition to payment services provided other commercial activity might invest the funds received from users of payment services or another provider of payment services provided that, at the end of the next business day following the day when the funds had been received, the funds had not yet been credited to the recipient's account or transferred to another provider of payment services and has not been credited to a separate account with a bank, as well as the assets, in which an electronic money institution might invest the funds that were received in exchange for the issued electronic money. The Regulations established the procedure for calculating own funds of a licensed payment institution and electronic money institution and for preparing and submitting reports to the Commission.

Amendments to the "**Regulations on the Internal Capital Adequacy Assessment Process**" established the minimum requirements for stress tests carried out in the framework of capital adequacy assessment, including the requirement that a bank whose credit risk, operational risk, market risk and concentration risk are material had to perform stress tests of these risks and take into account stress tests results when establishing the amount of capital needed to cover the respective risk. According to the amendments, in order to establish the amount of the capital buffer, a bank shall consider several macroeconomic development scenarios — the baseline scenario and at least one materially adverse development scenario. Amendments introduce additional requirements for assessing market risks and planning the subordinated capital and in respect of information that banks had to include in the report about capital adequacy assessment process to be submitted to the Commission.

Amendments to the **“Regulations for Calculating the Minimum Capital Requirements”** established the requirement to calculate capital requirement for settlement risk in respect of all exposures, not only those included in the trading book, increased capital requirements for equities included in the trading book as well as for securitisation positions and repeated securitisation positions, established more stringent standards for internal models for calculating capital requirements for market risks and specified the elements of own funds.

In the amendments to the **“Regulations on the Preparation of Reports of Investment Funds”**, the main changes referred to the preparation of the reports about global risk of the fund, exposure to a counterparty of a financial derivative that was not admitted to trading on the regulated market, concentration of exposures, credit commitments of a fund and the synthetic indicator to be disclosed in the key investor information that was calculated by reference to the requirements in the Commission’s **“Regulations for Calculating the Fund’s Global Exposure and Risk Exposure to a Counterparty”** and **“Regulations for Drawing Up Key Investor Information”**.

“Regulations Governing the Merger of Funds, the Dealing Between Master-Feeder Structures and the Procedure for Marketing Investment Certificates” established detailed content and format of the information to be provided in the case of fund merger to investors of merging funds and the procedure whereby that information should be provided, content of the agreement and of fund rules for dealings between master-feeder structures, content of information to receive a permission to liquidate, merge or divide the master fund, and content of the agreement on exchanging information between custodian banks and sworn auditors.

Amendments to the **“Regulations on the Compliance with Restrictions on Exposures”** supplemented the types exposures that were exempt from restrictions with claims on central banks in the respective national currency that were taken into account when establishing compliance with the minimum reserve requirement.

The Commission participated in the development of regulatory provisions in relation to transposing into national laws the requirements of the Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to companies for collective investment in transferable securities (UCITS) and developed **“Regulations Governing the Use of the Name of a Money Market Fund”**. The norms included in the regulations derived from the guidelines of the Committee of European Securities Regulators (CESR/10-049) and referred to a single definition of a money market fund for European companies for collective investment in transferable securities (UCITS).

Amendments to the **“Regulations on the Issue of Credit Institution and Credit Union Operating Licences, Obtaining Permits Regulating the Operation of Credit Institutions and Credit Unions, Settlement of Documents and Provision of Information”** were made to specify regulatory requirements and they included the norms that were in line with amendments to the Law on Payment Services and Electronic Money and the Credit Institution Law. In view of the amendments to the Law on Payment Services and Electronic Money, the Credit Institution Law and the said regulations no longer applied to electronic money institutions. As well, amendments included the requirement set out in the Credit Institution Law about the timing of scrutiny of an application submitted by a credit institution, a branch of a foreign credit institution and a credit union for receiving a licence and of the decision to grant a licence or to refuse granting a licence (it might not exceed 12 months of the day when the application for a licence had been received) and specified the procedure for the re-registration of a licence.

“Regulations on the Issue of Licences of Payment Institutions and Electronic Money Institutions, Procedure for Registration of a Payment Institution and an Electronic Money Institution and Submission of Documents and Information” established the procedure whereby the Commission issued a licence to a payment institution and an electronic money institution, registered a payment institution and an electronic money institution that did not need a licence to commence its operation, re-registered a licence as well as the procedure whereby a licensed payment institution and an electronic money institution notified about commencement of the provision of payment services or electronic money issuance in another Member State and notified the Commission about its officials and legal representatives, branches and representatives, as well as the change of its legal address.

“Regulations for Drawing up Reports about Financial Instruments Portfolios by System Participants” had been issued on the basis of the Investor Protection Law and established the procedure for preparing and submitting quarterly reports by investment service providers. The regulations aimed at ensuring that the Commission received information about the volume of portfolios of financial instruments that was necessary to perform its functions.

“Regulations for Establishing the Internal Control System of Investment Management Companies” set out the requirements for establishing an internal control system and were binding on investment management companies that were licensed in the Republic of Latvia when they provided management services. The regulations comprised requirements of the **“Risk Management Principles for UCITS”** (CESR/09-178) by the Committee of European Securities Regulators.

“Regulations for Drawing Up Key Investor Information” set out the procedure for establishing the synthetic indicator and ongoing charges figure when preparing key investor information referred to in Article 56 of the Law on Investment Management Companies. The regulations aimed at ensuring compliance with the requirements of EC Regulation No. 583/2010.

“Guidelines for Preparing the Key Investor Information Document” were prepared in view of the guidelines of the Committee of European Securities Regulators (CESR) about a transition from the simplified prospectus to key investor information document (CESR/10-1319), CESR’s guide to clear language and layout for the Key Investor Information document (CESR/10-1320), CESR guidelines for selection and presentation of performance scenarios in the key investor information document (KII) for structured UCITS (CESR/10-1318) and guidelines for CESR’s template for the key investor information document (CESR/10-1321).

“Regulations Governing the Content of the Agreement Between an Investment Management Company and a Custodian Bank” established the minimum amount of information to be included in the agreement between an investment management company that managed an open-end investment fund and the custodian bank of that fund referred to in Paragraph 4 of Article 47 of the Law on Investment Management Companies. The regulations were binding on investment management companies that were licensed in Member States and that provided fund management services to open-end funds registered in Latvia and on credit institutions that performed the functions of a custodian bank for an open-end investment fund registered in the Republic of Latvia.

EU Regulations Adopted in 2011

*Directive 2011/89/EU of the European Parliament and of the Council of 16 November 2011 amending Directives 98/78/EC, 2002/87/EC, 2006/48/EC and 2009/138/EC as regards the supplementary supervision of financial entities in a **financial conglomerate***

The Directive intended to ensure appropriate supplementary supervision and apply it to groups in which a parent company was a mixed financial holding companies; as well, it supplemented the banking directive and insurance directives in respect of supplementary supervision at the highest level of the group. Transposition deadline is 10 June 2013.

*Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on **Alternative Investment Fund Managers** and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010*

The Directive established the procedure whereby an authorised or registered AIFM operated by managing investment funds that were not subject to the regulation of UCITS (open-end investment funds referred to in the Law on Investment Management Companies), i.e., hedge funds, venture capital funds, private equity funds, real estate funds, and others.

The Commission has started drafting the law to determine the legal status of AIFMs, govern their operations, liability and supervision thereof and establish the rights, responsibilities and liability of the persons to which the requirements of the law will apply. Transposition deadline is 22 June 2013.

*Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 **on credit rating agencies***

European Securities and Markets Authority (ESMA) had been entrusted with exclusive supervisory powers over credit rating agencies registered in the EU in order to centralise and simplify their registration and supervision in Europe. ESMA had been authorised to require that credit rating agencies provide all information necessary for their supervision, carry out on-site inspections as well as a number of supervisory measures and impose fines to credit rating agencies where it detected that they had committed, intentionally or negligently, an infringement of Regulation (EC) No 1060/2009. Upon a previous agreement, ESMA might delegate specific supervisory tasks to the competent authority of a Member State.

Draft EU Regulations Discussed in 2011

Banking Sector

*Proposal for a Directive of the European Parliament and of the Council on the access to the **activity of credit institutions** and the prudential supervision of credit institutions and investment firms*

*Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for **credit institutions** and investment firms*

Both proposals aim at establishing enhanced requirements for the quality and volume of own funds by gradually introducing (from 2013 till 2019) several new capital adequacy indicators and establishing enhanced requirements for the level of capital adequacy indicators, at the same time providing Member States with an opportunity to establish higher requirements for capital adequacy indicators without a transition period, i.e., as of 1 January 2013. Two new minimum quantitative indicators for liquidity management will be introduced: liquidity coverage ratio for regulating short-term liquidity and net stable funding ratio for long-term liquidity regulation, as well as other requirements.

*Proposal for a Directive of the European Parliament and of the Council on **Deposit Guarantee Schemes** [recast]*

The proposal aims at the simplification and harmonisation of guaranteed deposits by ensuring a quicker payment of the guaranteed amount. By way of compromise it is foreseen to maintain the amount of the guaranteed compensation up to EUR 100 000, as it was established in Directive 2009/14/EC as of 1 January 2011. In the initial proposal, the guaranteed compensation should be paid to depositors within 20 days, the minimum target volume of DGF funding is 0.5% of the guaranteed deposits of the DGF participants and there is a possibility to make ex-post contributions to the Fund. However, the European Parliament could not reach an agreement with the Council about the proposal for the directive in the first reading therefore the date of approval of the directive is still not known.

Proposal for a Directive of the European Parliament and of the Council on credit agreements relating to residential property

The proposal aims at establishing basic requirements for separate aspects in relation to credit agreements signed between a credit institution and a consumer for acquiring a residential property. The proposal sets out information that the creditor and the credit intermediary must provide to the borrower prior to signing the agreement and during the validity of the agreement, establishes the obligation for a creditor to assess the borrower's creditworthiness and the obligation for the borrower to provide information to the creditor, the procedure whereby intermediaries are authorised and supervised and other issues.

Financial Instruments Market Sector

*Proposal for a Directive of the European Parliament and of the Council amending Directive 2004/109/EC on the **harmonisation of transparency requirements in relation to information about issuers** whose securities are admitted to trading on a regulated market and Commission Directive 2007/14/EC*

The proposal intends to reduce the administrative burden on issuers by abolishing the requirement to publish interim management Statements and quarterly financial reports, specifies the range of financial instruments to which reporting requirements apply, establishes more uniform requirements for reporting acquisition of a qualifying holding and sets out enhancements to the network of officially appointed storage mechanisms.

*Proposal for a Directive of the European Parliament and of the Council on **markets in financial instruments***
*Proposal for a Regulation of the European Parliament and of the Council on **markets in financial instruments** and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories*

The proposals for a Directive and for a Regulation set out the notion of a financial instrument and establish that all organised trading in financial instruments must be carried out in regulated trading venues: regulated markets, multilateral trading facilities and organised trading facilities, and set out their respective definitions. The proposals establish changes in the requirements for disclosing pre-trading and post-trading information by applying them also to debt securities, structured financial products, trading in emission allowances and financial derivatives. Requirements for transaction reporting will be extended. Providers of investment services will have to report to financial supervisory authorities about all transactions in financial instruments, except those transactions where financial instruments are traded on regulated trading venues. Regulated markets, multilateral trading facilities and organised trading facilities will have to report transaction details in the cases when a provider of investment services does not have an obligation to report transactions to supervisory authorities. Reporting of transactions will be carried out by means of an approved reporting mechanism.

*Proposal for a Regulation of the European Parliament and of the Council on **insider dealing and market manipulation** (market abuse)*

In view of the rapid development of the financial market, the existing Directive 2003/6/EC fails to ensure full-fledged regulation for monitoring abuse of inside information and market manipulation. The new proposal for a Regulation sets out modified provisions contained in the said regulation and, in line with the market development, supplements it with new market instruments and new markets, supplements the notions of inside information and of market manipulation and establishes more extensive and stricter authorisation of supervisory authorities and their cooperation for supervisory purposes. The Regulation will be directly applicable in Latvia and it will replace the regulatory norms of Directive 2003/6/EC as implemented in the Law on the Financial Instruments Market.

*Proposal for a Directive of the European Parliament and of the Council on **criminal sanctions for insider dealing and market manipulation***

The proposal sets out the minimum requirements for criminal sanctions in most serious cases of market abuse, i.e., abuse of inside information and market manipulation.

*Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No 1060/2009 on **credit rating agencies***

The proposal sets out the requirement for particular financial institutions to carry out their credit risk assessment to prevent over-reliance on the ratings assigned by credit rating agencies, improves rules on the disclosure of rating methodologies in order to promote appropriate rating process and improve the quality of ratings, and enhances the provisions for establishing sovereign ratings, and also suggests other issues.

*Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to **companies of collective investment in transferable securities (UCITS)** and Directive 2011/61/EU on **Alternative Investment Funds Managers** in respect of the excessive reliance on credit ratings*

The proposal will introduce the requirement to the effect that an investment management company when it assesses UCITS assets and an AIFM when it assesses the assets of these funds should not rely only on external credit ratings but use them as one of the factors in the assessment process.

*Proposal for a Directive of the European Parliament and of the Council amending Directive 97/9/EC of the European Parliament and of the Council on **investor compensation schemes***

The proposal sets out measures for enhancing efficiency of investor protection and for ensuring a level playing field in respect of the types of financial instruments subject to protection, adequate funding for compensations and necessary measures for ensuring compensations to investors. According to the proposal, the minimum compensation per investor will be increased to EUR 50 000 and a quicker payment of the guaranteed compensation will be ensured (not later than within nine months after the bankruptcy of the provider of investment services); as well, it ensures provision of more detailed information to investors about the compensation process and sets out a more efficient accumulation of funding for compensations by establishing a minimum target level that should be fully funded in advance.

*Proposal for a Regulation of the European Parliament and of the Council on **OTC derivatives, central counterparties and trade repositories***

The proposal establishes that information about OTC financial derivatives should be disclosed to trade repositories and financial supervisory authorities should have access to that information. It will also enhance availability of additional information in the market. According to the proposal, all standardised OTC derivatives should be cleared through CCPs. This will reduce counterparty credit risk, i.e., risk of default by a counterparty.

*Proposal for a Regulation of the European Parliament and of the Council on **short selling and certain aspects of credit default swaps***

The Regulation introduces to the EU the reporting and disclosure requirements in respect of short selling of shares and material net short positions in relation to sovereign debt issuers in the EU or equivalent uncovered positions in CDSs. In emergency situations, supervisory authorities will have temporary authorisation to set restrictions on short selling of positions and CDSs. In such situation ESMA will have authorisation to coordinate the activities of supervisory authorities to ensure that the measures taken are proportionate. In particular ESMA will be authorised to interfere where there is a threat to the functioning and security of the EU financial system.

*Proposal for a Regulation of the European Parliament and of the Council on **European Venture Capital Funds***

*Proposal for a Regulation of the European Parliament and of the Council on **European Social Entrepreneurship Funds***

The Regulations set out which alternative investment funds may qualify as European Venture Capital Funds and European Social Entrepreneurship Funds and will be entitled to use that name. They are addressed to the managers of European Venture Capital Funds and European Social Entrepreneur-

ship Funds that are registered with the competent authority in accordance with the requirements of Directive 2011/61/EC on AIFMs and whose asset management does not exceed the threshold of EUR 500 million. The said registration will entitle them to trade units of European Venture Capital Funds and European Social Entrepreneurship Funds in all Member States.

Insurance and Pension Fund Sector

Proposal for a Directive of the European Parliament and of the Council amending Directives 2003/71/EC and 2009/138/EC in respect of the powers of the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority (Omnibus II)

The proposal sets out the powers for the European Insurance and Occupational Pensions Authority to develop binding technical standard and rights to settle disagreements between the supervisory authorities of Member States in the area of insurance. In addition, it extends the implementation period of Solvency II Directive and establishes a transition period for implementing the requirement, therefore ensuring a gradual transition of EU Member States to the new regime. The range of issues for which the EU is entitled to adopt delegated or implementation acts is extended.

Planned EU Initiatives in 2012

In 2012, the EC intends to issue several new legislative proposals: a proposal for a Directive on **establishing a framework for the recovery and resolution of banks** that will set out crisis management framework in the banking sector, a Regulation on **central securities depositories** aimed at shortening the time necessary for the securities settlement and reducing, as much as possible, the number of failed settlements. To ensure information to consumers and consumer protection when offering more complex investment products, the proposal for a Directive on **Packaged Retail Investment Products (PRIPs)** will be disclosed and in parallel the Directive on **insurance intermediaries** will be supplemented. The proposal for a Directive on **holding securities** with securities accounts as well as amendments to the Directive on **companies of collective investment in transferable securities** are intended for disclosure. As well, the EC is due to approve legal acts in the areas of **delegated and implementation measures in respect of prospectuses, alternative investment funds, Solvency II, financial market infrastructure, the new capital requirements framework (CRDIV/CRR), credit rating agencies** a.o. areas.

FINANCIAL STABILITY SYSTEM

In Latvia, the structure of the financial stability system was as follows:

1. the Deposit Guarantee Fund (20 banks);
2. the Fund for the Protection of the Insured (life FPI: nine companies, other FPI: 13 companies);
3. protection of the customers of the financial instruments market (investors) (13 investment management companies, 19 banks as providers of investment services, six investment firms);
4. financial stability fee (20 banks, 10 branches of foreign banks).

The scheme of guarantee funds was a **part of the financial stability system** and it was characterised by a number of specific functions related to ensuring protection to bank depositors, insured persons and participants of the financial instruments market, and it had to be interrelated with other participants of the financial system security network in order to ensure financial stability. An efficient guarantee scheme was an important support element of the financial stability and it had a vital role in promoting financial system stability and depositor protection.

Deposit Guarantee Fund

As of 2011, the guaranteed compensation to customers of Latvian banks (natural and legal persons other than the central bank or a deposit taker, a financial institution, a transit fund or an institution that is financed from the State budget or the local government budget) had been EUR 100 000 in each bank (or an equivalent amount in another currency). The payment of the guaranteed compensation had been ensured in the Latvian national currency, the lats.

The State guaranteed that every customer of a bank was compensated an amount of up to EUR 100 000 irrespective of the fact whether there were sufficient funds in the DGF at that time. According to the Deposit Guarantee Law, if the funds were insufficient, they should be provided with the intermediation of the Commission by borrowing them from the State budget of the Republic of Latvia.

In 2011, the depositor protection scheme incorporated in the Deposit Guarantee Law was used for the first time in respect of the customers of two entities that had been taking deposits (JSC "Latvijas Krājbanka" and Rauna Cooperative Credit Union).

Payment of the Guaranteed Compensation after Unavailability of Deposits at Rauna Cooperative Credit Union

On 5 May 2011, the Commission uncovered that there was unavailability of deposits at Rauna Cooperative Credit Union. The amount of the guaranteed compensation paid to the members of the said credit union from the DGF assets was 10 thousand lats.

Payment of the Guaranteed Compensation after Unavailability of Deposits at JSC "Latvijas Krājbanka"

When the Commission detected unavailability of deposits at JSC "Latvijas Krājbanka", 220 000 depositors had the rights to receive the guaranteed compensation and the total amount of the compensations was 335.6 million lats. The amount of deposits that was likely to be considered as a payable guaranteed compensation was determined in the amount of 2.8 million lats. The deposit guarantee scheme covered full amount of deposits for 99.8% of depositors of JSC "Latvijas Krājbanka". The guaranteed compensation had to be paid not later than within 20 business days of the day of the occurrence of unavailability of deposits (unavailability of deposits at JSC "Latvijas Krājbanka" became effective on 22 November 2011). Before the DGF determined a centralised venue for paying the guaranteed compensation on the fifth business day after the occurrence of unavailability of deposits, partial payment of the guaranteed compensation (up to 50 lats) was ensured already on the next day after unavailability of deposits.

A summary of the payment of the guaranteed compensation to the depositors of Rauna Cooperative Credit Union and of JSC "Latvijas Krājbanka": a detailed overview of the guaranteed compensations paid

Summary of the guaranteed compensation (GC) to depositors of Rauna Cooperative Credit Union, 31.12.2011

GC to be provided from DGF	Indicators	GC paid until 31.12.2011	Outstanding GC on 31.12.2011	Share of outstanding GC, %
24	Number of depositors	12	12*	50
10 281	Amount of GC, in lats	10 009	272	3

*Depositors who failed to indicate the account for transferring the GC or the place for receiving the GC.

Summary of the guaranteed compensation (GC) to depositors of JSC "Latvijas Krājbanka", 31.12.2011

GC to be provided from DGF	Indicators	Payment of GC to residents until 31.12.2011	Payment of GC to non-residents until 31.12.2011	Total payment of GC* until 31.12.2011	Outstanding GC 31.12.2011	Share of outstanding GC, %
220 528	Number of depositors	86 230	434	86 664	133 864	60.7
335 689 233	Amount of GC, in lats	289 812 304	6 036 937	295 849 241	39 839 992	11.9
2 847 034	Amount of deposits that is likely to be considered as a payable GC					

*46% of paid GC were transferred to current accounts with JSC "Citadele banka", 39% to accounts with other banks, 16% were received in cash.

When unavailability of deposits occurred at JSC "Latvijas Krājbanka", total assets of DGF were 149.9 million lats. Since DGF had to ensure 335.6 million lats to pay the guaranteed compensation to the depositors of JSC "Latvijas Krājbanka", the shortfall of 185.6 million lats was lent to the DGF (the Commission) by the Republic of Latvia. The borrowing from the Republic of Latvia will be repaid from DGF assets that are supplemented quarterly with payments that deposit takers make in due course of the Deposit Guarantee Law and from the funds recovered from JSC "Latvijas Krājbanka" for the paid guaranteed compensations. DGF's rights of claim rank first in the amount of the guaranteed compensations in respect of both Rauna Cooperative Credit Union and JSC "Latvijas Krājbanka".

In accordance with the Deposit Guarantee Law deposit takers (banks and credit unions) make a quarterly payment to DGF amounting to 0.05% of the average balance of deposits with the deposit taker in the previous quarter. The Commission establishes the ratio that is applicable to the payment of each deposit taker. When establishing the ratio, the Commission takes into account deposit taker's capital adequacy, liquidity and large exposure indicators as well as the quality of the credit portfolio in the previous calendar year. In their payments for 2011, deposit takers paid into DGF 18.4 million lats. In accordance with the Deposit Guarantee Law, after the payment of the guaranteed compensation to depositors, the Commission, in order to accelerate the accumulation of funds, may increase the amount of payments to DGF for a term of up to one year. In 2012, the Commission increased payments to DGF 1.5 times. Thereby it is intended that in 2012 deposit takers will pay 27 million lats to DGF and by the end of 2014 DGF assets will have reached the level that was before making the payments to the depositors of JSC "Latvijas Krājbanka".

At the end of 2011, the amount of the guaranteed deposits with deposit takers in Latvia was as follows:

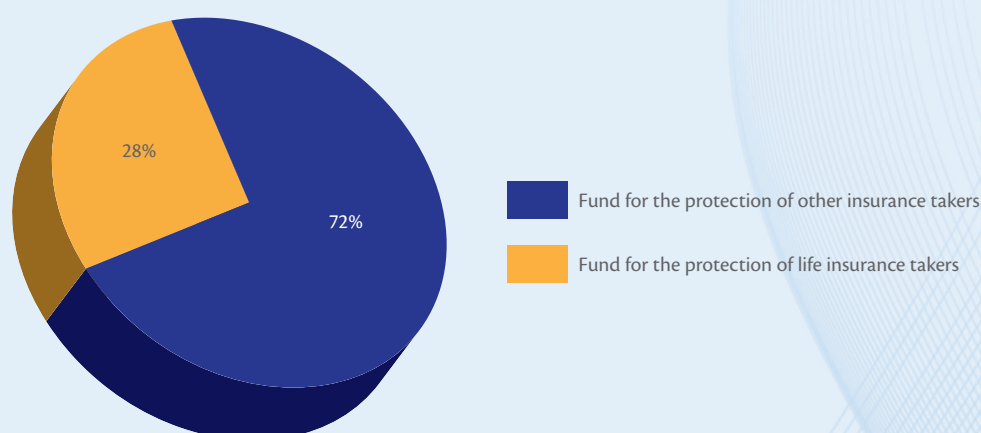
	Amount	Share, %
Total number of depositors	2 267 796	100.0
incl. up to the amount of GC	2 254 027	99.4
incl. above the amount of GC	13 769	0.6
Average balance of deposits, in thousand lats	8 705 629	100.0
incl. up to the amount of GC	2 639 558	30.3
incl. above the amount of GC	6 066 071	69.7
Guaranteed deposits in due course of Deposit Guarantee Law, in thousand lats	3 607 098	

Fund for the Protection of the Insured

The assets of the Fund for the Protection of the Insured (FPI) were comprised of deductions of 1% of insurance companies from the total gross insurance premiums received from natural persons for the types of insurance specified in law. At the end of 2011, 8 million lats were accrued in the FPI (see Charts 1 and 2).

Chart 1

FPI asset profile as a percentage (at end-2011)

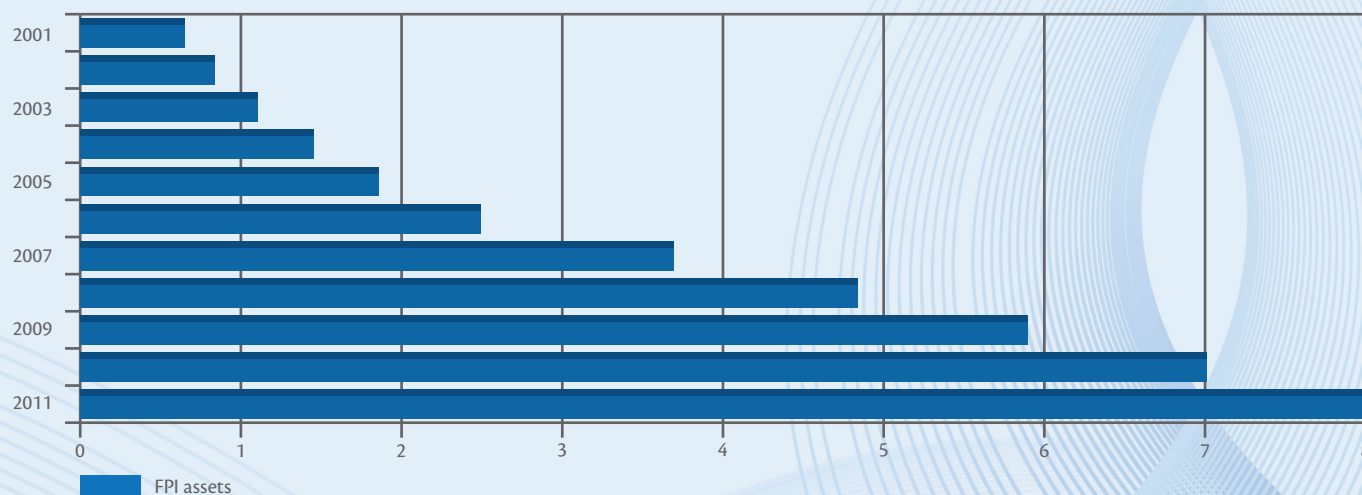


As of the beginning of its operation, 8671 lats had been used to pay guaranteed compensations. In the case of an insurer's default, the compensation could be paid only to a policyholder that is a natural person:

- 1) for life insurance, 100% of the insurance compensation but not more than 10 000 lats per policyholder, excluding insurance in respect of a market-related life insurance policy;
- 2) for other types of insurance set out in law, 50% of the insurance compensation but not more than 2000 lats per policyholder.

Chart 2

Growth dynamics of FPI assets, 2001-2011 (end of the year, in million lats)



In 2011, FPI assets increased by 1.02 million lats due to the contributions by fund participants and as a result of the Commission's investment of the FPI funds in Latvian government securities, received interest income for short-term deposits with the Bank of Latvia and for the cash balance in the settlement account. The FPI investment structure and return on investments were determined by the supply of the Latvian government securities and the funds accrued in the FPI at the time of supply (see Table 2 and Chart 3).

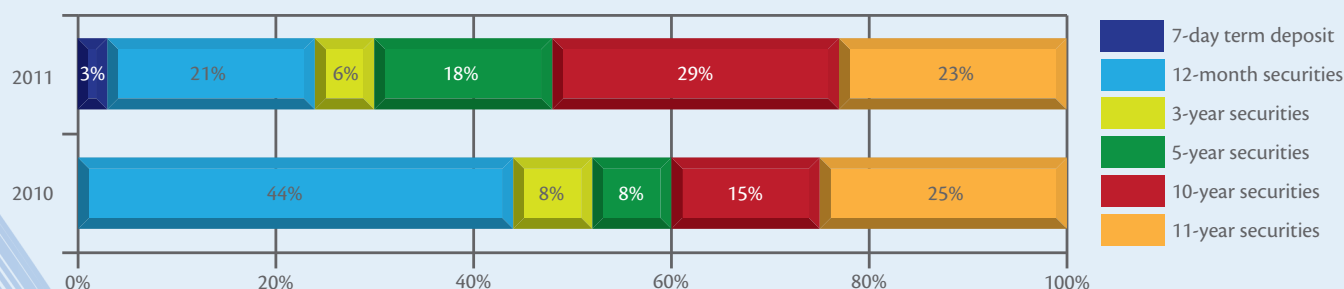
Table 2

FPI income indicators, 2008-2011

	2008	2009	2010	2011	Strategy
Payments by FPI participants, in million lats	0.9	0.7	0.6	0.7	1% of total guaranteed insurance premiums
Investment income, in million lats	0.2	0.3	0.4	0.3	Exceed the costs for maintaining deposits and making investments
Return on assets, %	5.18	6.29	6.84	4.41	In accordance with the fixed income rate fluctuations of the Latvian government securities

Chart 3

FPI investment structure by initial maturity, 2010-2011 (at the end of the year, %)



Protection of the Customers of the Financial Instruments Market (Investors)

The investor protection system is based on the Investor Protection Law. Compensation per investor is calculated for irreversibly lost financial instruments or losses caused by a non-executed investment service. Compensation to one investor is 90% of the value of irreversibly lost financial instruments or of the loss caused by a non-executed investment service but not more than EUR 20 000. Compensation payment is ensured by the Commission and compensation payments are monitored by the Commission's Consultative Council of the Financial and Capital Market.

The funds for the payment of the compensation are ensured by the participants of the system that are legal persons to which the Commission has issued a permission (licence) for the provision of investment services. During a year, the total of these funds must not exceed 4% of the total value of the financial instruments portfolio of system's participants. The payment of each system's participant for ensuring compensations is established in proportion to the participant's share in the joint financial instruments portfolio of system's participants. Where the payments of the system's participants are not sufficient to pay compensations in line with the Investor Protection Law, the Commission is entitled to borrow funds for the payment of compensations.

Financial Stability Fee

In 2011, with the implementation of fiscal consolidation measures in the State budget, the Financial Stability Fee Law was developed. The objective of the financial stability fee (FSF) is to strengthen the whole financial system in order, if necessary, to finance measures which would decrease the negative impact of the credit institutions having entered into financial difficulties on the other participants of the financial market, as well as partially compensate for the State budget financing diverted in order to stabilise the situation in the financial sector from which the banking sector as a whole gained a direct or indirect benefit.

FSF is of a regulatory nature because the fee increases the costs for credit institutions when they assume less stable liabilities whose disproportionately high share in the liability structure of credit institutions may potentially aggravate the stability of the financial sector. By discouraging the financial sector to assume excessive amount of risky liabilities, the potential adverse effects on the economy in general are mitigated. FSF is mainly applied to liabilities of credit institutions to other credit institutions and also to deposits that are not guaranteed by a deposit guarantee scheme of any EU Member State.

Administration of FSF is ensured by the Commission. In 2011, FSF rate was 0.036% of the total liabilities of the fee object, a credit institution, at the end of the taxation period (excluding deposits to which the guarantee scheme applies, mortgage debentures and the subordinated capital or own funds). In the reporting year, FSF had a minimum impact on the availability of financial resources on the market.

In 2011, income from FSF payments was 2.3 million lats (or about 0.2% from total losses of the banking sector in 2009–2011) and it was credited to the total revenues of the general State budget. Fee is payable as an advance payment for the calendar year and, at the end of the year, the amount of the fee is recalculated taking into account the performance of the credit institution during the calendar year. For the year 2011, payments to the State budget in the form of FSF totalled 3.17 million lats, but that amount was adjusted and reduced by 0.8 thousand lats.

COOPERATION

Cooperation at the National Level

For the performance of its tasks, the Commission's activity was also directed towards cooperation with customers and cooperation partners. In 2011, the Commission's representatives participated, on a regular basis, in the meetings of the Budget and Finance (Taxation) Committee and of the Public Expenditure and Audit Committee of the Saeima during which draft laws related to the regulation and supervision of the Latvian financial sector were discussed and reviewed. The management of the Commission also participated in the meetings of the National Security Committee of the Saeima.

In 2011, the management of the Commission had several meetings with the President of the State to discuss topical issues in the Latvian financial sector.

In the reporting year, the Commission continued regular exchange of information with the Bank of Latvia and the Ministry of Finance and it submitted, at least quarterly, summary information to the Bank and the Ministry about the situation in the financial and capital market.

In accordance with the signed cooperation agreement, the cooperation with the Consumer Rights Protection Centre continued in 2011 in order to ensure more operative and efficient protection of consumer rights in respect of the provision of financial services.

Representatives of the Commission participated in the working groups established by the Cabinet of Ministers and by ministries (Working Group

for Improving Cooperation with International Rating Agencies at the Cabinet of Ministers, Transaction Assessment Commission at the Cabinet of Ministers, Working Group for Developing Latvia's Position in respect of the Proposal for a Directive of the European Parliament and of the Council on credit agreements relating to residential property at the Ministry of Economics, Working Group on EU Court Issues at the Ministry of Justice, Working Group on Developing Amendments to the Commercial Law and the Criminal Law at the Ministry of Justice, Working Group on Time Schedule and Administration of Auctioning of Greenhouse Gas Emission Allowances at the Ministry of Environmental Protection and Regional Development, Working Group on the Financial Sector Development Strategy at the Ministry of Finance), in councils (National IT Security Council, Financial Sector Development Council, Audit Consultative Council, OECD Consultative Council at the Ministry of Foreign Affairs), in committees (Latvian-Swiss Management Committee of the Draft Cooperation Programme "Technical Assistance in Financial Reporting Issues"). In 2011, the Commission cooperated with the Prosecutor General Office, Economic Police and Ministry of the Interior in relation with the suspension of the activity of JSC "Latvijas Krājbanka".

International Cooperation

Even though the Commission took note of the number of significant changes in the regulation and supervision of the financial and capital recently around the globe, it was taking active part mainly in the events in Europe. In the reporting year, the Commission participated in discussing draft regulations in the Council of the European Union and EC Committees and also in the work of the newly established European financial supervisory authorities.

Participation in the Work of the Council of the European Union and EC Committees in the Area of Financial Services

In 2011, the EC made a number of legislative proposals concerning the financial sector: new capital requirements framework for credit institutions CRD IV/CRR, amendments to the MiFID and market abuse directives, Solvency II and other directives, and the proposals disclosed in 2010 were further discussed in the Council of the EU. The Commission's experts were involved in developing the national positions and discussing proposals in the Financial Services Working Group of the Council of the EU. In several cases, in cooperation with the representatives of other Member States, changes in the initial wording were made in accordance with the proposals.

At the level of the EC Committees whose membership included the Commission's experts, the work was carried out in respect of EC regulations that were subject to directives in respect of issue prospectuses, alternative investment funds, UCITS and insurance and reinsurance companies (Solvency II) and the planned EC initiatives in respect of the financial sector were discussed. The Table "The Most Important EU Legislative Acts Developed and Adopted with the Commission's Participation" (below) presents a survey of the regulations that were discussed in the EU bodies in 2011 and the actions planned in respect of these regulations in 2012.

The Most Important EU Legislative Acts Developed and Adopted with the Commission's Participation

EU legislative act	Activity in 2011	Planned activity in 2012
Banking Sector		
Directive on financial conglomerates	Discussion of proposed amendments to the Directive in the Council of the EU and European Parliament, approval of the proposal.	Developing amendments to the Financial Conglomerates Law and Credit Institution Law. Incorporating the respective requirements in the draft Law on Insurance and Reinsurance Companies.
Capital requirements Directive and Regulation (CRD IV/CRR)	Discussion of amendments to the Directive and a proposal for a new Regulation in the Working Group at the Council of the EU.	The discussion of amendments to the Directive and the Proposal for a Regulation are planned to finish in 2012. The European Banking Authority will work on developing technical standards.
Directive on deposit guarantee scheme	Discussion of the proposed amendments to the Directive in the Council of the EU and European Parliament.	Since the European Parliament did not reach an agreement with the Council of the EU about the proposal for the directive in the first reading, currently the approval of amendments to the Directive in 2012 is still unresolved.
Directive on credit agreements relating to residential property	Discussion of the proposal for a new directive in the Working Group at the Council of EU.	Discussion of the Directive could finish in 2012.
Directive on establishing a framework for the recovery and resolution of banks (crisis management framework)	Provision of answers in the EC public consultation on crisis management framework.	The proposal for an EC Directive is planned to be disclosed in the 2nd quarter of 2012.
Financial Instruments Sector		
Directive on Alternative Investment Fund Managers	Discussion of proposed amendments to the Directive in the Council of the EU and European Parliament, approval of the proposal. Discussion of the delegated and implementation measures of the Directive in the European Securities Committee.	The discussion of the delegated and implementation measures in the EC is planned to continue in 2012. European Securities and Markets Authority (ESMA) will work on developing technical standards. Developing draft Law on Alternative Investment Fund Managers.
Transparency requirements Directive	Discussion of the proposed amendments to the Directive in the Working Group at the Council of EU.	The discussion of the Directive is planned to finish in the 4th quarter of 2012.
Directive and Regulation on the market in financial instruments	Discussion of amendments to the Directive and a proposal for a new Regulation in the Working Group at the Council of the EU.	The discussion of amendments to the Directive and a proposal for a Regulation is planned to finish in the 4th quarter of 2012.

Market abuse Directive	Discussion of a proposal for a new Regulation and Directive in respect of criminal sanctions in the Working Group at the Council of the EU.	The discussion of the Directive and the Regulation is planned to finish in the 4th quarter of 2012.
Regulation on credit rating agencies	An amendment to the Regulation was approved whereby ESMA is entrusted with exclusive supervisory powers over credit rating agencies. Discussion of further amendments to the Regulation in the Working Group at the Council of the EU.	The discussion of amendments to the Regulation is planned to finish in the 3rd quarter of 2012.
Directive on investor compensation schemes	Discussion of the proposed amendments to the Directive in the Council of the EU and the European Parliament.	The discussion of the Directive is planned to finish in the 3rd quarter of 2012.
Regulation on European market infrastructure	Discussion of the proposal for a new Regulation in the Council of the EU and the European Parliament. ESMA will develop technical standards.	The Regulation is planned to take effect in the 2nd quarter of 2012. EC adopted technical standards must take effect in the 1st quarter of 2013. EC will approve technical standards.
Regulation on short selling and certain aspects of credit default swaps	Discussion of the proposal for a new Regulation in the Council of the EU and the European Parliament, adoption of the proposal.	Regulation was adopted on 14 March 2012. ESMA works on developing technical standards that must take effect in November 2012.
Regulation on European Venture Capital Funds and Regulation on European Social Entrepreneurship Funds	Discussion of the proposals for a new Regulation in the Working Group at the Council of the EU.	The discussion of the proposals for Regulations is planned to finish in 2012. ESMA will prepare technical advice for delegated and implementation measures.
Regulation on central securities depositories	Development of a proposal for a new Regulation in the EC.	Discussion of the proposal for a Regulation in the Working Group at the Council of the EU. The discussion of the Regulation is planned to finish at the beginning of 2013.
Directive on UCITS	Development of amendments to the Directive and of implementation measures at the EC.	The proposed amendments to the Directive are planned to be disclosed in the 2nd quarter of 2012.
Directive on securities rights	Development of a proposal for a new Directive at the EC.	The proposal for an EC Directive is planned to be disclosed in the 3rd quarter of 2012.
Prospectuses Directive	Incorporation of amendments to the Directive in the Law on the Financial Instruments Market. Development and discussion of delegated EC legal acts in the European Securities Committee.	Approval of the delegated acts by the EC. ESMA works on making proposals for possible amendments to the Directive.
Resolution framework for the financial market infrastructure		The proposal for a EC regulatory act is planned to be disclosed in 2012.
Insurance and Pension Fund Sector		
Insolvency II Directive	Discussion of the delegated and implementation measures of the Directive at the European Insurance and Occupational Pensions Authority (EIOPA). Development of the draft Law on Insurance and Reinsurance.	Promotion of the draft Law for promulgation at the meeting of State secretaries. Approval of delegated and implementation acts at the EC.
Omnibus II Directive (amendment to Solvency II)	Discussion of the proposed amendments to the Directive in the Council of the EU and European Parliament.	The discussion of the Directive is planned to finish in 2012. Development of technical standards by EIOPA.
Directive on insurance intermediaries	Development of the proposed amendments to the Directive at the EC.	The proposed amendments to the Directive are planned to be disclosed in the 2nd quarter of 2012.
Directive on PRIPS	Development of a proposal for a new Directive at the EC.	The proposed amendments to the Directive are planned to be disclosed in the 2nd quarter of 2012.
Directive on the activities and supervision of institutions for occupational (supplementary) retirement provision	Discussion of the proposed amendments to the Directive at EIOPA.	The proposed amendments to the Directive are planned to be disclosed in the 3rd quarter of 2012.
Directive on insurance guarantee schemes		The proposal for EC Directive is planned to be disclosed in 2013.
Payment Services Sector		
Payment services Directive	Discussion of the implementation of the Directive at the European Payments Committee.	EC will assess the necessity for amendments and by 1 November 2012 will prepare a report about the implementation of the directive and its impact.
Second Directive on electronic money	Discussion of the implementation of the Directive at the European Payments Committee.	EC will assess the necessity for amendments and by 1 November 2012 will prepare a report about the implementation of the directive and its impact.

Participation in the Work of European Supervisory Authorities

In January 2011, the European Systemic Risk Board and European supervisory authorities — European Banking Authority, European Insurance and Occupational Pensions Authority and European Securities and Markets Authority — became operational; the aim was to move towards harmonised standards and convergence of supervision in the EU by developing technical standards, guidelines and recommendations.

In 2011, the European Systemic Risk Board approved three important recommendations. Recommendation on lending in foreign currencies aims at controlling excessive lending in foreign currencies and mitigating the risks of price “bubbles”. Recommendation on the macro-prudential mandate of national authorities established that Member States had to set financial system stability as the main goal of their macro-prudential policy and appoint a macro-prudential authority by granting to it respective powers and tools. Recommendation on US dollar denominated funding of credit institutions provided recommendations to supervisory authorities, when they exercised control over general funding and liquidity items of credit institutions, to follow closely the risks associated with US dollar-denominated funding and liquidity assumed by credit institutions. Member States must implement the recommendations during 2012–2013.

For the second year, the European Banking Authority carried out EU-wide stress tests of the banking sector in which major EU cross-border banking groups, incl. those represented in Latvia, participated; the aim was to assess overall stability of the EU banking sector and banks' ability to absorb the probable future shocks created by credit risk and market risk. In view of the sovereign debt problems in the euro area, at the end of 2011, the European Banking Authority required that, by 30 June 2012, major EU banks established a temporary capital buffer at the level of a consolidation group (for 71 banking groups in general) so that the capital adequacy ratio in respect of Tier I equity would reach 9% of risk weighted assets. In the area of regulations, the EBA priority directions for 2011 were related with the efficient introduction of the discussed capital requirements framework (CRD IV/CRR) and the necessity to develop technical standards. For example, work was started in developing delegated technical standards in respect of liquidity requirements, supervisory financial reporting and other areas. The work was continuing in developing guidelines (e.g., internal management guidelines and guidelines on data acquisition exercise in the area of remuneration policy were approved). The monitoring of colleges was enhanced by assessing the implementation of guidelines for the activity of colleges. Additional information about the EBA is available on its Internet homepage at www.eba.europa.eu.

The main priorities of the European Insurance and Occupational Pensions Authority in 2011 were developing technical standards for the implementation of Solvency II Directive. In spring 2011, the results of the quantitative impact assessment study QIS 5 on the impact of Solvency II regime on the insurance market in EU MS were obtained. The EIOPA carried out significant work to prepare a proposal for changes in the private pension sector and amendments to the supplementary retirement provision. Priorities included also consumer protection. Additional information about the activities of EIOPA is available on its Internet homepage at www.eiopa.europa.eu.

The priorities of the European Securities and Markets Authority in 2011 were proposals for technical standards in the area of market infrastructure in line with the delegation of the new Regulation. On the basis of the EC mandate, ESMA prepared technical proposals in the area of alternative investment funds and technical proposals for amending the market abuse directive. The necessary measures were taken to ensure registration of credit rating agencies and transfer of supervision thereof to the competence of ESMA. Peer reviews were carried out about the volume of sanctions and their imposition in Member States by following legal acts on market abuse and on financial instruments market. Attention was paid to improving various data exchanges between supervisory authorities and ESMA. Additional information about the activities of ESMA is available on its Internet homepage at www.esma.europa.eu.

In 2011, work was continuing in the area of pension fund supervision in European committees. The Commission's representatives took active part in the work of the European Insurance and Occupational Pensions Authority in the area of supervision of pension funds, and also in the work of EIOPA's Occupational Pensions Committee that was dealing with topical issues in the supervision of pension funds in Europe. In 2011, the work of the Occupational Pensions Committee was directed mainly towards drafting the answer to the EC about revised Directive 2003/41/EC on the activities and supervision of institutions for occupational (supplementary) retirement provision, in particular participating in drafting proposals about the regulation in the areas related with corporate management, disclosure of information to participants and investment rules and drafting proposals for the regulation of outsourced services and supervision thereof and for investment rules. As well, the Commission was represented in the projects of the Occupational Pensions Committee “DC Risks Related Project” and “Risk Mitigation Mechanisms for DC Related Risks”.

Cooperation with Supervisory Authorities of Other Countries

In accordance with the authorisation determined by regulations, the Commission was entitled to sign information exchange and cooperation agreements with supervisory authorities of other countries in the area of banks, insurance and financial instruments. Such agreements did not substitute the relevant regulatory framework, but ensured a more efficient cooperation in the case of cross-border supervision of market participants.

Separate agreements on cooperation and information exchange were concluded for cross-border supervision of banking groups if subsidiaries of banks of Member States operated in Latvia or subsidiaries of Latvian banks operated in Member States, and they governed the operation of those colleges of supervisors of banking groups in which the Commission's representatives participated. As well, in the area of insurance the Commission's representatives were involved in the work of three supervisory colleges of insurance and reinsurance groups, and, at the end of 2011, work started on developing the legal framework for the supervision of these insurance groups.

Bilateral Cooperation Agreements

Country	In the area of banking (year of signing the agreement)	In the area of insurance (year of signing the agreement)	In the area of securities (year of signing the agreement)
Lithuania	2000	2002	
Denmark	2002	2002	2002
Finland	2011	2002	
Sweden	2001		2000
Luxembourg			2001
Germany	2000	2002	
Estonia	2000	1998	
Lithuania		1998	1997
Belorussia	2001		
Ukraine	2003		
The Netherlands	2006		
USA	2007		
Cyprus	2009		
Russia	2010		
Iceland	2001		
Poland			2001
Portugal	2008		

Multilateral Cooperation Agreements

Organisation, parties to the agreement	Area	In the area of banking (year of signing the agreement)	In the area of insurance (year of signing the agreement)	In the area of securities (year of signing the agreement)
Lithuania, Latvia, Estonia	Supervision of <i>SNORAS</i> banking group	2009		
Estonia, Latvia, Lithuania	Supervision of <i>Swedbank</i> group	2010		
Italy, Austria, Bulgaria, Croatia, the Czech Republic, Germany, Ireland, Latvia, Luxembourg, Poland, Romania, Serbia, Slovakia, Slovenia	Supervision of <i>UniCredit</i> banking group	2009		
Denmark, Finland, Luxembourg, UK, Estonia, Germany, Ireland, Latvia, Lithuania, Norway, Poland, Sweden	Supervision of <i>Danske Bank</i> group	2009		
Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway, Sweden	Nordic-Baltic agreement in the area of cross-border financial stability, crisis management and prevention	2010	2010	2010
Sweden, Denmark, Norway, Finland, Poland, Luxembourg, Estonia, Latvia, Lithuania	Supervision of <i>Nordea</i> group	2011		
Sweden, Germany, Estonia, Lithuania, Latvia, Denmark, Norway, Finland, Luxembourg, Poland	Supervision of <i>SEB</i> group	2011		
Latvia, Lithuania, Estonia, Sweden, Germany	Supervision of <i>Citadele banka</i> group	2011		
Norway, Denmark, Latvia, Lithuania, Estonia, Luxembourg, Poland, Sweden	Supervision of <i>DNB banka</i> group			
Member States of the Committee of European Insurance and Occupational Pensions Supervisors	Cooperation with Swiss insurance supervisory authority		2006	

Banking supervisory authorities, central banks and ministries of finance of all Member States	On cooperation in financial crisis situations	2005		
Payment system oversight authorities and banking supervisory authorities of all MS	On cooperation in the payment system oversight	2004		
Central banks and banking supervisory authorities of all MS	On cooperation in financial crisis situations	2004		
Member States of the Committee of European Securities Regulators	On cooperation and information exchange	2004		

Moreover, in 2011, the Commission continued negotiations with the central bank of Azerbaijan about signing a bilateral agreement on cooperation in the area of banking, and a draft cooperation agreement on cooperation and information exchange was prepared with the Deposit Guarantee Fund of Portugal in the case of payment of the guaranteed compensation to the customers of the Portuguese branch of a Latvian bank (JSC "PrivatBank").

CUSTOMER PROTECTION

In 2011, protecting the rights of customers of market participants was an important aspect of supervision, incl. **reviewing customer complaints**, summarising and determining their typology, warning the general public and requesting them to **refrain from cooperation with unauthorised providers of financial services**. As well, the Commission ensured regular **information about the activities of guarantee funds**, thereby strengthening public confidence in the financial sector.

In order to protect investor interests, the Commission, whenever it had information about an illegal provider of investment services in Latvia, used mass media and its Internet homepage to warn investors and attract their attention to the particular illegal provider of investment services; the Commission stressed that it did not supervise operations of such companies in due course of law and therefore the State did not protect investor interests in such cases. In 2011, six warnings to this effect were published in mass media and on the Commission's homepage. To restrict the operations of such unauthorised companies, the Commission turned for assistance to the relevant law enforcement bodies.

In recent years, the number of unauthorised companies that offer foreign currency trading (FOREX) deals or use their trading platforms had been increasing in the EU; therefore, the Commission published the warning of the European Securities and Markets Authority on its homepage and also in mass media requesting people to refrain from cooperation with unauthorised companies and entities that offered foreign currency trading (FOREX) deals in the foreign currency market as well as information about the risks related to FOREX deals.

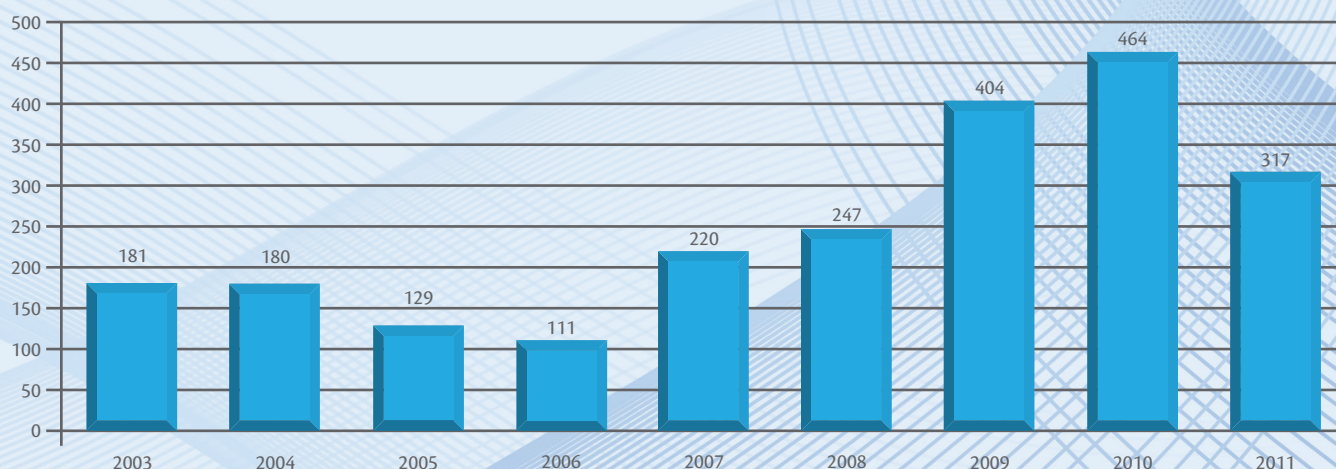
The Commission summarized and published quarterly information about the received customer complaints, and it also provided regular information to the public about the most frequent reasons for complaints.

In 2011, the Commission received and reviewed **317** applications in respect of the behaviour of the participants of the financial and capital market, incl. **201** complaints from customers of banks, **70** complaints from customers of insurance companies, **14** applications about insurance intermediaries, **17** applications about the participants of the financial instruments market, **5** applications about credit unions, **1** application about a private pension fund whereas **9** applications referred to various issues related with the financial market.

In 2011, the number of complaints and applications about market participants had decreased year-on-year (in 2010, the Commission received 464 complaints from customers of market participants) (see Chart 4).

Chart 4

The number of complaints received, by year



When receiving an application from a customer, the Commission requested the respective market participant to provide an explanation that was assessed before preparing the answer or providing a consultation to the customer about the essence of the application. The Commission also checked whether the market participant had not violated laws.

Bank customer complaints were mostly about the behaviour of banks when providing lending services, incl. about the settlement of liabilities ahead of maturity or restructuring liabilities, and also about increasing credit rates. In essence, customer applications were also related with the effecting of payments, provision of deposit services, servicing of payment cards and other issues. Customers of insurance companies complained mainly about a refusal to pay insurance indemnity, the calculated amount of indemnity or delayed decision-taking.

In respect of the payment of guaranteed compensations to the depositors of JSC "Latvijas Krājbanka" in 2011 and with a view to ensure effective solution of customer-related matters, the Commission dealt separately with the applications that were about the payment of the guaranteed compensation up to EUR 100 000 from DGF. Overall, 695 applications to this effect were received in November and December 2011.

In order to strengthen public confidence in the financial sector, in 2011, the Commission continued providing information to the public about the operations of the guarantee funds, their management and assets accumulated therein. In order to promote the DGF and FPI, the logos of the two funds were developed and displayed on the Commission's homepage thus providing direct access to the corresponding sections about both funds.

COMMUNICATION WITH GENERAL PUBLIC AND EDUCATING THE CUSTOMERS OF THE FINANCIAL SECTOR

In the reporting year, communication with general public was a significant part in the Commission's work; it was carried out by providing, where necessary, analytical or explanatory information in addition to the daily information and also by providing effective consultations to a wide range of people when the activity of JSC "Latvijas Krājbanka" was suspended and also during the so-called "Swedbank crisis".

In order to provide full-fledged information to the public about topical developments in the financial and capital market, in 2011, the Commission disseminated 96 Statements (59 in 2010) to mass media, including 25 Statements during the suspension of the operations of JSC "Latvijas Krājbanka", payment of guaranteed compensations and selection of the administrator.

Crisis Communication Process

On 22 November 2011, the operations of JSC "Latvijas Krājbanka" were suspended. During that crisis period, the Commission's experts provided explanations to general public and mass media about each decision taken by the Commission in respect of JSC "Latvijas Krājbanka". At the time when the bank's operations were suspended and unavailability of deposits detected, specific explanations were provided on the Commission's homepage and via mass media to various customer groups, e.g., owners of certificates, holders of financial instruments, borrowers and also all depositors irrespective of whether they were subject to the State guarantee system or not. As a result, these customers became creditors of the bank and received relevant information about their rights.

On the first days after the suspension of the activity of JSC "Latvijas Krājbanka", the Commission's staff were redeployed (5-6 specialists of the Commission were involved in addition to the regular communication staff) to provide efficient consultations on the phone to the customers of JSC "Latvijas Krājbanka", incl. beyond the regular business hours of the Commission and in line with the amount of daily requests.

In cooperation with JSC "Citadele banka" the Commission held a press conference to notify general public about the progress of the payment of guaranteed compensations, the calculation of the compensation and the deadlines. Further information was disclosed to the public, on a regular basis, about the process of the payment, the volume of compensations paid and other issues. In cooperation with the Ministry of Interior and the State Police the Commission issued a special Statement before the commencement of the payment of the guaranteed compensations whereby it requested customers of JSC "Latvijas Krājbanka" to be prudent and informed them about the most material risks in the process of receiving money. In order to reach as many customers of JSC "Latvijas Krājbanka" as possible, the Commission provided information about the commencement of the payment of guaranteed compensations to the most famous radio stations and the largest newspapers in both Latvian and Russian languages.

A detailed chronology of events of JSC "Latvijas Krājbanka" is currently available on the Commission's homepage. The Commission continues to provide regular information to the public about the resolution of the bank's insolvency process at court and supervision of the activity of the selected administrator.

Shortly after the suspension of the activity of JSC "Latvijas Krājbanka" another crisis situation in the communication area occurred in relation to another market participant: due to unjustified and intentionally spread rumours numerous customers of "Swedbank" JSC withdrew cash from the bank during the weekend. In some ATMs the amount of cash was not sufficient and there was a threat that the created panic, incl. on social networks, could spread to customers of other banks. The Commission efficiently ensured statements by its officials in various mass media and provided mass media and news agencies with topical information; as well, the Commission's management explained the actual situation live during the evening news on TV. In cooperation with the Swedish banking supervisory authority *Finansinspektionen*, the Latvian Security Police and other public institutions and also thanks to the involvement of the market participant itself that provided information and assurance to customers, the spread of panic and rumours was stopped within 24 hours.

In view of the practice implemented in both situations and the lessons learnt by the neighbouring countries in the area of communication during a crisis, the communication experts of the Commission were tasked by the Prime Minister to develop a Crisis Communication Plan for the financial sector and agree it with cooperation partners. The plan set out active cooperation among the Commission, the Bank of Latvia, the Ministry of Finance and the Office of the Prime Minister during crisis and involvement of market participants and their professional associations, where necessary. The plan was approved on 2 February 2012 during the meeting of the Financial Sector Development Council. The Commission intends to develop crisis communication guidelines for market participants whereby it will define concrete actions for a particular time and establish the basic principles for market participants to introduce their individual crisis communication plans.

Internet Site KLIENTU SKOLA (Client School) and Other Educational Measures

In continuance of the measures for educating customers and in line with the concept developed in 2010, on 1 March 2011, a new educational Internet homepage *KLIENTU SKOLA* (Client School) was launched. The site for educating customers was created to provide objective and understandable information about various financial services: it offered educational materials about the essence of the most popular financial products available in Latvia as well as their risk assessment so that all users of any new financial product had basic knowledge about the services and they could assess the probable future risks and their readiness to assume those risks. The content on the homepage will be supplemented as necessary. *KLIENTU SKOLA* is available on the Internet at www.klientuskola.lv.

The site offers easily comprehensible explanations about the fundamental principles of supervision of the financial sector, the deposit guarantee system, the essence of the FPI and investor protection and describes the competence of the supervisory authority of each sector that could be approached upon necessity. On the site Client School, users have an interactive opportunity to write to the Commission and receive replies to their questions. During 2011, in response to the requests by users of the Client School, the communication experts of the Commission, in cooperation with supervision experts, provided 49 consultations by e-mail.

In 2011, the Commission's representatives participated in the discussion "Possibilities of Education to Promote Financial Intelligence" organised by the Ministry of Education and Science. In future, the Commission intends to take part in the activities, of both global and local scale, aimed at promoting financial intelligence and to work on the diversification of the financial education methods. For that purpose, a new position will be opened in the Commission's Communication Division in 2012.

In parallel with customer education measures, the Commission also continued to educate market participants and held a seminar on topical issues for the providers of investment services taking into account the lessons learnt during the supervision. In 2011, the topic of the seminar was the prevention of conflicts of interests when providing investment services.

As well, in 2011, the Commission's representatives continued to participate in the training for bankers organised by the Association of Commercial Banks about the application of regulatory requirements.

To measure the indicator of confidence in the financial and capital market in general, the deposit guarantee scheme and the Commission as a supervisory authority, the annual survey of the Latvia's population was carried out in the reporting year. The summary of results will be used to plan further activities in the area of communication.

MAJOR TASKS IN 2012

1. In order to improve the regulatory framework governing the operations of insurers and reinsurers in view of the changes in the insurance and reinsurance market, risk management methods and the cross-border character of their operations, development of the law on insurance and reinsurance will continue.

2. To ensure compliance of the regulatory framework for financial conglomerates, investment management companies and alternative investment fund managers with EU requirements, amendments to the Conglomerates Law, Law on Investment Management Companies and Law on Alternative Investment Fund Managers will be developed.

3. In order to transpose the requirements of Directive 97/9/EC on investor protection in the regulatory requirements of the Republic of Latvia, amendments to the Investor Protection Law will be developed.

4. With a view to improving the regulatory framework for insolvency and liquidation of credit institutions, amendments to the Credit Institution Law will be developed.

5. The Commission intends to amend a number of its regulations; detailed information is provided in the work plan of the Commission for 2012.

6. To ensure harmonised approach in the EU to interpreting and applying legal norms, the Commission's management and specialists will continue their work in the newly established authorities of the European financial supervisory system and implement the guidelines and standards approved by European supervisory authorities.

7. With a view of carrying out the necessary measures to improve the deposit guarantee system and the protection of depositors, amendments to the Deposit Guarantee Law will be developed as well as to the "Regulations for Compiling and Providing Information about Guaranteed Compensation".

8. In order to improve the Commission's ability to ensure immediate action and coordination of the necessary measures in the case of unavailability of deposits at any deposit taker, the existing internal regulations of the Commission will be revised and improved and new regulations will be developed.

9. In order to increase financial intelligence of the general public, the Commission will continue to maintain its Internet site *KLIENTU SKOLA* (www.klientuskola.lv) by providing educational materials about the essence of the most popular financial products available in Latvia, presenting risk assessment of these products as well as supplementing and updating the content on the homepage as necessary. In parallel, the Commission will cooperate with the responsible Latvian public institutions to assess the existing educational programmes and ensure proposals for increasing financial intelligence.

10. The system for planning and evaluating the performance of Commission's employees will be improved further to ensure assessment of each individual result-oriented performance, development of staff competencies and linking individual remuneration with assessment results.

III. GOVERNANCE AND STRUCTURE OF THE COMMISSION

STAFF OF THE COMMISSION

Personnel is the most important resource of the Commission that ensures achieving the goals of the Commission and further development of the institution. In 2011, the Commission continued the reform of the personnel management processes initiated in previous years by linking remuneration, training and professional improvement opportunities with the results of the job performance assessment.

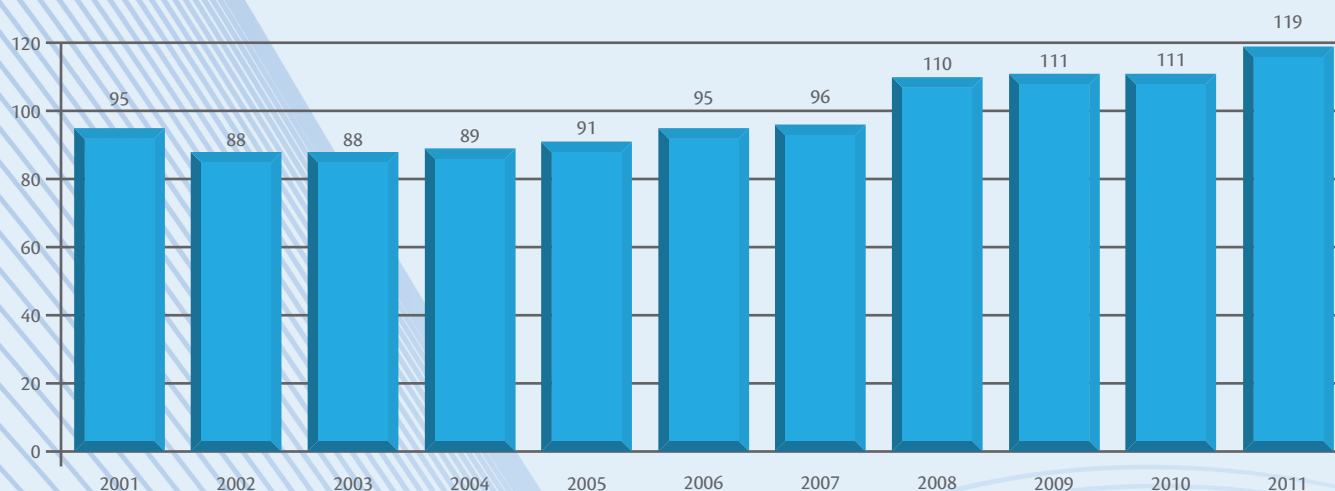
Changes in the Number of Employees and Other Personnel Changes

In the reporting year, the number of the persons employed by the Commission increased and was 119 (see Chart 5).

Of the eight newly recruited employees, six were performing core functions (they were supervision experts and one was a financial market analyst), whereas two were involved in support functions in the IT Division. To ensure staff were utilised in line with their competencies and improve the supervision of the banking sector, the Commission's structure was changed on 1 September 2011: the Banking and Institutional Investors Division of the Supervision Department in which 27 employees worked was reorganised and three new structural units were created: Monetary Financial Institutions Operations Analysis Division, Monetary Financial Institutions Risk Assessment Division and Pension and Investment Fund Division that were directly accountable to the Deputy Director of the Supervision Department.

Chart 5

Dynamics of the number of employees (2001-2011)



The average number of employees, including employees that had been absent for a long time, was 117 in 2011, of which:

- 92 (79%) were performing core activities and 25 (21%) were performing support functions;
- 83 (71%) were public officials and 34 (29%) were employees.

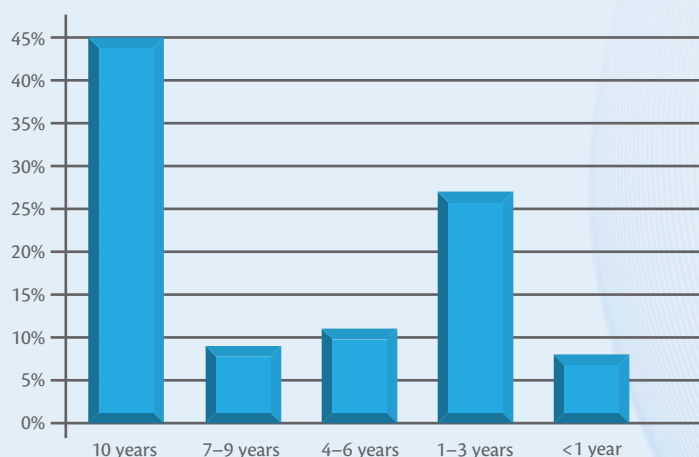
All employees were performing intellectual work.

In the reporting year, 49 (42%) employees attended on 180 business trips and of these employees:

- 35 employees were involved, on a regular basis, in the work of EU bodies and working groups of European financial supervisory authorities (European Banking Authority, European Insurance and Occupational Pensions Authority and European Securities and Markets Authority);
- Chairwoman of the Commission as a representative of the Republic of Latvia participated in eight meetings of the Board of Directors of the European Investment Bank and in the Spring and Annual Meetings of the IMF and World Bank, and also met the representatives of the US financial institutions on bank stabilisation issues.

In 2011, 91% (108) employees had worked in the Commission for more than one year, 45% (53) employees had been employed with the Commission for 10 years, i.e., as of its establishment, and 8% (10) employees had worked in the Commission for less than a year (see Chart 6).

Chart 6
Job duration profile of the Commission's employees (%)

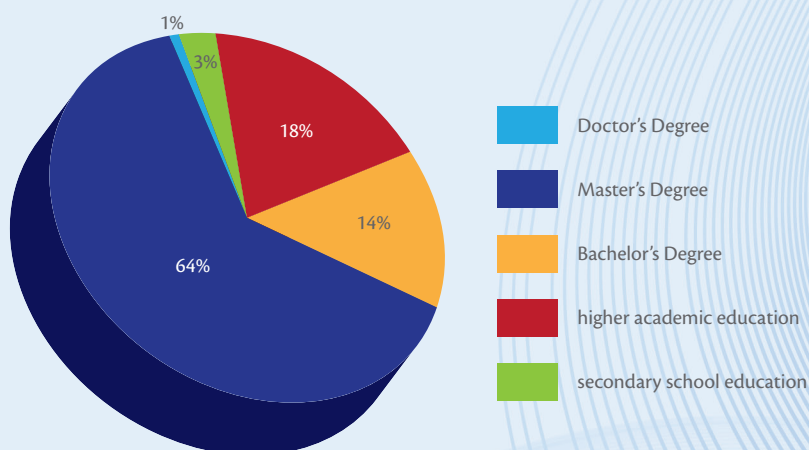


The staff turnover rate in 2011 was 6%. In the reporting year, 11 new employees were recruited, of which three employees had a job contract with the Commission to replace an employee during an extended absence (a child care leave). After the trial period, in accordance with the established adaptation period plan all eight employees received a positive assessment and continued their employment with the Commission. In the reporting year, the Commission terminated job relationship with seven employees, of which three took jobs in the private sector, two employees retired, one employee relocated with the family to live abroad; as well, following the submission of an application for voluntary resignation, the Saeima released Chairwoman of the Commission from the position on 8 December 2011.

Staff Qualifications

The Commission values educated and professional employees. In the reporting year, 96% (114) employees had university education (of which 64% had a Master's Degree), and 3% (4) employees had general secondary school or professional secondary school education (see Chart 7).

Chart 7
Education profile of the Commission's personnel (%)

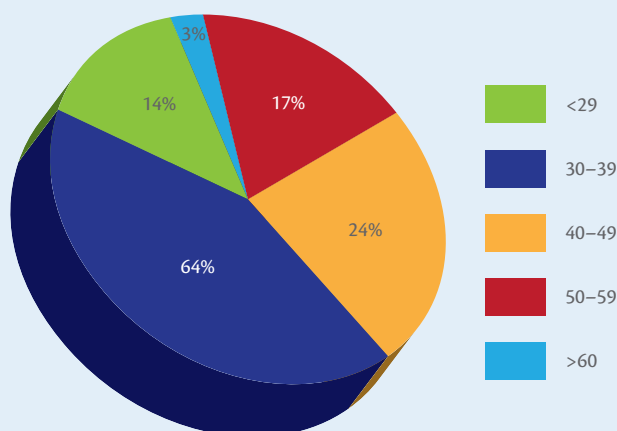


Demographic and Age Profile of the Commission's Staff

In 2011, of all Commission's employees 75% (88) were women and 25% (30) were men. The age profile of the staff was as follows: 14% employees were younger than 29, 42% were between 30 and 39, 24% were between 40 and 49 while 20% were older than 50 (see Chart 8). In the reporting year, like in the year before, the average age of the Commission's employees was 40.

Chart 8

Age profile of the Commission's staff (%)



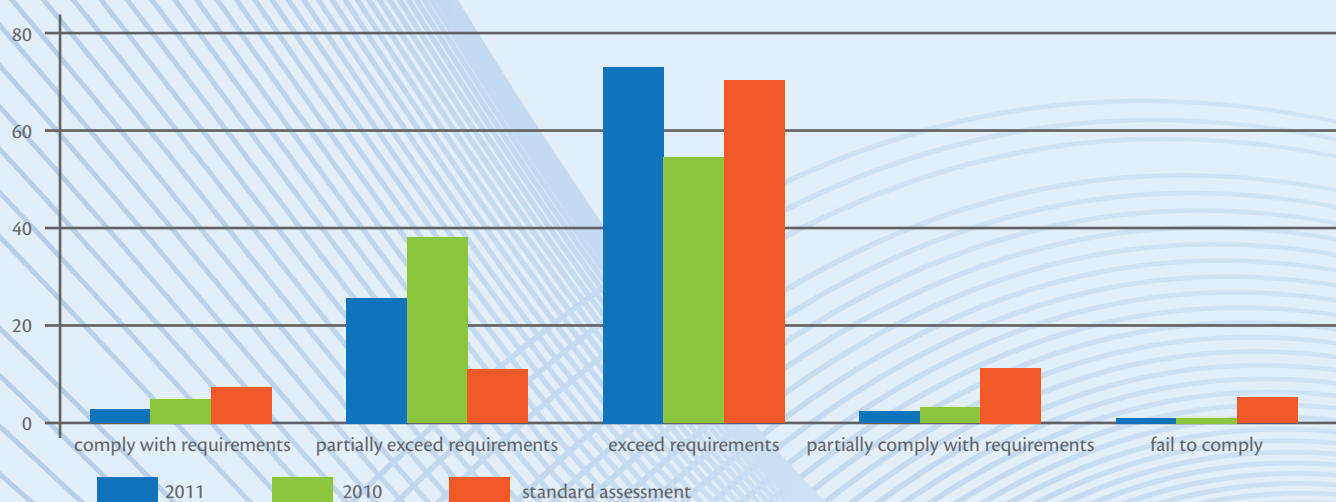
Performance Management Assessment

In 2010, the Commission launched Performance Management Assessment (PMA) of its employees. In due course of the Commission's procedures, 103 employees participated in PMA in the reporting year, of which 22 were heads of structural units (incl. four Board members) and 81 were experts. Four criteria were assessed: attaining the established goals, fulfilment of professional duties, compliance with the required qualifications (incl. the level of education, professional experience, expert knowledge and skills, language proficiency and computer skills) and the required job-related competencies.

After assessing all criteria, 73% of employees were recognised as "compliant with the requirements", 24% were recognised as "partially exceeding the requirements", and 2% were recognised as "exceeding the requirements" and 1% was recognised as "partially complying with the requirements". Like in the previous year, none of the employees was recognised as "non-compliant" (see Chart 9).

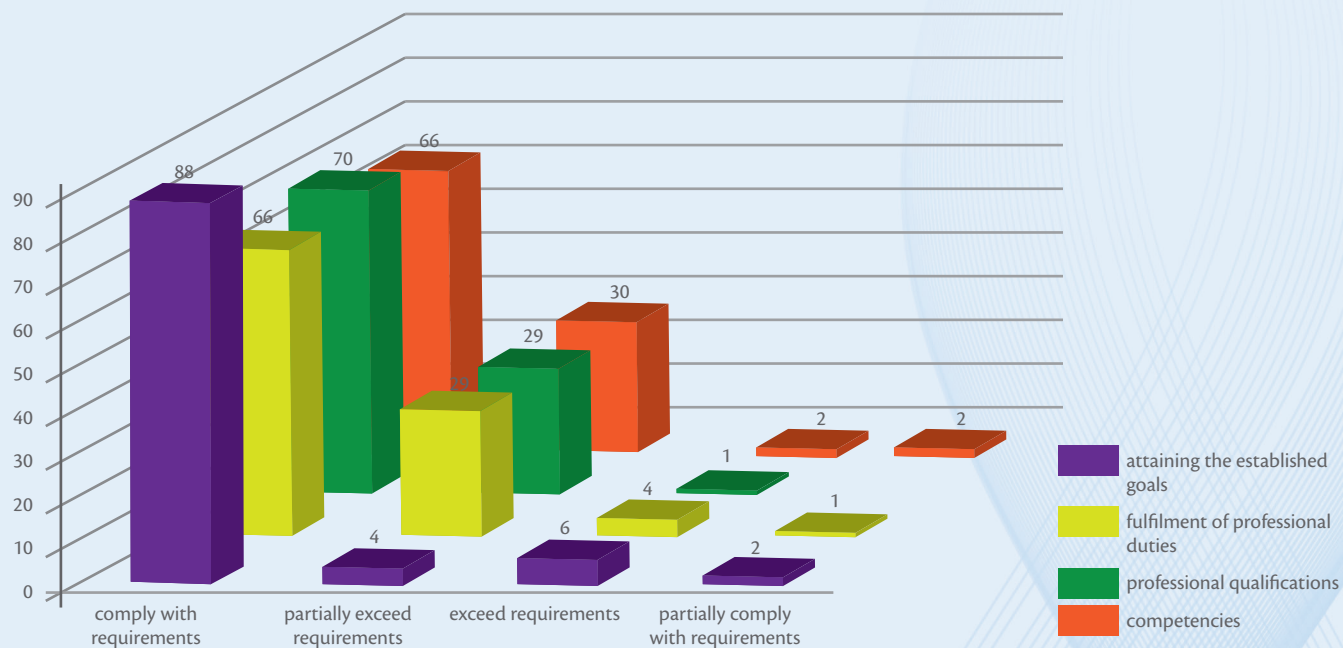
Chart 9

OVERALL PERFORMANCE MANAGEMENT ASSESSMENT



In the overall assessment by criteria the assessment profile was similar (see Chart 10).

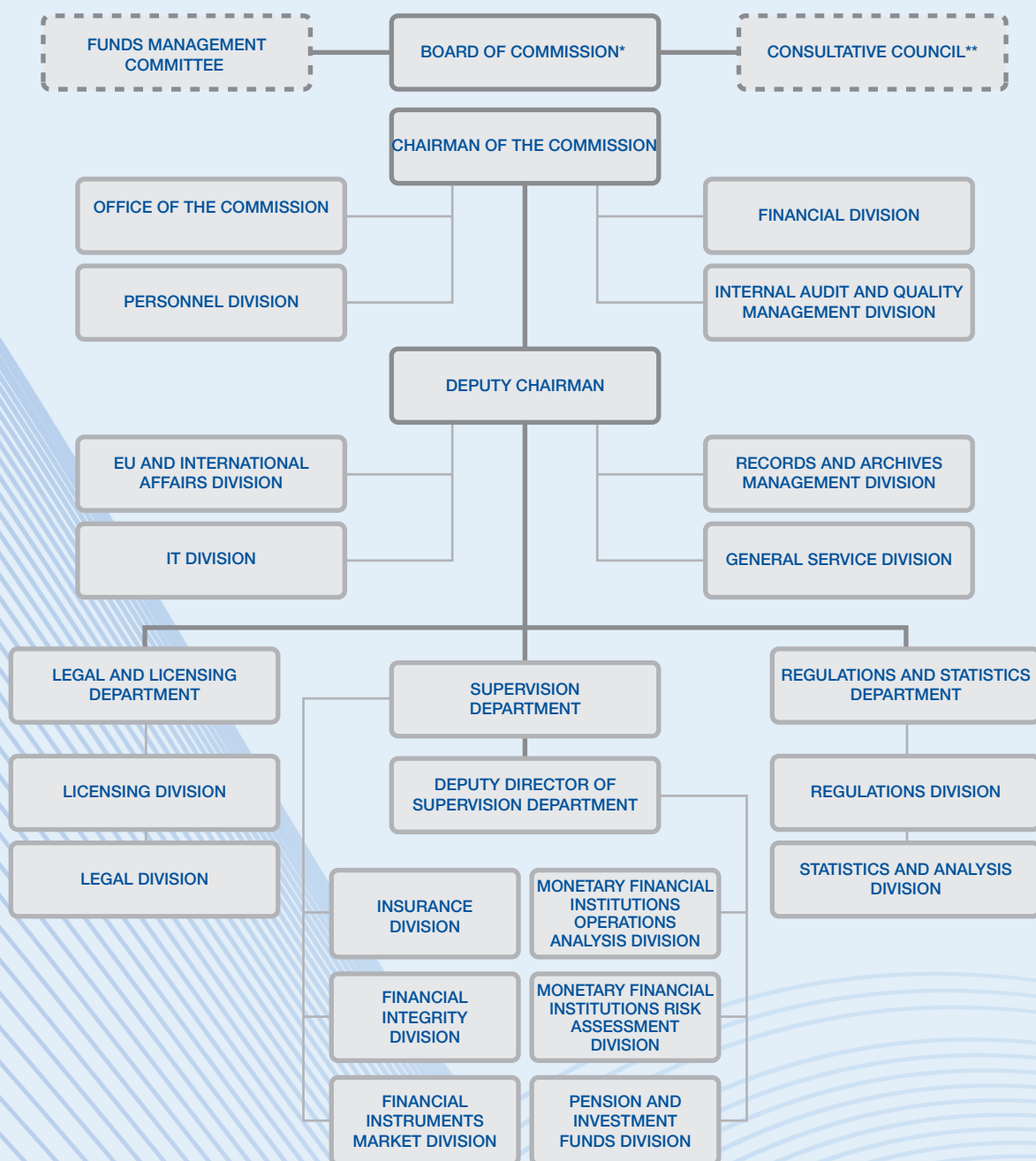
Chart 10
PMA ACCORDING TO CRITERIA (%)



Improving the Staff Qualifications

In order to ensure ongoing improvement of the Commission's activity processes, increase efficiency and productivity of the Commission's performance as well as ensure the supervision of the financial sector, the banking sector in particular, in line with the Commission's strategy, 84% (98) Commission's employees improved their qualifications in the reporting year by attending job-related training both in Latvia and other countries. In Latvia, they attended workshops to improve their knowledge in the area of legislation, financial analysis, risk management, electronic payments, procurement management, record keeping, information technology, job protection, presentation and management skills. To supplement knowledge in the area of banking risk management, stress testing methodology and practice, capital requirements for the insurance sector Solvency II, Basel Capital Accord II and other areas related to financial supervision, 35% (41) Commission's employee attended seminars abroad.

Structure of the Commission



* The Board consists of five Board Members: Chairman of the Commission, Deputy Chairman of the Commission and three Board Members who are simultaneously Directors of Departments

** The Consultative Council is formed on a parity basis of the Commission's representatives and heads of non-governmental organisations (professional associations) of the participants of the financial and capital market

FINANCING OF THE ACTIVITIES OF THE COMMISSION

In the reporting year, the activities of the Commission were fully financed from the payments by market participants. Within the budget for ensuring its activities, in the reporting year, the Commission also managed the DGF and the FPI and, in line with the responsibility vested to it, administered the financial stability fee as of its introduction in 2011.

(in lats)

	Actual result in 2010 ¹	In 2011			
		Actual result	Budget in the reporting year ¹	Budget result, %	Share of the actual result, %
INCOME (+)	3 992 754	4 069 576	4 117 870	98.8	100
PAYMENTS BY THE PARTICIPANTS OF THE FINANCIAL AND CAPITAL MARKET	3 980 299	4 059 505	4 110 370	98.8	99.8
INCOME RELATED TO THE SUPERVISION OF MONETARY FINANCIAL INSTITUTIONS	2 833 816	2 859 945	2 910 810	98.3	70.3
Payments by credit institutions	2 821 166	2 841 947	2 895 630	98.1	69.8
Payments by credit unions	12 650	15 983	15 180	105.3	0.4
Payments by payment institutions	-	1 823	-	-	-
Payments by electronic money institutions	-	192	-	-	-
INCOME RELATED TO THE SUPERVISION OF INSURANCE	936 073	930 940	930 940	100	22.9
Payments by life insurance companies	131 902	146 530	146 530	100	
Payments by other insurance companies	804 171	784 410	784 410	100	19.3
INCOME RELATED TO THE SUPERVISION OF THE FINANCIAL INSTRUMENTS MARKET AND PRIVATE PENSION FUNDS	208 694	268 620	268 620	100	6.6
Payments by the participants of the financial instruments market	163 694	213 510	213 510	100	5.2
Payments by private pension funds	45 000	55 110	55 110	100	1.4
INCOME FROM TERM DEPOSITS	12 454	10 071	7 500	134.3	0.2
EXPENSES (-)	3 471 844	3 639 102	4 103 840	88.7	100
REMUNERATION	2 721 418	2 782 829	2 986 050	93.2	76.6
Salaries ² and payments equivalent to salaries ³	2 163 524	2 243 487	2 407 630	93.2	61.8
Mandatory contributions to the State Social Insurance	521 571	539 342	578 420	93.2	14.8
Social guarantees	36 323	-	-	-	-
IMPROVING PROFESSIONAL QUALIFICATION OF THE STAFF AND BUSINESS TRIPS	166 211	186 168	269 450	69.1	5.1
SERVICES AND COMMODITIES TO ENSURE ACTIVITIES	429 737	471 525	574 580	82.1	13.0
Telecommunication, liaison and information	102 505	115 722	135 650	85.3	3.2
Information to the general public, internal and external communication	11 881	26 766	23 430	114.2	0.7
Maintenance and maintenance-related expenses	243 889	273 195	311 350	87.8	7.5
Professional services	71 462	55 842	104 150	53.6	1.5
PARTICIPATION FEES IN INTERNATIONAL ORGANISATIONS	100 504	138 076	209 100	66.0	3.6
AMORTISATION/DEPRECIATION OF CAPITAL INVESTMENT	53 974	60 504	64 660	93.6	1.7

¹In accordance with the accrual principle, excluding accruals for holidays that are not included in the budget.

²As of 1 March 2011, monthly remuneration of the Commission's officials and employees has been determined in accordance with the Law on Remuneration of Officials and Employees of State and Self-government Authorities.

³Payments equivalent to salary include one-off benefits to employees for the birth of a child, the death of a family member (the amount of the benefit was 180 lats in 2010, 200 lats in 2011), or a benefit when retiring and a compensation for correcting the eyesight with medical means (i.e., to buy glasses) as prescribed by a special doctor for vocational illnesses: up to 90 lats in 2010, 100 lats in 2011. These payments included also a supplementary payment for replacing employees who had been absent for a long time and for fulfilment of job duties under intensive working conditions during the suspension of the activity of JSC "Latvijas Krājbanka"; the amount was up to 20% of the daily salary rate for a particular number of days.

Taking into account that budget expenses were projected to increase slightly in 2011 (by 4.8%) in comparison with 2010, the payments by the participants of the financial and capital market to finance the activities of the Commission were also increased (by 3%). The payments by the participants of the financial and capital market to the Commission's income budget depend, in direct proportion, on the payment rates established to them for financing the Commission, on changes in the performance indicators of the financial market (their increase or decrease) as well as on the amount of the expenses needed to finance the Commission's activities (see Table 3).

Table 3

Changes in the financing for the Commission, 2007-2011, %

	2011/2010	2010/2009	2009/2008	2008/2007
Payments by the participants of the financial and capital market	2%	-22%	45%	4%
Income related to the supervision of monetary financial institutions	1%	-25%	58%	3%
Income related to the supervision of insurance	-1%	-11%	21%	0%
Income related to the supervision of the financial instruments market and private pension funds	29%	-17%	20%	36%

The dynamics of the funding for the Commission is also related with the share of the costs for supervising the respective sector and the sector's ability to ensure the necessary amount of financing. Over years, market sectors had provided financing to the Commission in proportion to the share of the costs needed to supervise the respective sector. In 2011, payment institutions and electronic money institutions were added to the monetary financial institutions as funding providers and they made a fixed payment of 100 lats a year to the Commission; with the indicators of the financial instruments market increasing, the ability of this sector to cover its supervision costs increased as well (see Charts 11 and 12).

Chart 11

Structure of the financing for the Commission, 2007-2011, share, %

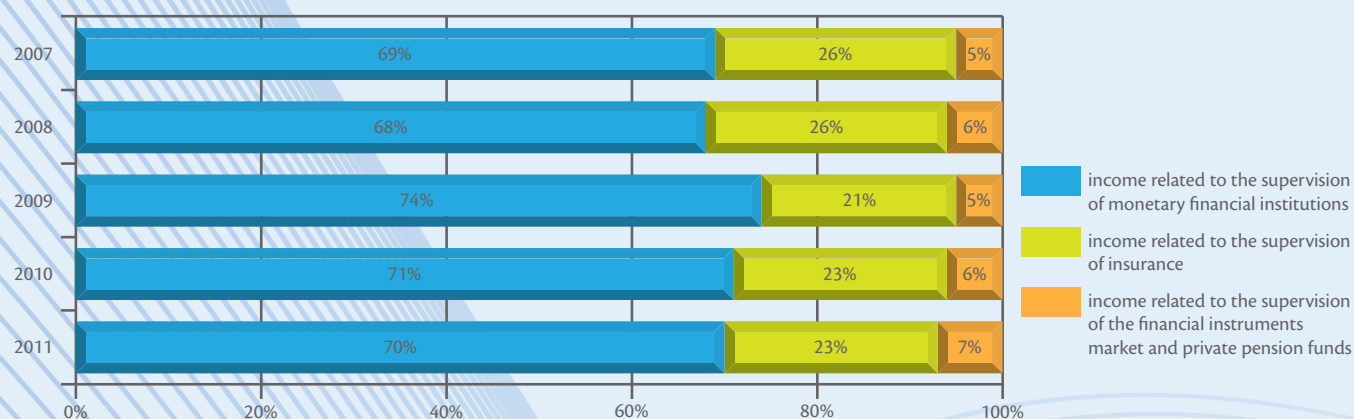
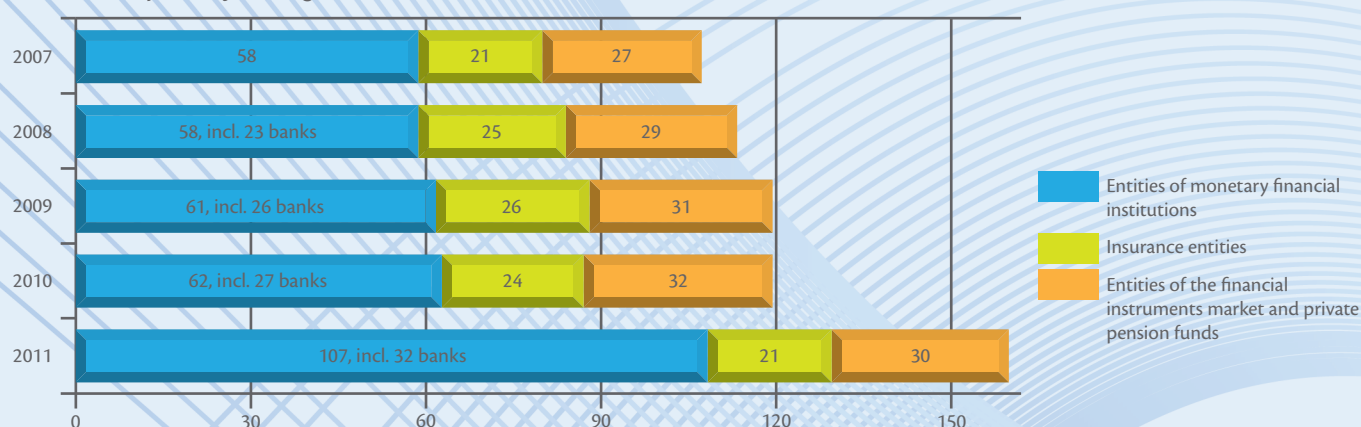


Chart 12

The number of funding providers to the Commission and of the entities of the financial and capital market subject to supervision, excluding the entities that do not provide financing to the Commission, 2007-2011



In 2011, staff remuneration costs formed the largest part (77%) of the Commission's expenses; the volume of remunerations changed along with the changes in the number of employees and in view of salary changes in the financial sector which served as a benchmark for the remuneration of the Commission's employees; the Commission also observed the restrictions on remuneration and social guarantees in public administration bodies. As of 1 March 2011, monthly remuneration of the Commission's officials and employees has been determined in accordance with the Law on Remuneration of Officials and Employees of State and Self-government Authorities, taking into account the importance of the position (the level of responsibility and job complexity), the qualifications and competencies assessment of the respective official or employee, as well as the remuneration of the employees in the financial sector. Remuneration of the Chairman of the Commission did not exceed the average monthly salary disclosed by the Central Statistical Bureau in its Statement about employees of the financial and insurance sector in the year before the previous year, i.e., in 2009, and to that salary a ratio of 4.95 was applied. In 2010, the Commission demonstrated its solidarity with other public administration bodies and reduced the salary of every employee by

20% on average, ceased insurance of its employees after the expiry of previous insurance contracts, and reduced the amount of benefits to its employees (see Table 4).

Table 4

Changes in the average remuneration of employees, 2008-2011, %

	2009/2008	2010/2009	2011/2010	2011/2008
Changes in the average remuneration of employees	-14	-20	-3	-34
of which salary and payments equivalent to salary	-5	-19	-2	-25
of which social guarantees ⁴	-80	-47	-100	-100

Structure of remuneration and other payments to the employees by structural units in 2011:

Structural segment	Number of employees	Share of employees, %	Share of remuneration, %
Board of the Commission	5	4.3	10.7
Personnel Division	3	2.6	2.0
Financial Division	4	3.4	3.2
IT Division	8	6.9	6.9
General Service Division	2	1.7	1.1
Internal Audit and Quality Management Division	2	1.7	1.9
EU and International Affairs Division	3	2.6	2.2
Office of the Commission	4	3.4	2.8
Records and Archives Management Division	6	5.2	3.1
Supervision Department ⁵	47	40.5	40.9
Legal and Licensing Department ⁶	16	13.8	11.3
Regulations and Statistics Department ⁷	16	13.8	13.9
Total	116	100	100

Remuneration of employees and other payments to employees, remuneration in respect of the contract for work performance and remuneration to the members of the Consultative Council of the financial and capital market amounted to 93.2% of the planned expenses, totalling 2.8 million lats, of which 19% were State social insurance mandatory contributions by the employer.

Salary and other payments by type in 2011:

Type of payment	Amount in lats	Share, %
Salary	1 948 584	86.8
Supplement	27 445	1.2
Payment for absence related to disability	11 027	0.5
Holidays (annual, supplementary, holiday compensation)	239 220	10.7
Paid day-off ⁸ while retaining the salary	6 028	0.3
Benefits (for a birth of a child, death of a relative, notable event)	3 724	0.2
Compensation for optical means correcting eye sight	3 644	0.2
Payment for meetings of Consultative Council	3 465	0.2
Contract for work performance	350	0.0
Total	2 243 482	100

As a result of economical use of resources and the selection of providers of commodities and services in accordance with the Public Procurement Law or by means of the electronic procurement system, in 2011, the Commission saved 23% of the projected expenses (27.5% in 2010).

As of its establishment, the Commission had invested notable funds in information technologies in order to optimise supervisory and its own organisational management processes and ensure more efficient processing of the financial information submitted by the entities of the financial and capital market for supervisory purposes. To ensure an efficient remuneration system of employees based on job assessments and taking into account the importance of the position (the level of responsibility and job complexity), the assessment of qualifications and competencies of each individual official or employee, as well as the achievements of each employee, the Commission had developed a Result Management System. In the reporting year, the Commission continued development of the IS Data Collection, Processing and Analysis System (DARIS) aimed at enabling comprehensive system-wide analysis of all participants of the financial and capital sectors. In the reporting year, 24 000 lats were spent for research and development of the system.

⁴Insurance of employees against the risk of illness, accident and an event of death.

⁵One position for less than a year as of 1 November 2011.

⁶One position for less than a year as of 1 September 2011.

⁷One position for less than a year as of 1 November 2011.

⁸In the cases stipulated by Labour Law and established by the Commission.

At the end of 2011, IT book value was 75% of total long-term investment (see Table 5).

Table 5

Dynamics of the Commission's long-term investment, 2007-2011 (year-end)

	2011	2010	2009	2008	2007
Book value of long-term investment, total in lats	212 436	196 970	193 126	182 898	88 948
Units, total	3 859	3 710	3 564	3 363	2 966
of which book value of software and IS, in lats	90 529	75 925	65 044	53 443	47 853
number of units	2 344	2 246	2 166	2 002	1 759
of which book value of IT equipment, in lats	68 100	68 521	72 321	66 542	23 021
number of units	360	382	367	374	307

Investments in information technologies included regular changing of the stock of computers to ensure their optimum performance for processing and servicing supervisory IS, developing and improving information systems as well as using licensed software. In order to ensure the flow of statistical and supervisory documents and records, several information systems had been developed and adjusted for the Commission's needs with the aim to diminish the flow of paper documents and the number of manual processes and ensure swift action, quality of data and comfortable cooperation environment for market participants (see Table 6).

Table 6

Dynamics of changes of the Commission's capital investment, 2007-2011

	Changes in 2011 ⁹	Changes in 2010 ⁹	Changes in 2009 ⁹	Changes in 2008 ⁹	Changes in 2007 ⁹
Total capital investment, in lats	3 199	56 291	38 236	99 222	32 156
Units, total	133	146	196	388	307
of which software and IS, in lats	32 435	33 105	35 074	32 394	30 798
number of units	77	87	156	229	265
of which improvements of the existing units	22	7	11	7	9
of which IT equipment, in lats	-37 886	19 660	10 547	51 712	3 094
number of units	-22	21	-7	67	7
of which improvements of the existing units	1	6	1	2	1

The financial Statements for 2011 of the Commission and of the DGF and the FPI managed by the Commission along with the opinion of independent auditors are available on the Commission's website at www.fktk.lv.

Internal Audit and Quality Management

Internal audit (Internal Audit and Quality Management Division) performed objective inspections of the Commission's functions and processes and provided the Commission's management with an independent assessment about efficiency of risk management, control system and processes as well as consultations for their improvement. Internal audit covered all areas of the Commission's activity but paid most attention to the core activity processes.

Internal audits were planned and carried out on the basis of risk assessment. The head of Internal Audit and Quality Management Division reported to the Board of the Commission about the results of each internal audit. Once a quarter, the Board revised the process whereby internal audit recommendations were implemented. Overall performance of the internal audit was reported to the Board of the Commission once a year.

In the reporting period, in line with the work plan of the Internal Audit and Quality Management Division for 2011, seven internal audits were carried out, of which six were planned and one had not been previously scheduled.

As a result of audits it was uncovered that the Commission's internal control system ensured completion of the tasks set out for the institution in line with its strategic goals and in compliance with regulatory requirements. Overall, the assessed control processes were functioning well, but it was necessary to improve separate internal control processes for managing guarantee funds, performing security inspections of the information systems of market participants, developing data collection, processing and analysis system and work safety and fire security.

In the reporting period, the internal audit provided 65 recommendations aimed at improving and developing the Commission's internal control system, and 31 recommendation or 48% was assessed as high priority, 24 or 37% as medium priority and 10 or 15% as low priority. Of the internal audit recommendations provided in the reporting year, 94.2% have been implemented. Whereas of the internal audit recommendations to be implemented in the reporting period, 95.6% have been implemented.

⁹Acquired during the year, without the excluded (in the amount of the historic cost).

Suspension of the activity of JSC "Latvijas Krājbanka" and the problems of "Swedbank" JSC created by unjustified rumours revealed shortcomings in the communication policy implemented by the Commission over the recent years. In the reporting year, the Commission started to assess these shortcomings and, after taking appropriate conclusions, it changed the management of the communication processes and the way it ensured prompt communication, and also started developing a crisis communication plan. To assess the measures taken to ensure supervision, suspension of activity, payment of guaranteed compensations, initiating insolvency proceedings, selecting an administrator, internal and external communication and to identify weaknesses and necessary improvement measures, the Commission plans to assess the entire crisis management process of JSC "Latvijas Krājbanka" in the first half of 2012.

To ensure compliance of the Commission's services with the interests of the State, of people and customers as well as with regulatory requirements, the improvement possibilities and available resources were used to establish quality management system. The Commission constantly improved its operational processes by taking into account the best practice examples and experience of the supervisory authorities of the financial sector. As of 2003, the Commission had been an institution certified with an ISO, and as of 2009 its quality management system had been certified pursuant to the requirements of ISO 9001:2008 standard. The regulation and oversight of the functioning of the financial and capital market and operations of market participants was the area of activity of the quality management system subject to certification. To ensure that its quality management system complied with the requirements of ISO 9001:2008 standard on an ongoing basis, in 2011, within the performed internal audits, the Internal Audit and Quality Management Division inspected compliance with the requirements of the said standard; as well, an oversight audit of the Commission's quality management system was carried out by certification organisation "Bureau Veritas Latvija". The oversight audit did not disclose any inconsistencies and it was stressed that the Commission carried out consistent work to constantly improve its quality management system and its efficiency.

IV. PERFORMANCE OF THE PARTICIPANTS OF THE FINANCIAL AND CAPITAL MARKET IN 2011

ECONOMIC DEVELOPMENT TRENDS IN 2011

In Latvia, 2011 was the year of economic growth and stabilisation, with GDP increase of 5.5%¹⁰ being the third best indicator in the EU.

Like in 2010, economic growth was supported by an increase in the volume of external trade by 28.2%, including an increase in export volume by 28.1% and of imports by 28.3%. With economic activity growing, there was a slight deficit in the current account of the balance-of-payments in 2011 that amounted to 1.2% of GDP¹¹.

Due to the increased utilisation of industrial production capacity, new investments were needed; this was reflected in the rapid growth of investments (by 24.6% in 2011) that contributed notably to a further development of the national economy. Investments were made not only by renewing and upgrading production facilities, but also by investing in new industrial objects causing a rapid increase of about 70% in building activities in the area of industrial plants and storehouses. Total building activity increased by 12.4% in 2011.

As a result of growing economic activity, the domestic market was also recovering in 2011. An increase in salaries in the economy by 4.4% on average and larger consumer confidence encouraged the increase in private consumption by 4.4% that was mainly ensured by the increased volume of non-food commodities trading. Despite the positive upward trend in salaries in the economy, the growing level of prices reduced the possibilities to increase private consumption; at the same time, private consumption increase was positively affected by a larger number of the employed that increased by 29.6 thousand or 3.1% in 2011.

Consumer prices in 2011 grew on average by 4.4%. Price increase was notably affected by the external environment factor related to the increase in food and energy prices in global markets. It was also underpinned by changes in tax rates in the first half of the year.

Due to the fragile domestic demand economic development in Latvia still depends on external demand trends and, with concerns about economic development in the euro area in 2012 and its impact on other European economies growing, growth forecasts for the Latvian economy are more moderate compared with 2011. Uncertainty surrounding economic development also impacts the development of the financial sector that largely depends on trends in the economy and justifies cautiousness about the possibilities for the banking sector to increase the volume of lending.

BANK PERFORMANCE¹²

At the end of 2011, 22 banks and eight branches of EU banks were operating in Latvia. During the year, JSC "Rigensis Bank" started its financial activity. A branch of a bank of EU MS (Latvian branch of *Pohjola Bank Plc* (Finland)) did not start financial activity in Latvia in 2011 despite its registration with the Commercial Register of the Republic of Latvia.

The market share of three banks with public capital (JSC "Citadele banka", public JSC "Latvijas Hipotēku un zemes banka" (Mortgage and Land Bank of Latvia) and JSC "Parex banka") in total assets did not change notably and was 14.7% at the end of the year. The market share of the four subsidiaries of EU banks and eight bank branches in total assets was 54% but it was even larger in the bank credit portfolio and amounted to 68%, incl. 73% in loans to residents.

¹⁰Macroeconomic data source here and further in the document is the homepage of the Central Statistical Bureau at www.csb.gov.lv.

¹¹Data source: Bank of Latvia homepage at www.bank.lv.

¹²Information has been prepared by summarising bank reports and it includes information about JSC "Latvijas Krājbanka", whose activity was suspended following the decision of the Board of the Commission of 21 November 2011.

With the macroeconomic situation improving, bank profit indicators were also improving and, even if the overall losses of the banking sector were 179 million lats at the end of 2011, these losses were twice smaller than in 2010 and were mainly due to JSC "Latvijas Krājbanka" and JSC "Parex banka"¹³. Excluding the losses made by both banks, the banking sector in general performed with a profit in 2011 that amounted to 97 million lats, and profit was reported by 11 Latvian banks and five branches of foreign banks – their total profit was 197.5 million lats (market share in total banking sector assets was 73%) (see Chart 13).

Chart 13

Structure of bank income and expenses (in million lats)



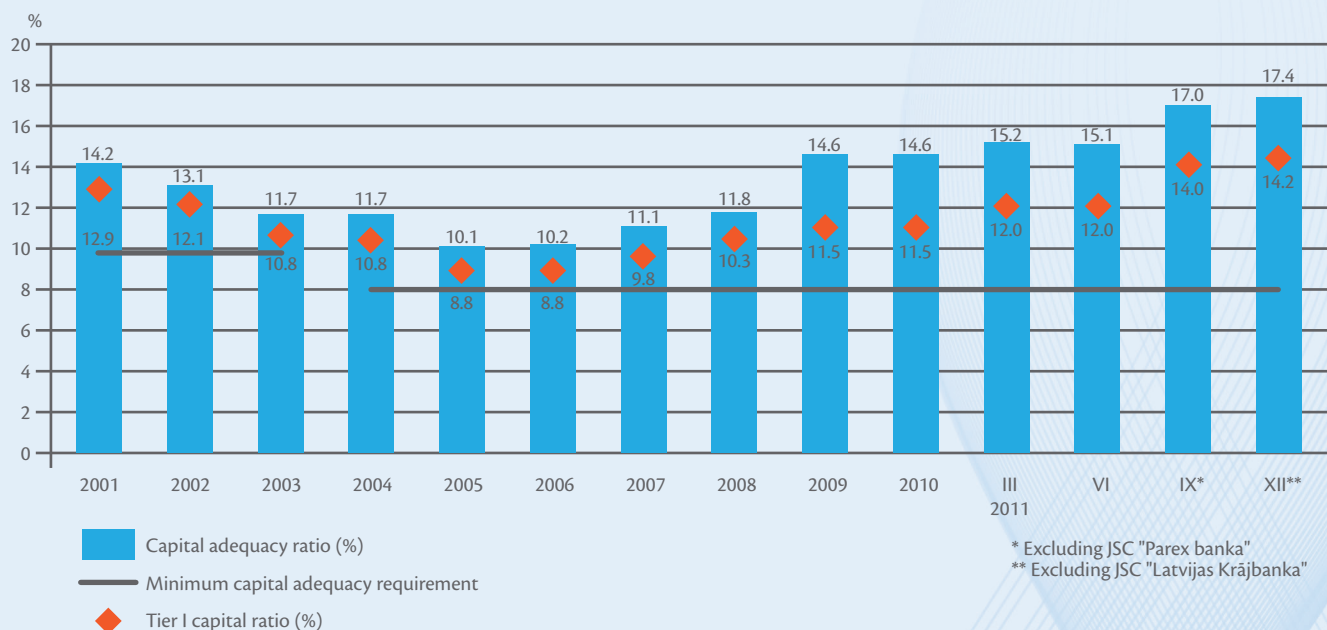
For the third consecutive year, profitability of the banking sector was influenced by persistently notable costs for provisions for doubtful debts that were 794 million lats or 48.9% of total costs (727 million lats in 2010). At the same time, the income structure of banks was increasingly dominated by income from reducing provisions; during the year, their amount increased by 86% and their share in income structure reached 28.4% at the end of the year (17.6% at the end of 2010).

In 2011, profit of the banking sector before provisions and taxes amounted to 238 million lats and by 66% exceeded the amount in the year before. For the first time since 2008, net interest income increased again (by 27%) (with the credit portfolio shrinking, interest income gained by the banking sector continued to decrease, yet at a slower pace; as well, total interest expenses of the banking sector decreased due to the decrease in deposit rates). As well, net commission fee income increased by 17.5% during the year and reached the level of 2008. Whereas administrative costs of the banking sector did not change notably in 2011 because already in 2009 banks revised their expenses and continued restricting their expenses also in 2010.

The fact that several banks regained profitability along with the measures to increase bank capital strengthened the capital base of the banking sector. Capital adequacy ratio of the banking sector was still at a high level — 17.4% at end-December 2011 (14.6% at the end of 2010), exceeding notably not only the current requirement to maintain own funds' adequacy ratio at the level of at least 8%, but also the historically highest level of capitalisation (see Chart 14). Capital adequacy ratio ranged from 11% to 65%. Tier 1 own funds ratio was 14.2% at end-December 2011 (11.5% at end-2010).

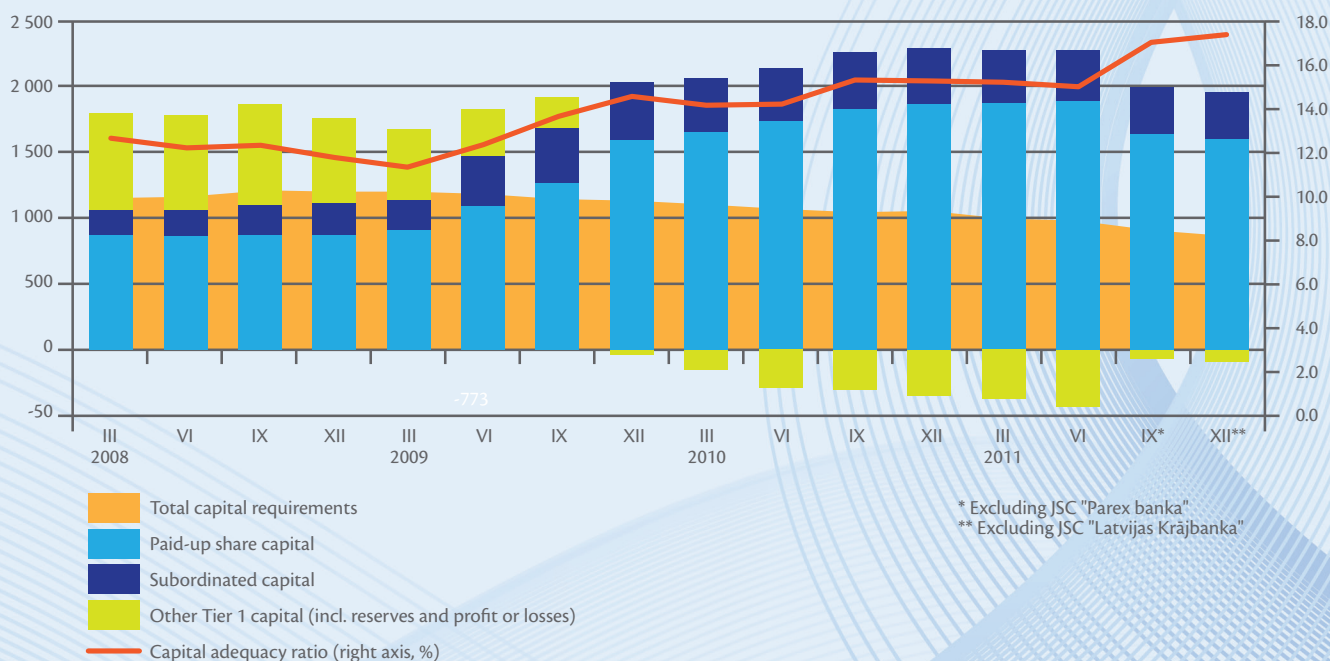
¹³The activity of JSC "Latvijas Krājbanka" was suspended after it was detected that bank's funds had been encumbered for the benefit of third parties, and JSC "Parex banka" did not carry out the functions of a credit institution in full amount (on 15 March 2012, its licence for performing the activity of a credit institution was withdrawn).

Chart 14

Capital adequacy ratio (at end-period)

The structure of the elements of own funds was dominated by the top quality capital: paid-up share capital was 1 630.5 million lats at end-December 2011 and constituted 85.5% of bank own funds (see Chart 15). During 2011, 12 banks increased their capital overall by 189.7 million lats. In the banking sector, the total amount of capital requirements continued to diminish in 2011 because, with the total volume of the credit portfolio decreasing, capital requirements for credit risk continued to diminish and were 89.3% of total capital requirements of the banking sector at end-December.

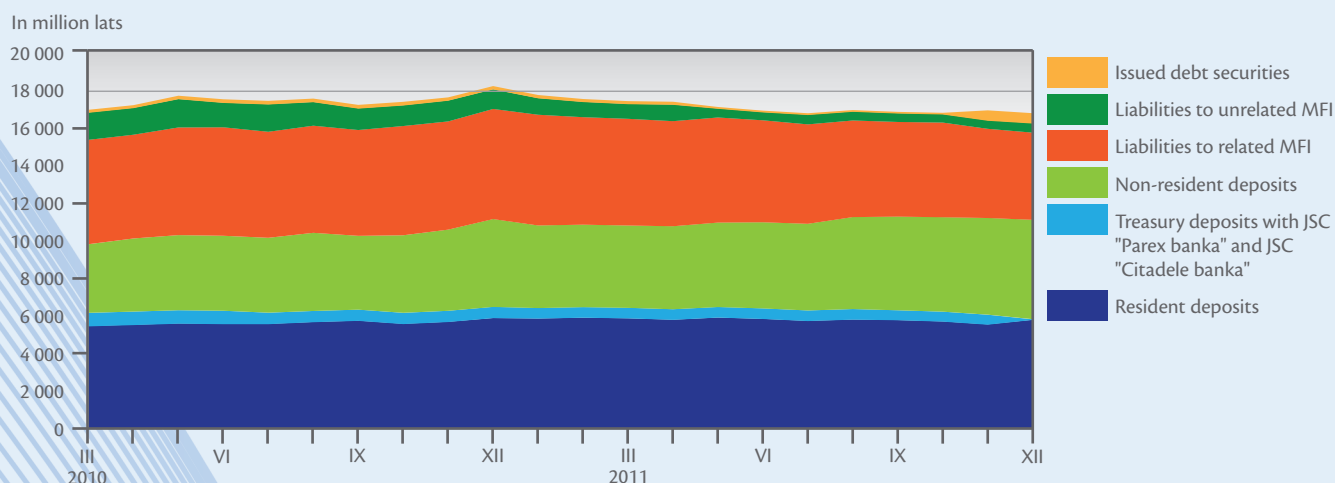
Chart 15

Own funds and total capital requirements (at end-period, in million lats)

Taking into account the deleveraging process as the financing from foreign banks (mainly parent banks) was decreasing gradually, the role of non-bank deposits continued to increase in the funding structure of Latvian banks in 2011. During the year, bank liabilities to monetary financial institutions (MFI) diminished by 1.7 billion lats or 25.1% (see Chart 16).

Chart 16

Bank funding sources

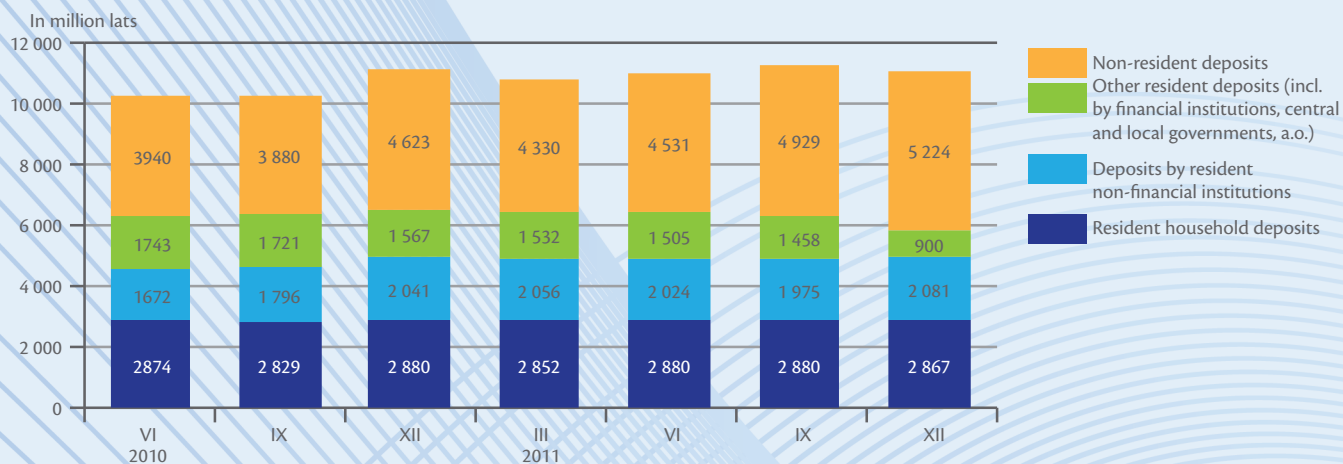


Liabilities to related financial institutions still dominated the funding structure of the subsidiaries and branches of EU banks; however, the importance of resident deposits increased notably and during the reporting year their share in total funding increased from 43% to 50%. In the funding structure of other banks, except banks with public capital, the largest part was made by non-resident deposits; their importance continued to increase in 2011 and their share increased from 54% to 63%.

In 2011, bank deposits decreased by 0.4%, including an increase in non-resident deposits by 13.0% and a decrease in resident deposits by 9.9% (see Chart 17); this was mainly affected by the repayment of State deposits by JSC "Citadele banka" and JSC "Parex banka" and the conversion of State deposits with JSC "Parex banka" into securities of a closed issue at end-2011. Suspension of the activity of JSC "Latvijas Krājbanka" in November 2011 did not cause deposit outflow in the banking sector, as deposits of households and non-financial companies (excluding JSC "Latvijas Krājbanka" and JSC "Parex banka") even increased in the last months of 2011.

Chart 17

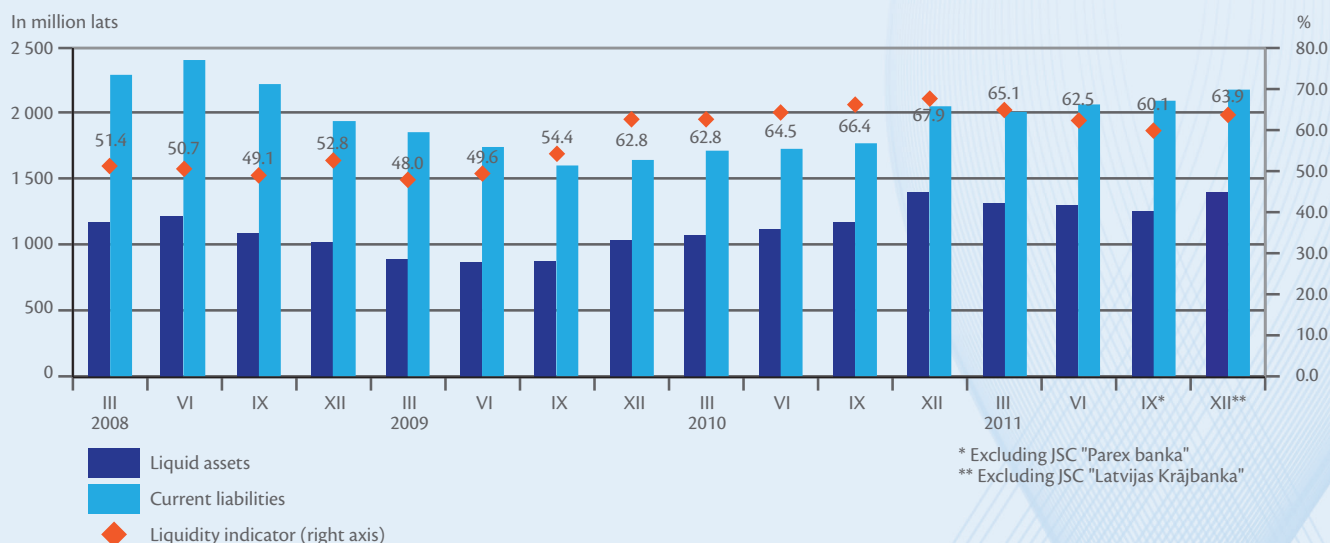
Bank deposits



In the reporting year, the liquidity indicator* of the banking sector remained high and was 63.9% at end-December (67.9% at the end of 2010) exceeding two-fold the minimum liquidity requirement (credit institutions are required to maintain a sufficient amount of liquid assets for the fulfilment of liabilities, but no less than 30% of total current liabilities) (see Chart 18.).

Chart 18

Bank liquid assets, current liabilities and the liquidity indicator



At end-2011, liquidity indicators of all banks¹⁵ exceeded 40%. The range of the liquidity indicator remained large, from 46.8% to 129.1%. Traditionally, a higher liquidity indicator was maintained by the banks that focused on servicing non-resident customers and providing payment services.

In view of the constant increase in deposit volume and the search for additional income opportunities, bank investments in securities increased by 12.7% in 2011 and were **1.6 billion lats** or 7.7% of total assets in the sector at end-December (6.6% at end-2010). About a half of the securities portfolio was comprised of investments in government debt securities, of which 56% or 416 million lats were invested in debt securities of Latvian central government. At end-2011, Latvian banks **did not have significant investments in the securities of the sovereigns affected by the euro area debt crisis** and investments in debt securities of PIIGS countries¹⁶ amounted to 35.8 million lats or just 0.2% of the assets of the banking sector.

As the volume of repaid and written off loans still exceeded the stream of new loans, the credit portfolio of the banking sector continued to shrink also in 2011; however, as a result of an improving macroeconomic situation in the country, banks restarted more active crediting of enterprises. In 2011, credits were mostly granted to the following sectors: trade, financial and insurance activities, transport and storage.

In 2011, **the volume of new loans amounted to 1.5 billion lats** (of which 664 million lats were granted for the development of Latvian enterprises, 87 million lats were issued to Latvia financial institutions, 168.5 million lats were issued to resident households and 620.6 million lats were granted to non-residents) (see Chart 19).

Chart 19

New loans granted by the banking sector (in the respective month)



¹⁵Capital adequacy and liquidity indicators of the banking sector do not include "Parex banka" (as of July 2011) and JSC "Latvijas Krājbanka" (as of November 2011).

¹⁶PIIGS countries – Portugal, Italy, Ireland, Greece and Spain.

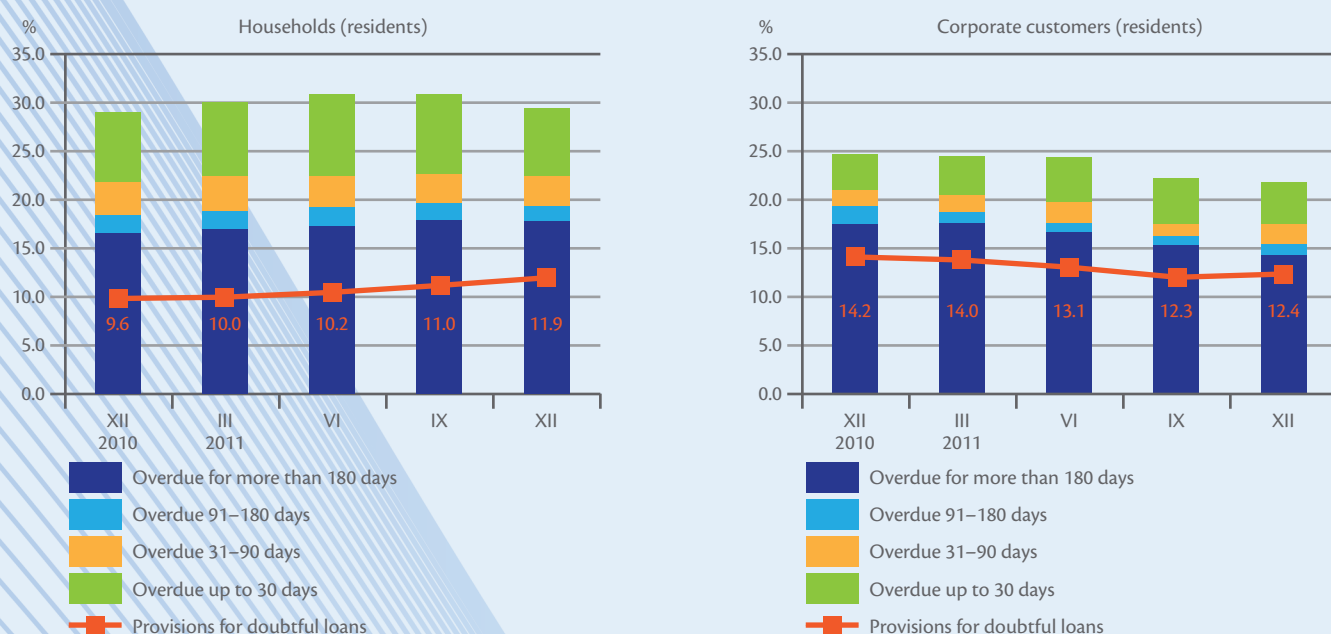
During 2011, the credit portfolio diminished by 8.1%, including a decrease of 7.8% of loans to resident households, whereas in the corporation sector the decrease was more rapid (by 8.7%); it was mainly affected by the decrease of the credit portfolio in the real estate related areas. Non-resident credit portfolio decreased by 7.2% during the year.

With unemployment decreasing and the number of the employed increasing, in 2011, the first signs of recovery in the credit portfolio of households were evident, and positive trends in the economy were reflected by the improving quality of loans to corporate customers that was also stimulated by writing off lost loans in household and corporation sectors.

The share of loans that were more than 90 days overdue continued to decrease in the total credit portfolio of the banking sector and, at end-2011, it reached 17.5% (19% at end-2010). With exports developing and domestic demand growing gradually, the financial situation of enterprises improved more rapidly than that of households. In the portfolio of corporate customers (residents), the share of loans that were more than 90 days overdue decreased from 19.5% to 15.5% in 2011 (see Chart 20). The decrease of such loans was the greatest in the operations involving real estate that was due to writing off the loans granted in that sector. At the same time, in the credit portfolio of households (residents), the share of such loans increased from 18.4% at end-2010 to 19.4% at end-2011 (the volume of such loans decreased by 2.9%), whereas in the last quarter of the year, the share of loans that were more than 90 days overdue and the total share of overdue loans decreased.

Chart 20

Loans with overdue payments to residents and provisions made for such loans (% of credit portfolio)



With the quality of loans stabilising, the provisions made by banks for doubtful loans decreased gradually and was 1.52 billion lats or 11.5% of the total credit portfolio of banks at the end of December 2011. Despite the decrease in the volume of provisions, the ratio of volume of provisions to the volume of loans that were more than 90 days overdue remained high and was 66% at end-2011 (59.7% at end-2010).

Banks cooperated with customers in difficulty and continued restructuring of loans in 2011. Over the year, loans amounting to 1.4 billion lats were added to the category of restructured loans. The share of restructured loans in the credit portfolio of the banking sector diminished from 19.9% at end-2010 to 17.5% at end-2011 that was influenced mainly by the reduced volume of restructured loans in the corporations sector. At the same time, loans amounting to 669 million lats were added to the category of loans under recovery and their share in the credit portfolio was 14.2% at end-2011 (15.3% at end-2010).

Banks were more actively writing off lost loans. During 2011, the banking sector wrote off loans in the amount of 312 million lats (incl. 95 million lats granted to resident households, 196 million lats granted to resident corporate customers, and 21 million lats granted to non-residents). In 2010, banks wrote off loans amounting to 273 million lats.

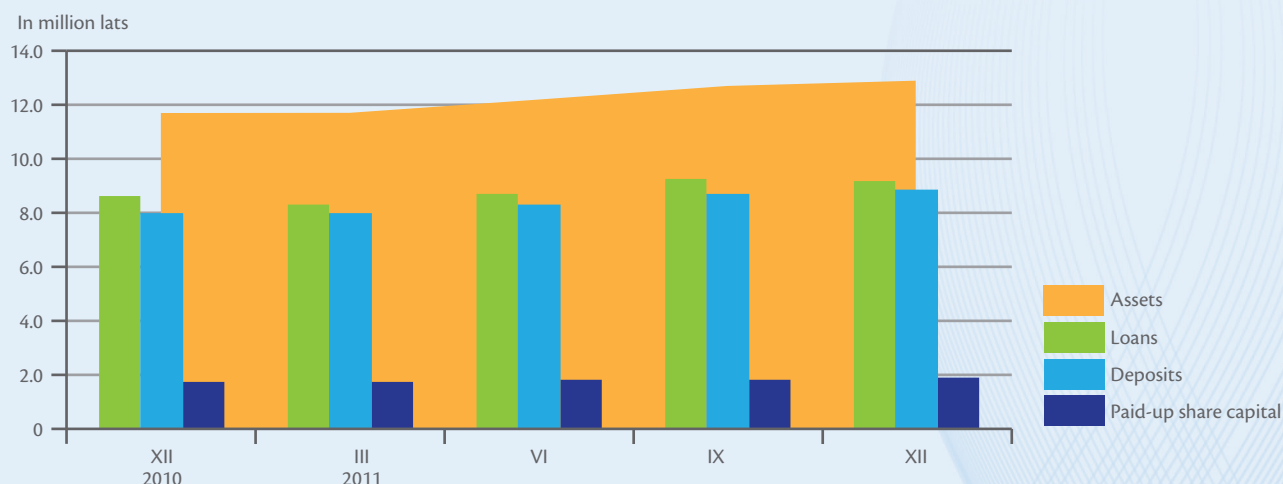
PERFORMANCE OF COOPERATIVE CREDIT UNIONS

At the end of 2011, 33 cooperative credit unions were operating in Latvia, and their total profit during the year was 130 thousand lats or by 10.8% less than in the previous year when their profit was 146 thousand lats. The amount of profit was negatively affected by the provisions for doubtful debts that increased by 32.6% during the year.

Capital adequacy indicator of the cooperative credit union sector remained high in 2011 and was 20.1% at the end of December (19.9% at end-2010) (the established minimum capital adequacy requirement is 10%).

Deposits by members were the largest source of funds and their volume increased by 10.8% during the year and was 8.9 million lats at the end of December, whereas the main area of their activity was granting loans to their members. Loans to members increased by 6.8% in 2011 and was 9.2 million lats at the end of December (see Chart 21).

Chart 21

Assets, loans, deposits and paid-up share capital of credit unions

Persistently high rate of unemployment in Latvia's rural areas affected the credit portfolio of cooperative credit unions. The total amount of non-performing loans (i.e., substandard, doubtful and lost loans) increased by 53% in 2011 and their share in the credit portfolio was 8.1% at the end of December, whereas 65% of the credit portfolio of credit unions were assessed as standard loans and 26.8% were loans under supervision (at end-2010, the indicators were 5.7%, 66.5% and 27.8% respectively). Special provisions for doubtful debts constituted 7% of the total credit portfolio of credit unions at the end of December 2011 (5.8% at end-2010).

PERFORMANCE OF INSURERS

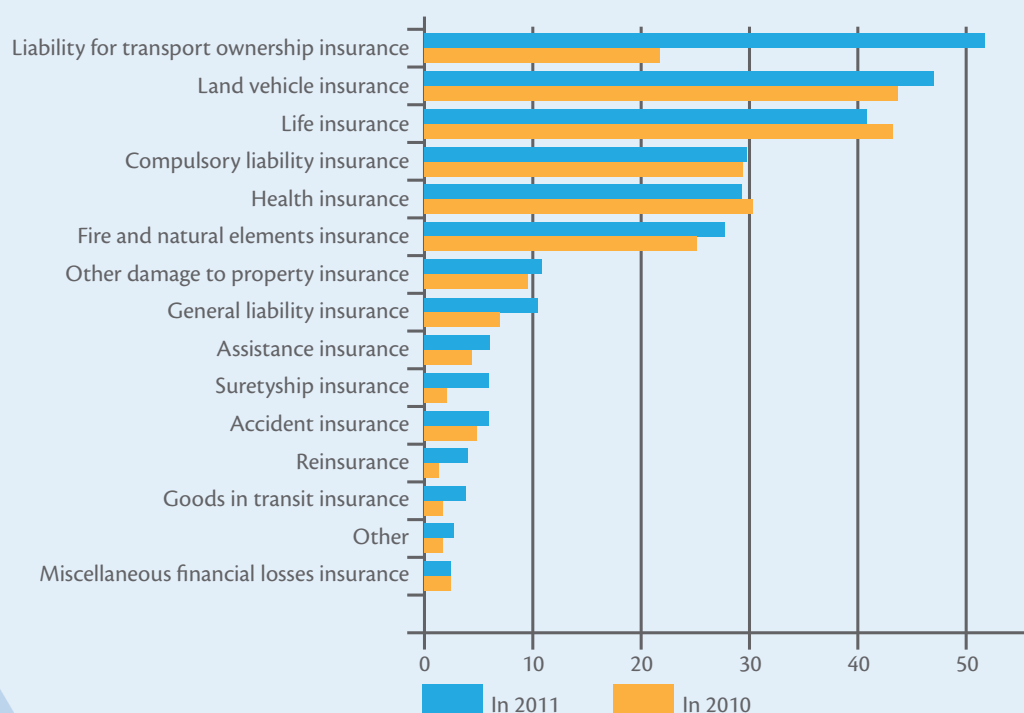
At the end of 2011, 12 insurance companies (three life insurance companies and nine non-life insurance companies of which one was mutual non-life insurance cooperative society), as well as ten branches of insurance companies of EU MS, five branches of life insurance companies and five branches of non-life insurance companies were operating in Latvia.

One life insurance company and three non-life insurance companies (insurance JSC "Gjensidige Baltic", insurance JSC "Balta", insurance JSC "ERGO Latvija", insurance JSC "Seesam Latvia") were subsidiaries of insurance companies of EU MS and their market share in total gross premiums written by insurance companies was 39.7% at end-2011 (49.8% at end-2010).

Insurance companies, after experiencing the shrinking of the insurance market for two years, started providing their services abroad thereby ensuring growth of the insurance market; in 2011 the amount of gross premiums written by insurance companies and branches of foreign insurance companies increased by 21% year-on-year and was 278 million lats. The amount of paid gross premiums increased at a slightly slower pace (by 20%) and was 155.3 million lats at the end of the reporting year. During 2011, gross written premiums increased in nearly all types of insurance, except life insurance and health insurance (see Chart 22).

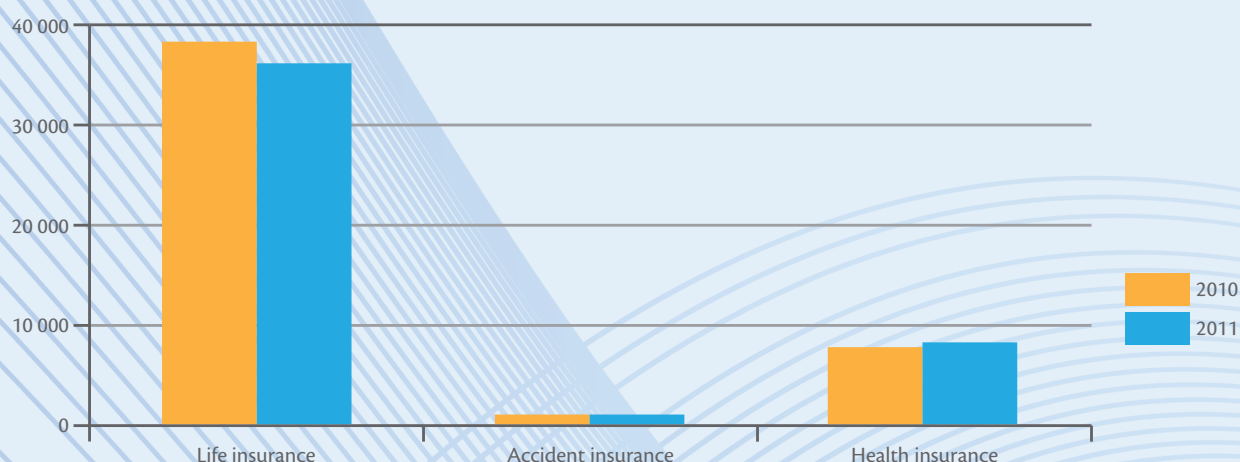
Since Latvian insurance companies started providing cross-border services more actively in EEA countries, in 2011, more than one third of all premiums were written outside Latvia (for 52 million lats in Lithuania, 12.5 million lats in Poland, 11.8 million lats in Estonia and 5 million lats in France). Liability for transport ownership insurance and land vehicle insurance had the largest shares in gross premiums written abroad (59% and 13%, respectively).

Chart 22

Written gross premiums by type of insurance (in million lats)

In 2011, the amount of written gross premiums by **life insurance companies and branches of foreign life insurance companies** totalled 51.3 million lats (of which 24.9 million lats were premiums written by life insurance companies) that was by 3% less year-on-year. At the same time, the amount of paid gross indemnities increased by 28.3% and was 28.6 million lats at the end of 2011 (see Chart 23).

Chart 23

Gross premiums written by life insurance companies and branches of foreign life insurance companies by type of insurance (in thousand lats)

In 2011, the portfolio structure of gross premiums written in life insurance did not change. In the portfolio of written gross premiums, the share of gross premiums in respect of life insurance products was 79.4%. In the area of life insurance the greatest share was for insurance products with an accrual and gross premiums written in respect of contracts attracted in the market, i.e., 46% and 31%, respectively, of the premiums written in life insurance.

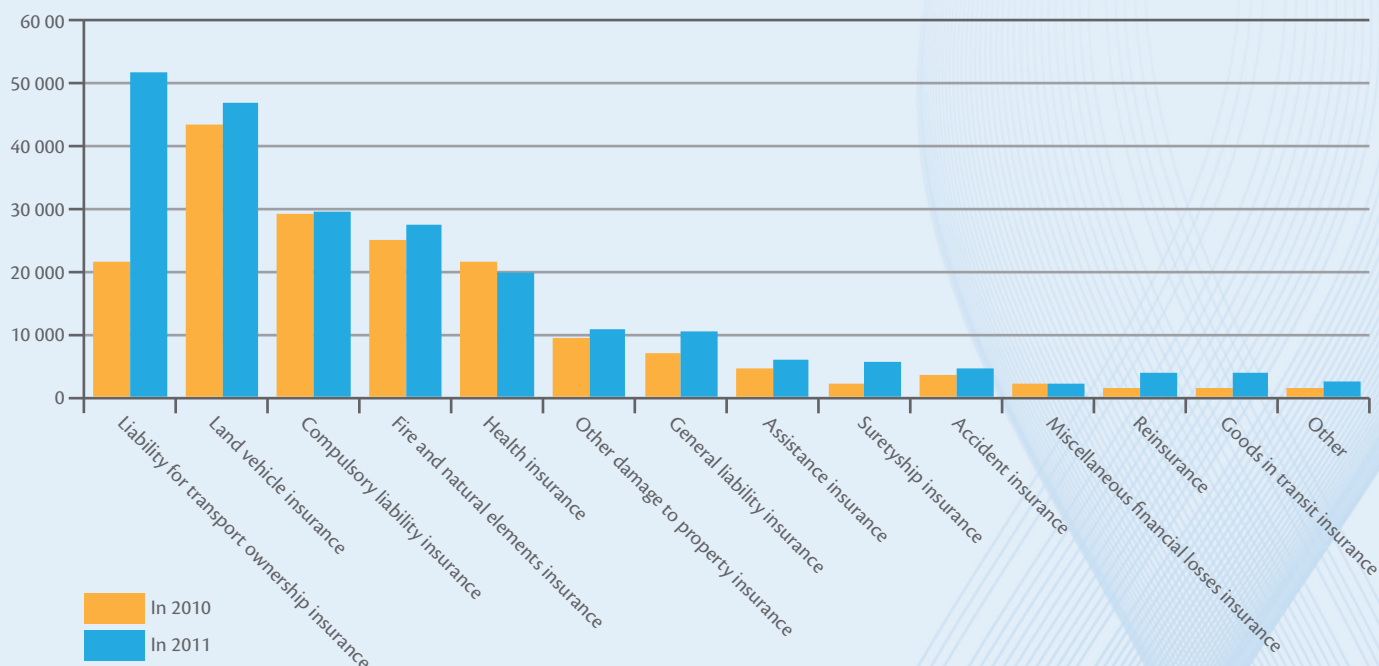
In 2011, the amount of written gross premiums by **non-life insurance companies and branches of foreign non-life insurance companies** totalled 226.8 million lats (of which 198 million lats were premiums written by non-life insurance companies) and was by 29.7% more year-on-year; as well, the amount of paid gross indemnities increased by 18.5% and was 126.7 million lats.

In 2011, the services provided by non-life insurers outside Latvia contributed to a rapid increase in written gross premiums and also triggered changes in the structure of insurance types. In respect of liability for transport ownership insurance, the amount of written gross premiums increased nearly 2.5 times and during the year their share increased from 12.4% to 22.8%. The amount of gross premiums written in respect of the land vehicles

insurance increased as well (by 7.7%), even if its share in the premiums written during the year decreased slightly from 25% to 21%. The amount of gross premiums written in respect of property insurance increased as well (by 11%) (see Chart 24).

Chart 24

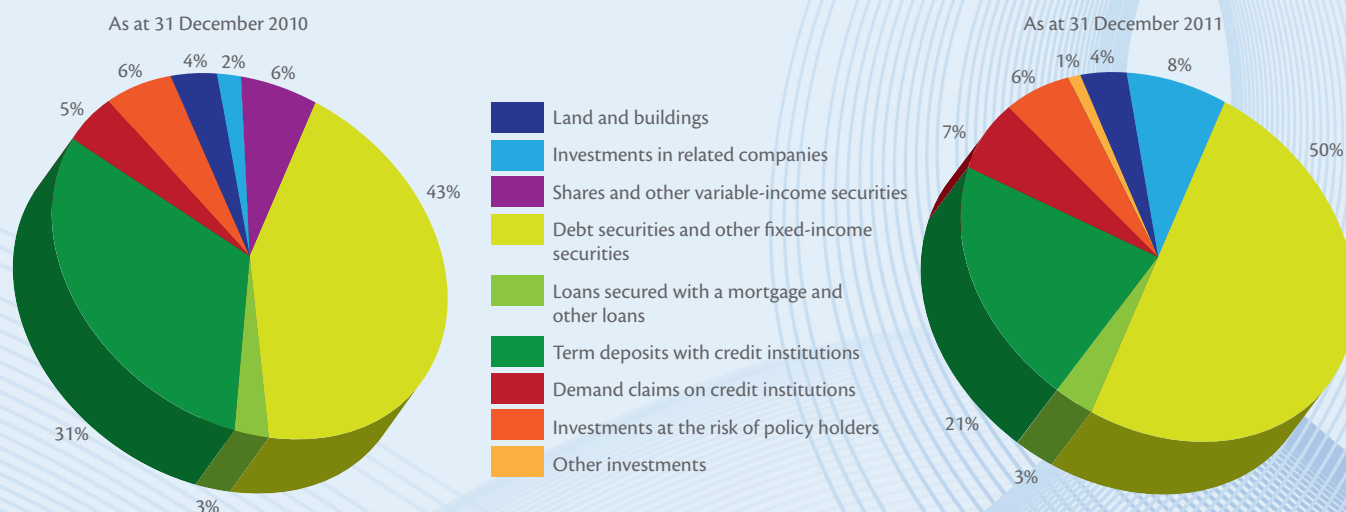
Gross premiums written by non-life insurance companies and branches of foreign non-life insurance companies by type of insurance
(in thousand lats)



Total investments by **insurance companies** were 288 million lats at the end of 2011. During the reporting year, insurance companies followed a conservative investment policy. Major investments were made in debt securities and other fixed-income securities, in term deposits with credit institutions, and also in shares and other variable-income securities, i.e., 50%, 20% and 8.4%, respectively, of total investments of insurance companies (see Chart 25).

Chart 25

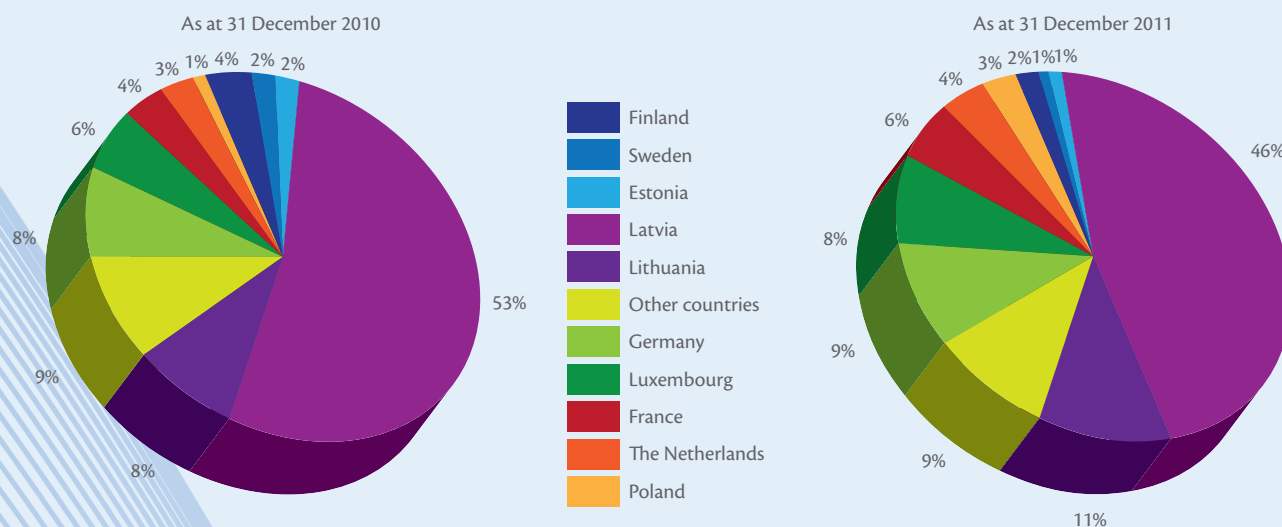
Investment structure of insurance companies



Year-on-year, the amount of investments by insurance companies in Latvia decreased by 16% and their share in total investments was 45.9% at the end of December of 2011 (see Chart 26). Investments in EU MS continued to grow slightly (by 0.9%) and at end-2011 such investments amounted to 95.5% of total investments abroad.

Chart 26

Investment structure of insurance companies by country



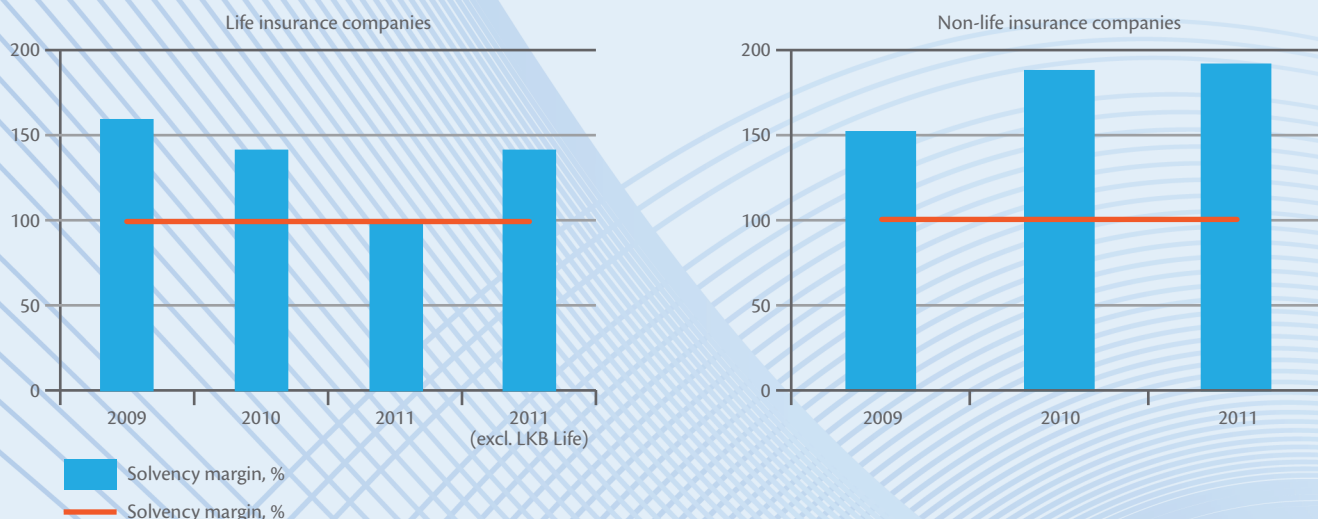
With both investment management expenses and investment revaluation losses increasing, return on investments of insurance companies decreased in 2011 (for life insurance companies RoI was negative, -7.9% (it was positive, 5.7%, in 2010), and for non-life insurance companies it was 2.7% (4.6% in 2010)).

In 2011, insurance companies operated with a loss of 1.8 million lats, incl. loss of 2.6 million lats of life insurance companies (all companies operated with a loss¹⁷), whereas non-life insurance companies operated with a profit in the reporting year and it was 741 thousand lats (four companies were operating with a loss). Losses of insurance companies were mainly due to such types of insurance as compulsory liability insurance, land vehicles insurance and health insurance.

As to solvency margin of insurance companies that shows whether the funds at disposal of an insurance company are sufficient to ensure its minimum solvency¹⁸, it was 100% for life insurance companies and 192.6% for non-life insurance companies in the reporting year (in 2010, the solvency margin was 141.7% and 188.2%, respectively) (see Chart 27).

Chart 27

Solvency margin of insurance companies (in per cent)



¹⁷On 19 April 2012, a licence for all types of insurance of one company (insurance JSC "LKB Life") was withdrawn.

¹⁸Minimum solvency or solvency margin is a quantifiable amount that shows the quantitative size of the risk associated with concluded insurance contracts.

PERFORMANCE OF THE SECOND AND THIRD TIER PENSION SYSTEM

Management of Assets of the State-funded Pension Scheme (Second Tier Pensions)

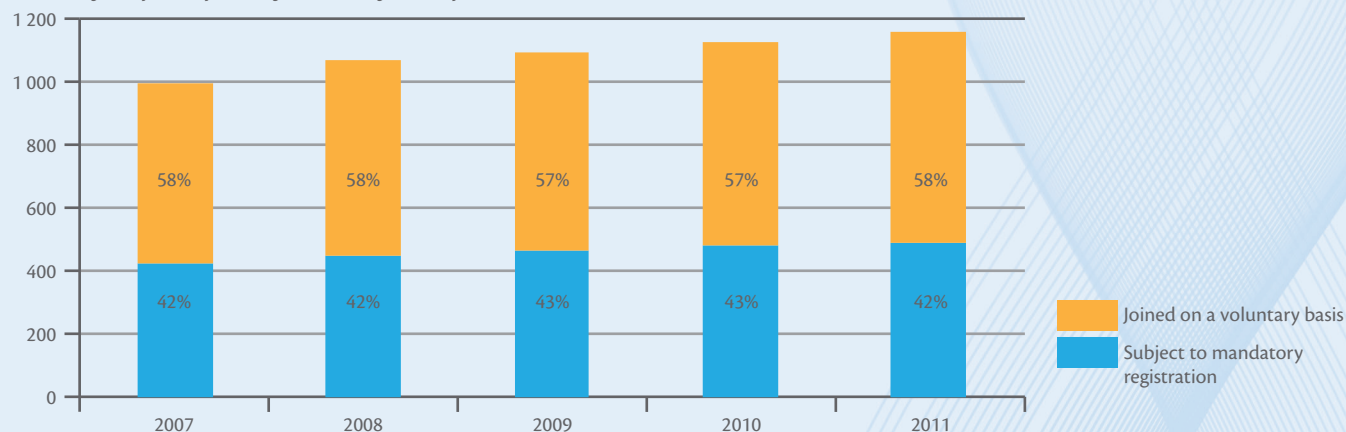
In 2011, assets of the State-funded pension scheme (second tier pension system) were managed by nine investment management companies (six of them were subsidiaries of Latvian banks) by offering 27 investment plans.

At the end of 2011, the volume of net assets of SFPS investment plans had increased by 5.8% year-on-year and amounted to 876 million lats.

By the end of 2011, 1 156 743¹⁹ participants had joined the second tier SFPS. Of all SFPS participants, 670 516 or 58% had joined on a mandatory basis²⁰ and 486 227 or 42% had joined on a voluntary basis (see Chart 28).

Chart 28

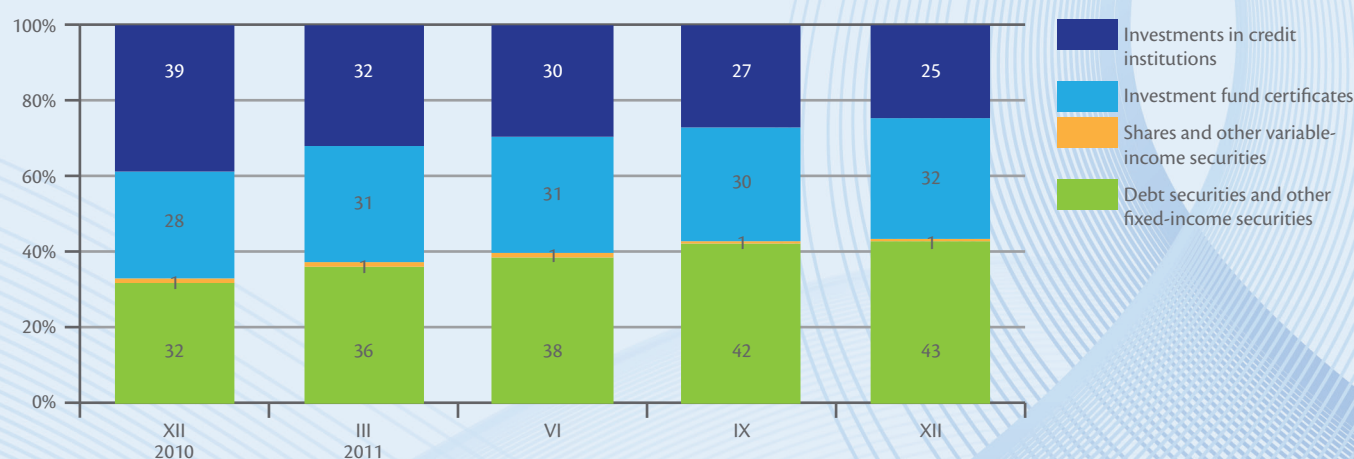
Structure of the participants of the State-funded pension scheme



The investment volume of investment plans of SFPS assets continued to increase and was 878.4 million lats at end 2011 that was by 5.9% more than at end-2010. At the same time, bank deposit rates were on a decrease and consequently the portion of investments in credit institutions continued to shrink in the investment structure whereas investments in debt securities and other fixed-income securities increased along with investments in investment fund certificates, by 25%, 43% and 32%, respectively (see Chart 29).

Chart 29

Structure of the investment portfolio of investment plans of the State-funded pension scheme (in per cent)



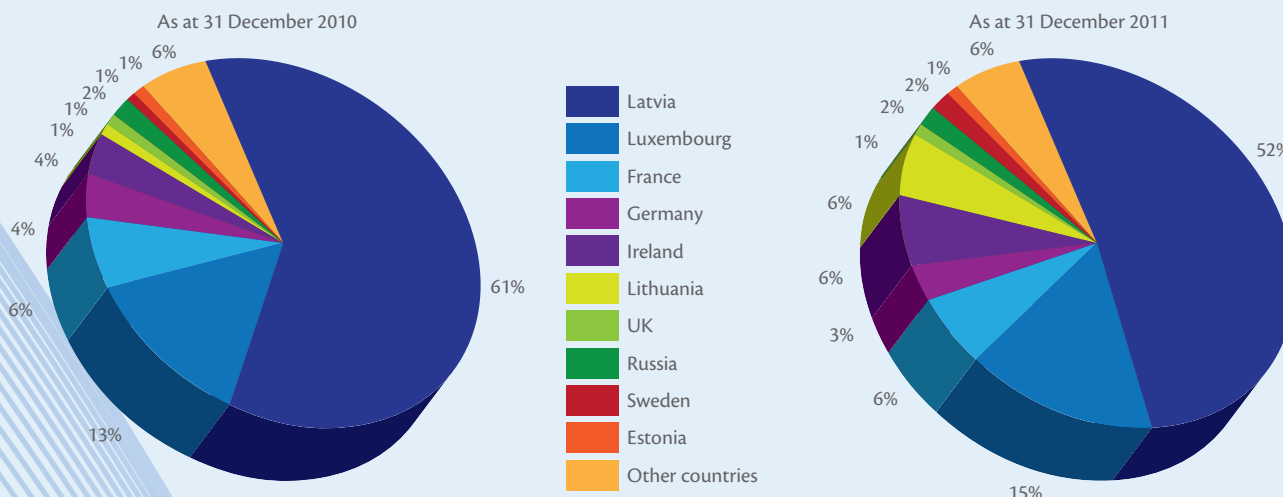
¹⁹Information collected by the State Social Insurance Agency about participants of the State-funded pension scheme.

²⁰All persons who were born after 1 July 1971 and are registered for State pension insurance are registered as scheme participants by the State Social Insurance Agency on a mandatory basis.

Of total investments of investment plans, 52.4% were invested in Latvia at the end of 2011 (by 9.2% less than in the previous year), whereas investments in EU MS increased slightly and were 91.7% of investments abroad (see Chart 30).

Chart 30

Structure of the investment portfolio of investment plans of the State-funded pension scheme by country (in per cent)



Average **profitability of SFPS investment plans**²¹ in 2011 was negative, -1.96% (in 2010, it was 7.6%), and for separate investment plans profitability ranged from negative, -4.9%, to positive, 4.7% (in 2010, the range was between 1.1% and 12.1%). However, profitability was positive for those investment plans that invested in low risk assets, for conservative plans average yearly profitability was 1.9%, for balanced plans it was 0.6%. The performance of active investment plans was most subject to financial market fluctuations therefore their average profitability was negative, -3.9%.

Expenses for managing investment plans in 2011 were similar to the expenses incurred in previous years and were 1.5% of average net assets of investment plans, 1.2% for conservative plans, 1.5% for balanced plans and 1.7% for active plans.

Private Pension Funds (Third Tier Pensions)

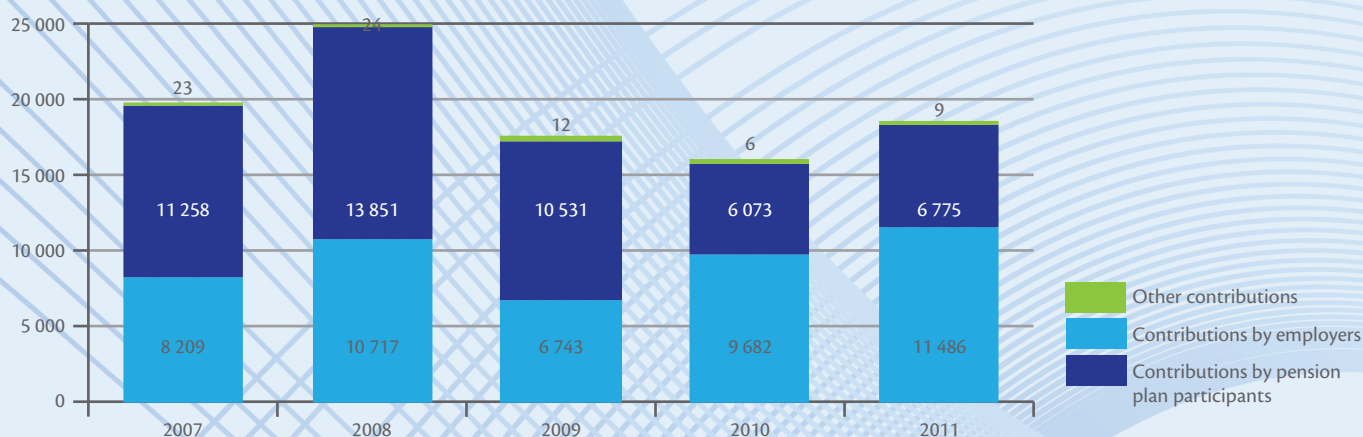
At the end of 2011, seven private pension funds were operating in Latvia: six were open-end funds (four were subsidiaries of Latvian banks) and one was closed-end pension fund. At the end of the reporting year, the seven private pension funds offered 21 pension plan.

In 2011, the **volume of assets of private pension funds increased** by 2.6% and was 1.9 million lats at the end of the year. At the same time, the profit of private pension funds amounted to 52 thousand lats (in 2010, their profit was 159 thousand lats).

By the end of the reporting year, the number of participants of pension plans had reached 198 575 and it was by 3.8% more than at end-2010 (17.2% of all economically active Latvian people²²). Of all participants, 99 950 or 50.3% had made contributions themselves or contributions had been made on their behalf during the past 12 months and 46 371 or 23.4% were passive participants who continued their participation without making contributions.

Chart 31

Contributions to pension plans (in thousand lats)



At the end of 2011, the share of the participants who had reached the retirement age determined in the pension plan and no longer made contributions but continued their participation and received portions of the accumulated retirement benefit capital, was 26.3% (or 52 254 participants).

During 2011, the total of 18.3 million lats were paid into pension plans that was by 15.9% more than in 2010 (15.8 million lats). During the year, both contributions by employers and by individual participants of pension plans increased (by 11.6% and 18.6%, respectively) (see Chart 31).

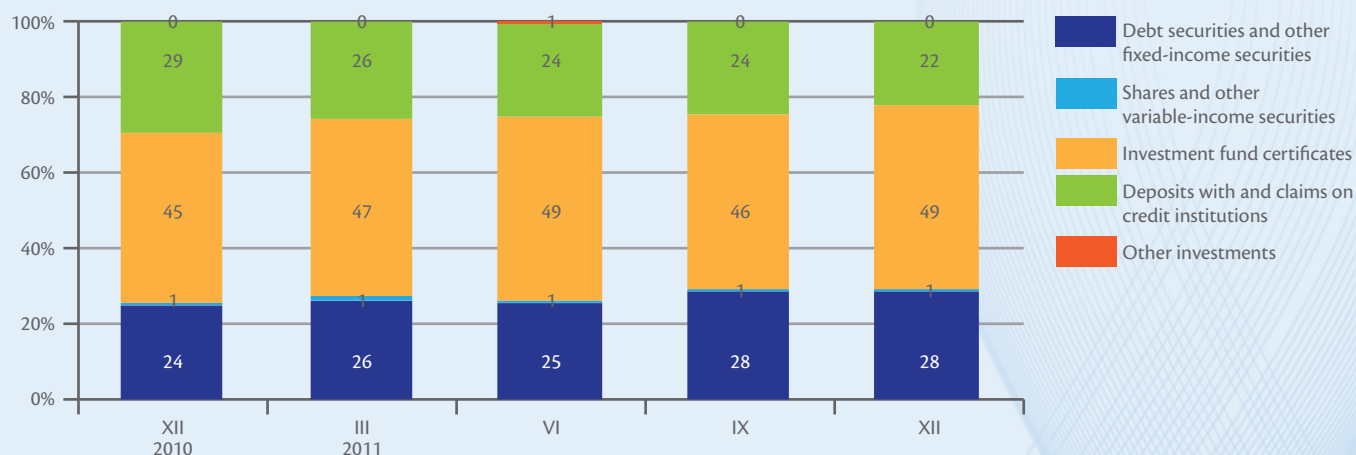
²¹Profitability of investment plans are changes of the value of an investment plan unit against the value at the beginning of the year, expressed as a percentage.

²²Information of the Central Statistical Bureau; www.csb.lv.

From retirement benefit capital 6.7 million lats were paid out. The major part or 96.9% of funds were paid to the retiring participants of pension plans and 3.1% were paid to heirs because of the death of a pension plan participant. Net assets of pension plans had increased by 6.7% year-on-year and was 119.5 million lats at the end of the year. However, the investment structure of pension plans was still dominated by investments in investment fund certificates (49%) (see Chart 32).

Chart 32

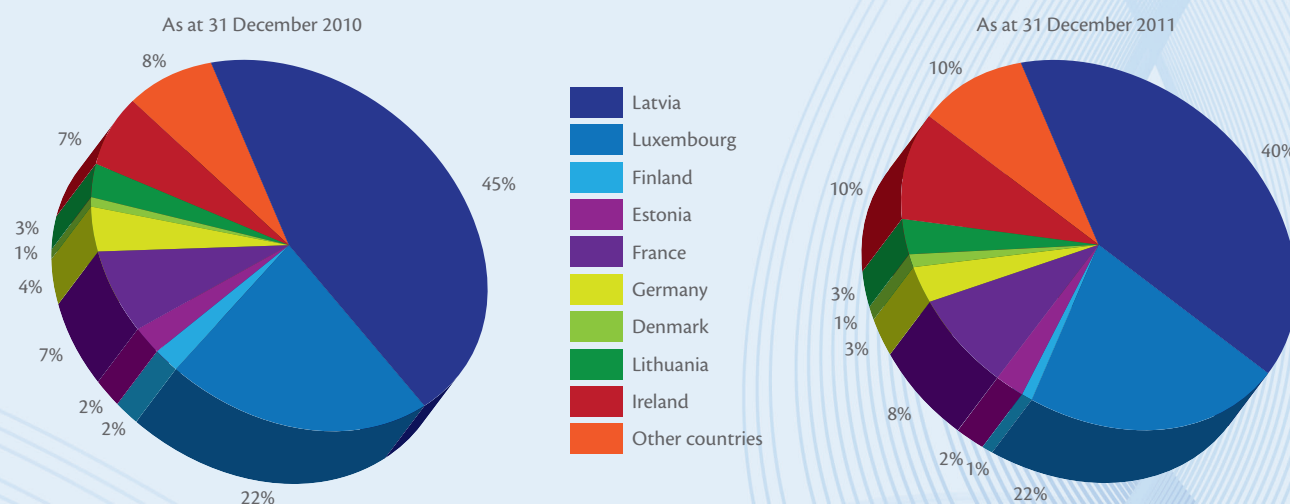
Structure of the investment portfolio of pension plans (in per cent)



Even if the volume of the investment portfolio of pension plans increased by 3.8% during 2011 and, at the end of the year, it was 113.3 million lats, investments made in Latvia were on a decrease (they were negative, -8.7%) and their volume was 44.8 million lats or 39.6% of total investments by pension plans (in 2010, their share in total investments was 45%) (see Chart 33). Of investments abroad, most part (95.2%) were invested in EU MS, incl. 38% in Luxembourg, 17.8% in Ireland and 14.3% in France.

Chart 33

Structure of the investment portfolio of pension plans by country (in per cent)



With volatility persisting in global financial markets and as a result of investment revaluation losses, the average profitability of pension plans diminished and was negative at the end of 2011, -2.7%, whereas profitability of individual pension plans ranged from negative, -13.9%, to positive, 2.9% (in 2010, it was 7.9% or it ranged from 2.7% to 11.5% for individual plans).

In 2011, the expenses for managing pension plans²³ remained at the level of 2.1% of the average net assets of investment plans.

PERFORMANCE OF INVESTMENT MANAGEMENT COMPANIES AND INVESTMENT FUNDS

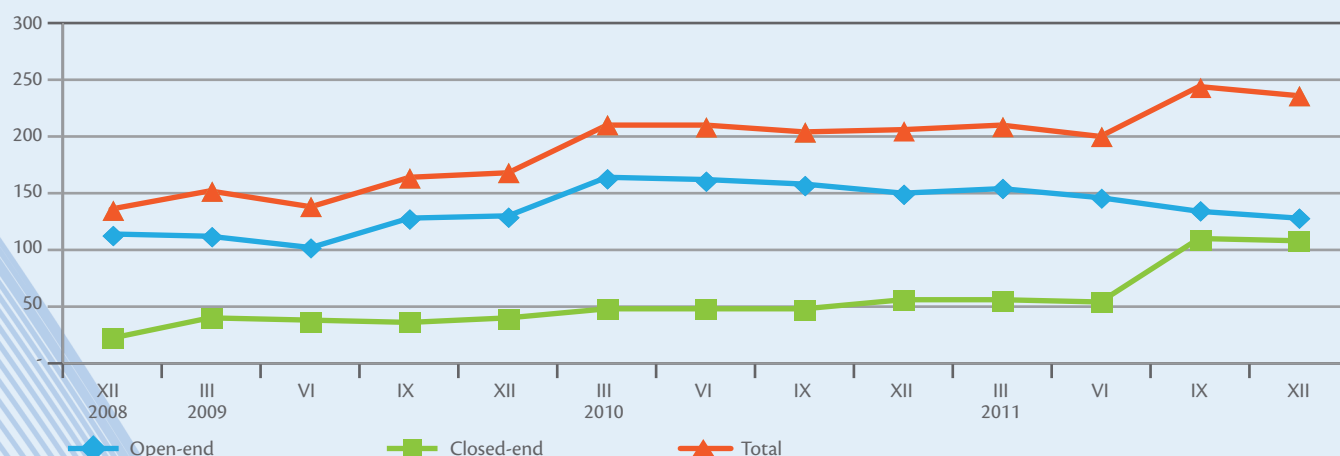
At the end of 2011, 15 investment management companies operated in Latvia and they managed 44 investment funds (22 open-end and 22 closed-end funds).

The assets of the investment funds managed by investment management companies increased during the year by 15.1% (see Chart 34). In 2011, several negative external developments, mainly escalation of debt crisis in the euro area and lower US credit rating, shocked the financial markets, and as a result the assets of open-end funds shrank by 14.1% during the year and were 128.5 million lats at end-2011. For one investment management company that was actively registering new closed-end funds, the assets of closed-end funds increased nearly twofold during the year (by 93%) and were 108.5 million lats at end-2011.

²³Costs of managing pension plans is the ratio of administrative costs of pension plans and costs for managing investments to average value of net assets during the period (as from the beginning of the year), expressed as a percentage.

Chart 34

Assets of investment funds (in million lats)

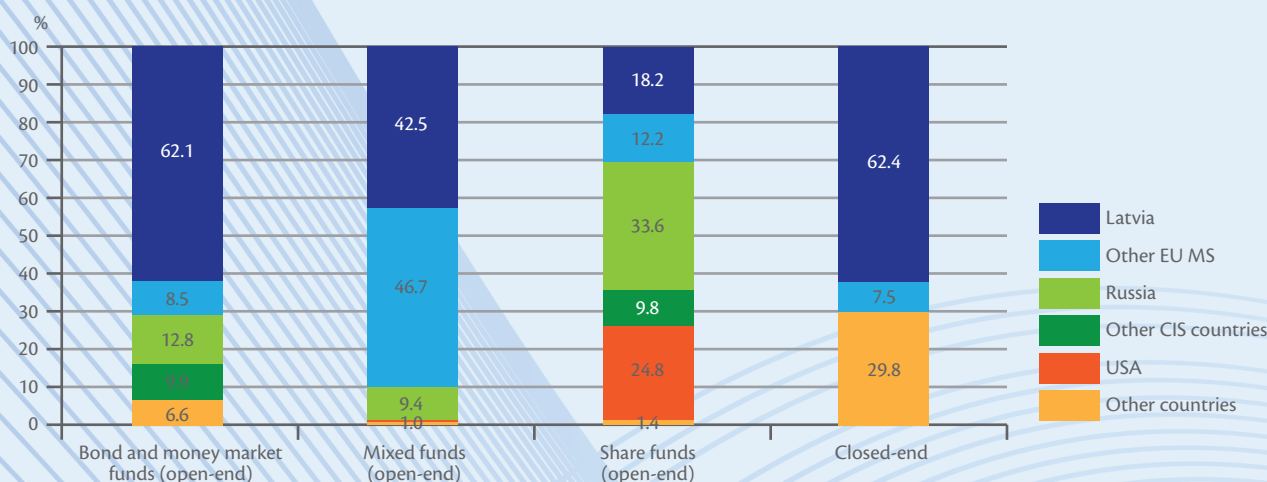


In 2011, **investment management companies** yielded profit of 3.7 million lats that was by 17.9% less year-on-year. Reduction in profit was mainly due to an increase in administrative costs (by 7.8%). The assets of investment management companies increased by 4.8% during the year and were 20.7 million lats at end-2011.

Open-end bond funds and money market funds* invested their assets mainly in Latvia (see Chart 35): at the end of 2011, their total investment in Latvia was 67.4 million lats or 62.1% of their total investment portfolio, and the major part of these investments (about 90%) were cash funds. Of the financial instruments held in the portfolio of these funds, 8.5% were placed in other EU MS (excluding Latvia), 12.8% in Russia, 9.9% in other CIS countries and 6.7% in the financial instruments of issuers of other countries. At the end of 2011, the average 12-month profitability** of open-end bond funds and money market funds was negative, -0.9%, but it was positive for seven funds.

Chart 35

Structure of the investment portfolio of investment funds by country as at 31 December 2011



Open-end mixed funds* invested nearly 90% of their assets in EU MS. Of their portfolio, 42.5% were investments in Latvia (91.3% were placed in claims on demand to credit institutions). Notable investments had been made in Luxembourg (13.6% of the portfolio), France (13% of the portfolio) and Ireland (10.8% of the portfolio), and 92.6% of the investments made in these countries were in investment certificates of open-end funds registered in MS or of equivalent funds. Of mixed funds' portfolio, 9.4% were investments in Russia and 77.4% of these funds were invested in debt securities (issued mainly by commercial companies). At the end of 2011, the average 12-month profitability of open-end mixed funds was negative, -6.4%, and it was negative for all these funds.

As at the end of 2011, **open-end share funds*** had invested their assets mainly in CIS countries. About one third of their total investment portfolio was comprised of investments in Russia, one fourth were investments in the USA, whereas 30.4% were invested in EU MS, incl. 18.2% in Latvia. Despite the recovering of open-end share funds during the fourth quarter of 2011 after the sharp decrease in the previous quarter, they could only partly offset the losses they incurred in the previous quarter. At the end of 2011, the average 12-month profitability of open-end share funds was negative, -16.2%, and it was negative for all open-end share funds except one; the negative profitability was mostly affected by the adverse developments in the Russian share market in 2011 (during the year, RTS²⁴ index shrank by 22%, MICEX²⁵ by 16.9%).

In 2011, the most part of assets of **closed-end funds** were invested in Latvia (62%) but the share of these investments decreased during the year (at the end of 2010, it was 89%). Closed-end funds made investments mainly in shares (63.6%).

²³<http://www.rts.ru/en/index/stat/dailyhistory.html?code=RTSL>.

²⁴<http://www.micex.com/marketdata/indices/shares/composite#&index=MICEXINDEXCF>.

* In accordance with the division of investment funds according to their investment policy available at the Bank of Latvia's website at <http://www.bank.lv/statistika/mfi-un-citu-finansu-starpnieku-saraksti/latvijas-republikas-ieguldijumu-fondu-saraksts> (available in Latvian).

** Profitability has been calculated as the ratio of changes of the value of investment fund's investment certificate in the reporting period to the value of investment fund's investment certificate at the beginning of the reporting period, expressed as a percentage.

PERFORMANCE OF INVESTMENT FIRMS

At the end of 2011, six investment brokerage firms were operating in Latvia. **The capital adequacy indicator of investment brokerage firms** was 30.2% at end-2011 (45% at end-2010) (the minimum capital adequacy requirement was 8%).

In 2011, the profit of investment brokerage firms was 928 thousand lats and it was notably more than in the previous year when the profit was 518 thousand lats. In 2011, four investment brokerage firms operated with a profit that amounted to 1.3 million lats, while the other two operated with a loss. Of all income of investment brokerage firms, 97.2% were commission fees and other similar fees for services to customers, whereas administrative costs were the most significant expenses item (58.6%).

Despite the fact that two investment brokerage firms had licences to manage financial instruments of investors on an individual basis, they were not active in this segment in 2011 and none had customer assets for managing at the end of the year. Several investment brokerage firms offered their customers the transactions in trading platforms, i.e., an investor could submit trading orders on the Internet directly to the relevant stock exchange via electronic trading systems.

At the end of the reporting year, customer funds in settlements accounts that investment brokerage firms held with credit institutions amounted to 995 thousand lats. Customers' assets (financial instruments belonging to customers and funds for making transactions in the financial instruments market that could not be used to satisfy the claims of creditors of an investment brokerage firm) in investment brokerage firms were held distinct from own assets of the investment brokerage firm and therefore they were not disclosed in the balance sheet of the investment brokerage firm.

PERFORMANCE OF PAYMENT INSTITUTIONS AND ELECTRONIC MONEY INSTITUTIONS

The Commission had been registering, issuing licences and supervising payment institutions as of 2010 and electronic money institutions as of 2011. At the end of 2011, 33 payment institutions (of which 26 had started their operations) and eight electronic money institutions (two of which were also authorised to provide payment services) were registered.

In 2011, total payments by payment institutions amounted to 32.4 million lats. Total liquid assets of payment institutions were 2.2 million lats at the end of 2011.

The average outstanding electronic money of electronic money institutions was 1.3 million lats in the last six months of 2011. At the end of 2011, total liquid assets of electronic money institutions were 4.3 million lats, of which cash in hand was 58.6 thousand lats, claims on banks to cover the liabilities in respect of issued electronic money were 1.6 million lats and claims on banks to ensure payment services were 2.6 million lats.