FINANŠU UN
KAPITĀLA
TIRGUS
KOMISIJA

ANNUAL REPORT OF THE FINANCIAL AND
CAPITAL MARKET COMMISSION FOR 2003

Table of Contents

Latvian Financial Market and the European Union

The year 2003 offered new opportunities for development of the Latvian financial and capital market before its integration into the common market of Member States of the European Union (hereinafter – EU).

Notwithstanding the fact that, in 2003, the assets of the Latvian banking sector were almost three thousand times less than those of EU banks[1], the Latvian banking sector has been more efficient and profitable than the EU banking system.

A major indicator characterising the relative significance of the banking sector for the national economy is the ratio of the banking sector assets to the gross domestic product (hereinafter – GDP). In the reporting year, this ratio for Latvia was 0.97[2]. The EU average[3] was 2.66. The Latvian banking sector will reach the EU average of today within approximately 10 years, provided assets of the Latvian banking sector continue to increase by 20% while the GDP in actual prices, by 10% each year.

Latvian banks have been more profitable than European banks. The return on equity (ROE) characterising the overall profitability of European banks was 8.64%[4], while for Latvian banks it was almost two times higher, i.e. 16.7%. However, it should be born in mind that Latvia and Europe have different economic cycles. While the average rate of GDP growth in Europe, especially in the largest euro-zone countries, is low, Latvia's GDP has grown by more than 7% per year since 2000, thus further enhancing profits of banks.

Sometimes an opinion prevails that Latvia has too many banks. In the EU, there are 20 banks per one million inhabitants[5]. Only three of the current EU Member States have a smaller number of banks than Latvia, i.e. 10 banks per one million inhabitants. This proves that the judgment about Latvia as a country with a large number of banks is unfounded.

The income structure for Latvian and European banks was similar. The main source of income for both Latvian and European banks was net interest income, that is, 62% of total income (compared to 54.3% in Latvia). Fee and commission income constitutes approximately 25-26% of the income derived by Latvian and European banks. Latvian banks, in turn, make larger profits from currency and securities trade (11.2% of income), while European banks only 5% of income.

[1] Data of the European Central Bank (hereinafter – the ECB) on EU banking assets in 2002. Latvian banking assets at the end of 2002 were evaluated according to the lats and euro exchange rate set by the Bank of Latvia.
[2] Data of the Central Statistics Board of the Republic of Latvia on the gross domestic product in absolute prices for 2003, and data of the Financial and Capital Market Commission on the volume of Latvian banking assets at the end of 2003.
[3] Statistics on EU banks for 2000, incorporated into the ECB's Structural Analysis of the EU Banking Sector, conducted in November of 2002.
[4] Statistics on EU banks for 2002, incorporated into the ECB's Report on the EU Banking Sector Stability, prepared in November of 2002. In calculating ROE, the ECB has taken into account only Tier I capital, thus the profitability of European banks would be even lower if Tier II capital were used in these calculations.
[5] Ibid.

When examining the information contained in balance sheets of Europe's 50 largest banks, it is evident that the Latvian banks do not substantially lag behind also in terms of asset quality. However, the ratio of specific provisions to the loan portfolio for European banks was only 0.57%[6], while for Latvian banks, almost two times more, i.e. 1.2%[7], which testifies to the fact that the business environment in Latvia is still more challenging than in the EU.

The stability of banks is also characterised by the capital adequacy ratio. The average of Europe's 50 largest banks was 11.4%[8], while in Latvia it was slightly higher, i.e. 11.7%[9]. It shall be remarked that the quality of Latvia's bank loan portfolio was good, since the share of non-performing loans (substandard, doubtful, or lost), for which specific provisions should be made, constituted 1.4% of total loans issued by the end of 2003.

Like other EU Member States, a deposit guarantee system operates in Latvia, in addition to regulatory requirements ensuring the stability of own banks. As of 2004, compensation not exceeding 6000 lats per depositor (both natural and legal person) per bank will be guaranteed (while in the reporting period compensation not exceeding 3 000 lats was guaranteed). After the transitional period, which has been granted to Latvia for the full implementation of the requirements of the relevant EU directive, as of 2008, a State-guaranteed compensation per person per bank in Latvia will reach 13 000 lats.

In recent years, a major part of the Latvian financial sector comprising banks has experienced particularly rapid development. Though the amount of mortgage loans issued by the end of 2003 reached 806 million lats, they still comprised only 27.9% of all loans issued to undertakings and private persons and only 14% of total banking assets. In 2003, the amount of loans issued to resident households increased particularly rapidly, i.e. by 77%, reaching 743 million lats by the end of the year. Such loans, however, made up only one-fourth of the loan portfolio and 13% of total banking assets. The volume of lending to households in the EU is usually comparable in size to that of corporate lending, whereas in Latvia it lags behind, i.e. by more than two times.

Considering the rapid development of Latvian banks and their future potential, it is unrealistic that in the foreseeable future any Latvian commercial bank could be among Europe's top fifty banks, which at the end of 2002 constituted 65% of 24.4 trillion euro worth of the EU's total banking assets[10]. Yet, three Latvia's largest banks have already become medium EU banks – assets exceeding 1.2 billion euros serve as a criterion for this. At the end of 2002, there were 933 such banks in the EU. The other Latvian banks will be able to compete with 4 099 small EU banks.

[6] Mid-2003.
[7] 4th quarter of 2003.
[8] Mid-2003.
[9] 4th quarter of 2003.
[10] According to the ECB's methodology, a bank with assets exceeding 122 billion euros is deemed to be a large EU bank.

Board of the Financial and Capital Market Commission

Uldis Cērps
Chairman

Jānis Brazovskis
Deputy Chairman

Ludmila Vojevoda
Director
Regulations and Statistics Department

Jānis Placis
Director
Supervision Department

Gvido Romeiko
Director
Legal and Licensing Department

Report of the Board of the Financial and Capital Market Commission

During the reporting year, the composition of the Board of the Commission did not change: Chairman – Uldis Cērps, Deputy Chairman – Jānis Brazovskis, Board Members – Ludmila Vojevoda, Jānis Placis and Gvido Romeiko. On 26 September 2000, the Chairman and the Deputy Chairman of the Commission were appointed to their posts by the *Saeima* (Parliament) of the Republic of Latvia for a period of six years, whereas the Members of the Board were appointed by the Chairman of the Commission, upon coordination of the relevant candidates with the Minister for Finance and the Governor of the Bank of Latvia.

The Commission, as an autonomous public institution, in accordance with the Law on the Financial and Capital Market Commission, carried out the supervision of the Latvian financial and capital market, promoting its stability and development and ensuring the protection of interests of investors, depositors, and the insured.

In 2003, 52 Board meetings took place, during which 308 decisions were taken. Twenty-six Board decisions were binding on all financial and capital market participants, and 230 decisions pertained to particular financial and capital market participants. Fifty-two decisions, in turn, were taken regarding the management of the Commission's own activities.

In the reporting year, the Consultative Council of the Financial and Capital Market[11] (hereinafter – the Consultative Council) held 17 meetings, aimed at discussing amendments to two draft laws (On Investment Firms, and On Private Pension Funds) and 23 Commission regulations, as well as at considering matters pertaining to the Deposit Guarantee Fund and the Fund for the Protection of the Insured, current payments made to these funds and assessing proposals from market participants.

The Consultative Council has approved the Commission's regulatory and supervisory strategy, given its evaluation of the implementation of the Commission's budget for 2003, as well as has approved the budget for 2004. The Consultative Council believes that the Commission has successfully implemented the functions assigned to it for 2003 and has ensured the stability of Latvia's financial and capital market.

The activities of the Commission in 2003 were financed from three sources – the State budget, the Bank of Latvia, and market participants (except for credit institutions). Since 2001, State budgetary funding has been gradually decreased according to the procedures and amounts specified by law, while funding provided by the Bank of Latvia in the reporting year remained unchanged. In 2007, upon an increase in market participant payments, the activities of the Commission will be financed exclusively from dues paid by financial and capital market participants. During the reporting year, the Commission did not provide any services for pay to the general public and did not receive any donations. The State Audit Office did not perform any audits relating to the activities of the Commission.

In 2003, specialists of the Commission participated in the formulation of the Draft Law on the Financial Instruments Market and in the preparation of amendments to three laws (the Credit Institution Law, the Law on Insurance Companies and Supervision Thereof, and the Investor Protection Law), and either drafted or amended nine of the Commission's own regulations.

In 2003, the Commission staff conducted 41 examinations of banks and one examination of a credit union. Like previous years, risk-weighted assets of banks were assessed and the internal control system analysed, paying particular attention to the policy and procedures for the prevention of money laundering. In the reporting year, 15 examinations were conducted in insurance companies, including seven full-scope and eight thematic inspections, two in private pension funds, eight in brokerage firms and banks performing intermediary activities in securities, five examinations of the operation of private asset managers of the State-funded pension scheme and six examinations of exchange and off-exchange securities transactions conducted by investors, as well as 13 comprehensive security audits of information systems of individual market participants. When supervising operations of issuers, the Commission staff conducted 49 examinations for ascertaining whether shareholders acquiring major holdings in joint stock companies had complied with the requirements of law and made a mandatory share buyout offer to minority shareholders.

Following the first evaluation, which took place in 2002, the work of the Commission in the reporting year was also evaluated by a group of experts from the European Commission (hereinafter – the EC). The EC experts had meetings with both the Commission staff and market participants, discussing matters related to the implementation of previously made proposals into practice and legislation. The Peer Review Report's overall evaluation of the supervision of the Latvian financial sector was positive.

In the reporting year, the Commission processed client complaints and applications regarding operations of market participants – in total, 181 applications. Concurrently, the Commission participated in establishing ombudsman institutions. The Ombudsman of the Association of Latvian Commercial Banks was established in 2003 with a view to review disputes among banks and their customers (natural persons) regarding credit transfers and electronic transactions. In addition, as from 2005, its competence will be extended to other banking services. In the reporting year, as a result of close cooperation between the Commission and the Latvian Insurers' Association, on 28 January 2004, the Ombudsman of the Latvian Insurers' Association was established, which initially reviewed complaints on insurance indemnities paid for life, assistance, and accident insurance.

[11] The Consultative Council of the Financial and Capital Market is formed on a parity basis from representatives of the Commission and heads of professional organisations of financial and capital market participants.

In 2003, the Commission asked its closest cooperation partners – the Bank of Latvia, the Ministry for Finance, and professional associations of financial and capital market participants – to evaluate their relationship with the Commission in all major aspects (namely, the conducting of on-site examinations, consultations, the formulation of regulatory enactments and the preparation of information). For the most part, cooperation with the Commission was evaluated as either 'very good' or 'good.' The cooperation partners' proposals will be reviewed at a meeting on quality management in order to further improve the Commission's performance.

The Commission's internal control system functioned efficiently and, on 7 May 2003, the Commission received an ISO 9001:2000 certificate issued by the Bureau Veritas Quality International, which testifies to the full conformity of the Commission's Quality Management System with this standard. In the reporting year, the maintenance and improvement of the Quality Management System continued.

In 2003, the number of staff positions at the Commission remained unchanged at 88.

In order that market participants and the general public may obtain more comprehensive information on the Commission and international developments, the Commission's website on the Internet at www.fktk.lv was enhanced by opening new sections, such as *Action Plans, Representative Offices of Foreign Financial Institutions in Latvia,* and *Financial Fraud.*

In 2003, the Commission approved its budget and action plan for 2004. This plan gives priority to the risk-based supervision, as well as to the ensurance of professional representation in EU institutions and working groups.

Drafting of Legislation

Also in 2003, when harmonising requirements of regulatory enactments applicable to the Latvian financial and capital market with the requirements of EU directives, the Commission actively participated in the formulation of several new draft laws and amendments to laws.

The Financial Instruments Market Law drafted by experts of the Commission, which replaced the Law on Securities, introduced several requirements of EU directives into the Latvian financial market regarding:

- prohibition against the use of inside information and market manipulation;
- investment services in the securities field;
- admission of securities to official listing on a stock exchange and the information required to be published on such securities; and
- as to how prospectuses that are to be published in connection with a public offer of securities should be drawn up, verified and distributed.

Public issue of securities that are offered to the public but are not intended for trading on regulated markets will not be subject to supervision. Credit institutions will not be required to obtain a separate licence issued by the Commission to provide investment services. The law also introduces 'the single licence principle' for the establishment of branches of investment brokerage firms registered in EU Member States and European Economic Area countries (hereinafter – Member States) and provision of services. This implies that, upon Latvia's accession to the EU, investment brokerage firms registered in Latvia will be entitled to provide investment services or open branches in Member States. Likewise, investment brokerage firms registered in Member States will be entitled to provide investment services in the Republic of Latvia.

Under the latest amendments of **the Credit Institution Law**, the minimum original maturity for subordinated loans is reduced from seven to five years. This affords credit institutions better opportunities to attract subordinated capital, without increasing risks to the banking system.

Amendments to **the Law on Insurance Companies and Their Supervision** were formulated for the purpose of introducing 'the single licence principle' for the establishment of branches of insurance companies registered in Member States and provision of investment services in Latvia, as well as for the establishment of branches of insurance companies registered in Latvia and provision of investment services in Member States. As a result of introducing 'the single licence principle', an insurance company registered in a Member State will not be required to obtain a licence to provide insurance in another Member State, in which it intends to open a branch or provide services. In order to improve the supervision of insurers, in turn, other amendments to this law provide for the right of the Commission not to allow an insurer to establish close links with third parties if such links may endanger the financial stability of the insurer and hinder the Commission in effecting its supervisory functions. Also, the amendments specify types of assets that may henceforth be accepted as cover for technical provisions, as well as lay down diversification rules to be observed, when establishing categories of assets accepted as cover for technical provisions. In addition, for the protection of interests of the insured, the said law stipulates that, henceforth, insurance brokerage firms will only be entitled to carry out insurance intermediary activity as well as other types of commercial activity directly related to insurance intermediary activity.

To ensure the full implementation of requirements of the Investor Compensation Directive, amendments to the **Investor Protection Law** were drafted, thereby determining the right of investment service providers registered in Latvia to join investor-protection schemes of other Member States, retaining concurrently the status of a participant in the Latvian investor-protection scheme.

Regulations Issued by the Commission

In 2003, the Commission's Board approved several regulations, thus, continuing their alignment with the requirements of EU directives and recommendations of international supervisory authorities. 13 staff members are employed by the Regulations and Statistics Department of the Commission.

For the purpose of increasing the transparency of credit institution operations and promoting market discipline by providing comparable information to market participants, creditors, investors and other interested persons regarding the financial standing and performance indicators of credit institutions, the Commission approved the **Regulations on the Preparation of Public Quarterly Reports**, which specify the minimum amount of information to be contained in public quarterly reports and the procedures for publishing these reports. Such quarterly reports with respect to every credit institution are available on the Internet home page of the relevant credit institution.

In the reporting year, the Commission's Board decided to repeal the **Regulations on Restrictions on Exposures Arising on Transactions with Residents of Zone B Countries**. The decision was made by taking into account the fact that the risk management in banks was advanced and the said regulations, which were adopted after the crisis of the Russian financial system in 1998, were no longer required. The Commission will retain the possibility to impose restrictions on country exposures on an individual basis.

In order to ensure a uniform approach to control the compliance with restrictions on exposure limits for banks and brokerage firms, the **Regulations on the Compliance with Restrictions on Exposures for Banks and Brokerage Firms** were adopted. In view of the Latvian economic development and the improved control over local government finances, the Commission's Board applied a 50% reduction factor to claims on local governments of the Republic of Latvia and claims secured by guarantees of local governments of the Republic of Latvia, when assessing the compliance with restrictions on large exposures. This will enable banks to participate to a greater extent in the financing of local government projects as well as in projects guaranteed by local governments.

For the purpose of obtaining up-to-date information for conducting supervision and drawing up a Report on Financial Accounts of the Bank of Latvia, a Balance of Payments and a Statistical Report, the **Regulations on the Preparation of Monthly Reports for Brokerage Firms** were adopted.

The **Regulations on the Calculation of the Available Solvency Margin for Insurance Companies**, approved by the Commission's Board, introduced new elements eligible for inclusion in the available solvency margin and the procedure for calculation of the available solvency margin for insurance companies. These Regulations have been drafted by considering amendments introduced to the Law on Insurance Companies and Supervision Thereof, as a result of transposing requirements of EU directives.

During the reporting year, in order to ensure a more efficient procedure for out-of-court settlement of disputes between an insurer and customers regarding insurance indemnity payments, the Commission prepared the **Recommendations for the Formulation of Efficient Procedures for Out-of-court Settlement of Disputes between an Insurer and Its Customers regarding Insurance Indemnity Payments**. These Recommendations set the basic principles for a more efficient dispute settlement process than provided by the general procedures for the court settlement of disputes. Recommendations for the formulation of efficient procedures for the out-of-court settlement of disputes between a credit institution and its customers were adopted already in 2002.

The approved **Regulations on the Preparation of Annual Reports for Private Pension Funds** envisage that the evaluation of financial statement items for a pension fund and each pension plan and the preparation of an annual report shall be carried out in accordance with the International Financial Reporting Standards.

The **Regulations on the Preparation of Quarterly Reports for Private Pension Funds** were prepared to obtain up-to-date information for conducting supervision and drawing up a Report on Financial Accounts of the Bank of Latvia, a Balance of Payments and a Statistical Report of the Statistical Office of the European Union (EUROSTAT).

Licensing

The harmonisation of Latvian legislation with the requirements of EU directives was commenced already in mid-1990s, and, by the end of 2003, almost all laws binding on the financial and capital market incorporated the requirements of EU directives, thus, the readiness of the Latvian financial sector for operations in the EU financial market was practically ensured already on the first EU accession day. The Legal and Licensing Department of the Commission employs 14 staff members.

The new licensing procedure, which was introduced in 2003, stipulates that, henceforth, financial services in the EU common market may only be provided by those financial and capital market participants whose amount of capital complies with the requirements of law and whose owners having a qualifying holding (owning 10% or more of the share capital) have an impeccable reputation, provided the origin of funds invested in their capital is explicit and verifiable. This is of particular importance also because of the fact that any company – a bank, an insurer or an investment management company – licensed in one EU Member State will be entitled to provide financial services also in other EU Member States.

Before the implementation of EU directives, the acquisition of shares of a financial market participant, when acquiring a major holding, was subject to permission from the Commission, whereas, as early as the reporting year, natural and legal persons could already acquire shares by notifying the Commission thereof. Such notifications must be made prior to acquisition of shares; consequently, one of the EU fundamental rights – free movement of capital – is not infringed. In cases where a person acquiring a qualifying holding does not comply with the requirements of law, for example, may not prove the legal origin of the funds invested in its capital, the regulatory enactments stipulate that the Commission is entitled to prohibit the exercise of voting rights attaching to all acquired shares, but the said person does not lose his property rights. They may be sold, pledged, changed, or used for other transactions.

One of the most significant functions of the Commission has been the issuance of licences and certificates to financial and capital market participants, as well as the suspension or cancellation thereof in cases where the financial and capital market participants do not observe the requirements of laws and other regulatory enactments, or decide to terminate or discontinue operations themselves.

At the end of 2003, there were 22 banks and one branch of a foreign bank in Latvia and no credit institution operating licence was issued or cancelled.

In the reporting year, new credit union operating licences were issued to three cooperative credit unions, whereas one credit union operating licence (that of the cooperative credit union *KKS Āgenskalns R*) was cancelled. As a result, at the end of the reporting year, there were 28 cooperative credit unions in Latvia.

In 2003, Latvia's insurance sector comprised 19 insurance companies. In the reporting year, no new licences for insurance operations were issued, whereas all licences issued for insurance operations to one insurance company (JSIC Zurich Latvia Limited) were cancelled.

At the end of 2003, there were 30 insurance brokerage firms in Latvia. New licences were issued to four insurance brokerage firms, whereas the licences of three insurance brokerage firms were cancelled. Two companies were refused an insurance brokerage firm operating licence.

In 2003, interest in insurance brokerage activities was considerable, as demonstrated by the issue of certificates to 32 persons for insurance brokerage operations. 22 insurance brokerage certificates were cancelled, since their holders discontinued their brokerage activities. At the end of 2003, there were 195 registered insurance brokers in Latvia.

Until 30 April 2003, when amendments to the Law on Insurance Companies and Supervision Thereof took effect, thereby determining that the Commission shall no longer register insurance agents and agencies, three new insurance agencies were registered, whereas three insurance agencies were excluded from the register during the reporting year, therefore their number remained unchanged at 59. On 30 April 2003, the insurance market comprised 8 177 insurance agents. During this period, 322 new agents were registered, while 114 agents were struck from the registry for insurance agents. After 30 April 2003, the registry for insurance agents was comprised of insurers and insurance agencies.

In 2003, a new licence was issued to one private pension fund. Four pension plans were licensed, but, at the pension fund's request, one pension plan licence was cancelled. At the end of 2003, there were five private pension funds offering a total of 12 pension plans.

In 2003, an investment firm operating licence was issued to two investment management companies and a licence for managing State-funded pension scheme assets was issued to one investment management company. At the end of the year, there were eight investment firms, six of them had obtained a licence for managing State-funded pension scheme assets. In 2003, four new open-end and three new closed-end investment funds were registered. As a result, at the end of the year, investment firms managed 10 open-end and six closed-end investment funds.

In 2003, no new foreign investment fund announced its intention to distribute securities in Latvia. In total, four investment funds registered abroad were entitled to distribute their securities in Latvia in 2003.

In the reporting year, 26 licensed intermediary companies – 20 credit institutions and six investment brokerage firms – operated in the securities market. In 2003, the Commission issued a new licence for intermediary activity in the securities market (the opening, maintenance and servicing of securities accounts) to one credit institution. At their request, two investment brokerage firms had their licences for intermediary activity cancelled, while one firm was refused a licence for intermediary activity.

In 2003, professional securities market specialist certificates were issued to 53 persons. At the end of the year, the financial instruments market comprised 620 certified specialists.

At the end of 2003, there were 86 securities issuers registered with the Commission, including 84 share issuers and two debt securities issuers. During the reporting year, two share issues at a face value of 7 million lats, two bond issues at a face value of 10 million lats, and three mortgage bond issues at a face value of 13 million lats, were registered.

In 2003, shares of the JSC *Rīgas Fonds RIF-INVEST*, the JSC *Viesnīca Latvija*, the JSC *Solo-Riga*, the JSC *Ventspils zivju konservu kombināts*, the JSC *Misas kūdra*, totalling 2 341 375 shares, were withdrawn from public trading.

Supervision

Since 1 July 2001, all Latvian financial and capital market participants – credit institutions, credit unions, securities market participants (issuers, investors, the Riga Stock Exchange, the Latvian Central Depository, investment brokerage firms, brokers, investment management companies), insurance companies and also private pension funds – have been supervised by the Commission. Supervision in the banking field has been carried out based on the Basel Committee Core Principles for Effective Banking Supervision while in the insurance field, on the IAIS Core Principles and in the securities field, on the Principles of Securities Regulation of IOSCO. The relevant core principles have been incorporated into Latvia's regulatory enactments as well.

The Supervision Department, which comprises two divisions (the Banking and Securities Market Division and the Insurance Division) is the largest department of the Commission. Around half of the Commission's budget is spent to ensure the performance of functions of the Supervision Department. In the reporting year, the Banking and Securities Market Division employed 26 staff members, while the Insurance Division, seven staff members. In 2003, the supervision of operations of market participants carried out by the Commission was comprised of on-site examinations and an analysis of submitted reports and the most substantial risks.

The primary task of on-site examinations is to assess the financial standing and capital adequacy for market participants under supervision, as well as whether the internal control system ensures adequate risk evaluation and management. Duly detection of causes of potential problems and finding of preventative solutions during examinations reduce a possibility for individual market participants to default on their obligations as well as the effects of their potential problems on the entire financial and capital market.

The analysis of financial statements of market participants, in turn, allows the evaluation of the financial standing, operational risks and their tendencies, as well as of the conformity of operations with regulatory enactments. Conclusions from these analyses were regularly submitted to the Commission's Board, at which priorities of supervisory activities were discussed with a view to reduce risks inherent in operations of market participants.

In 2003, the supervision of the financial sector was ensured by adhering to the following priorities:

- evaluation of the capital adequacy for market participants and assessment of operational risks and management controls thereof;
- the compliance of market participant operations with laws, other regulatory enactments, principles of the best practice and standards of professional ethics;
- particular attention to those market participants who occupy an essential role in the financial market;
- protection of interests of customers of market participants, ascertaining whether the market participants provide customers with accurate and true information concerning the legislative requirements for financial services, and assisting customers in understanding the procedure for reviewing complaints and disputes as well as their rights and obligations in general;
- a continuous dialogue with individual market participants and professional associations;
- unambiguous and motivated decisions and administrative actions, upon thorough consultations with the involved market participants.

In 2003, following recommendations of the International Monetary Fund, the Commission launched its work on developing a system that would ensure a continuous and systematic evaluation of risks of individual market participants. This system, which is designed to assess risks, will also be required for the implementation of the new Basel Capital Accord. This work will be completed during 2004.

For the purpose of ensuring efficient and qualitative supervision, providing for equal treatment of all market participants, the Commission has developed a Supervision Manual, which establishes guidelines and procedures for conducting examinations. In 2003, based on changes in the financial market, some parts of the manual, i.e. those pertaining to the review of separate risk (credit risk and market risk) management and control adequacy, were amended.

In the reporting year, specialists of the Commission also reviewed client complaints on financial and capital market participants (181 complaints). For the most part, complaints dealt with credit transfers and electronic transactions in credit institutions, insurance indemnity payments in insurance companies, operations of issuers and share buyout offers to minority shareholders in the securities market. Client complaints, in fact, were a useful source of information indicating to possible market participants' deficiencies. Irrespective of this, in the majority of cases, the Commission had to conclude that it was not entitled to settle civil disputes among market participants and their clients, as such disputes should only and exclusively be settled in court. Experts of the Commission familiarised themselves with the contents of complaints, as well as requested additional information from market participants in order to, upon receipt of such information, ascertain whether the market participants had breached laws or regulations, the compliance with which is overseen by the Commission. In deciding what sanctions to impose, the Commission applied the principle of proportionality, thus, taking into account the general interests of the public and stimulating the elimination of detected deficiencies.

Banks and Credit Unions

In 2003, banks made up 96.1% while credit unions, 0.1% of total assets of the Latvian financial system.

In 2003, the Commission conducted 41 bank examinations and one credit union examination. As in previous years, the main focus was on the asset quality and internal control systems of institutions. The Commission also assessed the compliance of bank procedures for identifying clients and detecting unusual and suspicious financial transactions with the requirements of the Law on the Prevention of Laundering of Proceeds Derived from Criminal Activity. The Commission, on the basis of consolidated financial statements, carried out the supervision of eight banks forming banking groups. This included the examination of operations by undertakings belonging to these banking groups (leasing companies and one foreign bank). The Commission sought to ascertain whether the banking groups had established efficient internal control systems that ensured the preparation of adequate information for supervision needs, as well as risk management systems enabling the banks to continuously control risk transactions within their banking groups.

Credit Risk

In the reporting year, the amount of issued bank loans continued to increase substantially. Therefore, when assessing individual risks during its bank examinations, the Commission paid particular attention to the evaluation of banks' credit risk management systems in order to identify any shortcomings and potential problems related to loan repayment. The banks' strategies, as well as their policies and procedures regarding the granting of loans were also assessed. During examinations conducted within the year 2003, the Commission examined individual loans, which, in total, constituted almost half of each bank's loan portfolio. Such examination methodology justifies itself under circumstances where the previous high rate of growth in lending is retained. In 2003, considering an increase in the volume of issued loans, the share of newly issued loans in banks' loan portfolios was comparatively large.

In general, loan evaluation results did not substantially differ from banks' own evaluations. The Commission focussed its attention on the system and practice developed by banks to adequately assess the borrower's creditworthiness, i.e. how both the amount and repayment term for loans had been matched to the amount and regularity of the borrower's income and the collateral coverage. This was of particular importance with respect to consumer and mortgage loans issued to private persons.

In the reporting year, based on examination results, the Commission temporarily suspended lending activities of two banks, as their operations did not comply with the requirements of law and Commission regulations. These banks were required to eliminate any deficiencies detected and the Commission proceeded with the supervision of this process.

Liquidity Risk

All in all, examinations of banks confirmed that the Latvian banking sector maintained the high level of capitalisation and liquidity. The liquidity ratios of Latvian banks exceed the minimum liquidity ratio specified by the Commission. In conducting bank examinations, it was important to ascertain whether the banks ensured day-to-day management and control of liquidity and complied with the limits on internal transactions and whether their operations did not entail any increased liquidity risk for the future.

Market Risks

Latvia's banks do not have any substantial market risks, as investments in financial instruments are not large. At the end of 2003, total investments in securities accounted for 16.4% of assets. Moreover, 42.4% of these investments were made in central government securities. In conducting bank on-site examinations, attention was confined to the procedures for managing and assessing investments in financial instruments.

Reputational Risk

In 2003, the Commission continued the supervision of activities to reduce the risk of involvement of Latvian financial and capital market participants and their clients in money laundering. Close attention was paid to banks, as they are key market participants in terms of asset value. Specific minimum requirements for ensuring the functioning of an internal control system to prevent money laundering were communicated by the Commission to all banks. The communication letter dealt also with the application of the 'know your client' principle in day-to-day operations. The Commission, on a regular basis, informed market participants of the initiatives of various international organisations and national anti-money laundering authorities. At the request of the Association of Latvian Commercial Banks, the Commission provided bank staff members with training in money laundering prevention. The Commission participated in drafting amendments to the Law on the Prevention of Laundering Proceeds Derived from Criminal Activity, which were adopted by the *Saeima* (Parliament) of the Republic of Latvia on 18 December 2003. Amendments were required for bringing the Latvian legislation into line with the second EU money-laundering directive. In 2003, the Commission continued its participation in meetings held by experts of the Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL) and, by virtue of its membership in the said committee, took part in separate meetings of the Financial Action Task Force.

When conducting examinations, the Commission paid special attention to the matters pertaining to identification of actual beneficiaries and business activities of customers. The compliance with the 'know your client' rules is the key to minimising the risk of market participant involvement in money laundering and identifying unusual and suspicious financial transactions. During examinations conducted in 2003, the Commission identified and notified the Office for the Prevention of Laundering of Proceeds Derived from Criminal Activity of 61 suspicious or unusual financial transactions entered into by individual financial and capital market participants.

In 2003, the Commission passed five administrative acts pertaining to deficiencies detected during examinations and required taking measures to improve internal control systems.

The Commission holds the view that the year 2003 saw considerable changes in the internal control systems of Latvian banks as regards the prevention of money laundering. The internal control systems have become very sophisticated, taking into account recommendations of international organisations and the world's best practice for combating money laundering and financing of terrorism.

New Products

In 2003, the Commission processed 17 applications submitted by credit institutions for new financial products or amendments to the procedure for providing financial services. Pursuant to Commission regulations, a credit institution shall submit to the Commission a description of policies and procedures for managing risks inherent in new services. New products were mainly related to settlement systems and lending services. The Commission verified whether the submitted policies and procedures ensured adequate risk management and in two cases it objected to the provision of new services, since adequate risk management was not ensured or the requirements of Latvian law were not met.

Insurance Companies

At the end of 2003, there were 13 non-life insurance companies and six life insurance companies operating in Latvia. In total, Latvia's insurance companies comprised 2.4% of assets of the Latvian financial system and, for the most part, they were constituted by non-life insurance companies.

The supervision of insurance companies was effected in two stages – the Commission staff analysed reports submitted by insurance companies and subsequently conducted on-site company examinations. During these examinations the Commission evaluated the conformity of insurance company operations with the requirements of law and other regulatory enactments and, on a regular basis, monitored prudential indicators of insurance companies, their trends and, where necessary, took specific measures to eliminate deficiencies. In the reporting year, the Insurance Division employed seven staff members.

In 2003, the Commission staff conducted 15 examinations of insurance companies, including seven full-scope and eight thematic inspections. During these examinations, attention was focussed on the solvency margin and adequacy of technical provisions for insurance companies. The Commission also assessed whether technical provisions were fully covered by eligible investments as prescribed by law.

The Commission also evaluated the capability of insurers to comply with the requirements of the Law on the Prevention of Laundering Proceeds Derived from Criminal Activity. The main focus was on internal control systems in order to ascertain how insurers controlled possible risks. Where necessary, insurers were requested to take specific measures to reduce some risks or to ensure more stringent controls. Risk evaluation for each insurer was prepared and subsequently assessed by the Commission's Board. The evaluation included risks associated with underwriting, adequacy of technical provisions, reinsurance, investment operations, as well as management, operational and reputational risks.

In 2003, the Commission formulated and approved the Regulations on the Volume and Structure of an Actuarial Valuation for Insurers Engaged in Any Class of Civil Liability Insurance. Pursuant to these Regulations, said insurers will henceforth submit an annual report accompanied by an actuarial evaluation, in which the insurer's chief actuary will evaluate the sufficiency or insufficiency of the technical provisions established by the insurer.

In the reporting year, the Commission's Board decided to impose a penalty on one insurance company for the non-compliance of its operations with the requirements of Latvian law, taking into account considerations of usefulness and based upon the Law on Insurance Companies and Supervision Thereof.

Investment Brokerage Firms, Investment Funds and Pension Funds

At the end of 2003, investment brokerage firms made up 0.1% while investment funds, 4% and private pension funds 0.3% of assets of the Latvian financial system.

In 2003, the Commission conducted eight examinations of investment brokerage firms and banks performing intermediary activities, two examinations of private pension funds and five examinations of investment management companies – managers of State-funded pension scheme assets. Also, the Commission conducted six examinations of exchange and off-exchange securities transactions concluded by investors.

When conducting examinations of the operation of asset managers of the State-funded pension scheme (hereinafter – the SFPS), the Commission assessed investment plan policies and the compliance with restrictions specified by Latvian law, as well as the management and holding of assets to ensure their conformity with Latvian laws and other regulatory enactments. Since, as of 2003, SFPS participants may choose between the State Treasury and private asset managers and, once a year, change the selected asset manager, examinations were focussed on the compliance of the operation of private asset managers with the common principles, ensuring comparable public information on the activities of private asset managers to enable SFPS participants, when opting for an asset manager, to compare the operation of investment plans available in Latvia and their profitability indicators.

When carrying out intermediary activity examinations and consistently analysing exchange and off-exchange transactions, attention was paid to such transactions as cause suspicion that:

- inside information has been used, i.e. information which has not been made public and which, if it had been made public, would have had a significant effect on the price of securities;
- they have been undertaken for manipulative purposes, for example, by giving false or misleading signals as to the supply and demand, or securing the price at an artificial level.

When investigating one case, the Commission found that, by using professional specialist services, some shareholders involved in the financial instruments market effected mutual transactions in public company shares for the purpose of creating a false impression about the turnover of these shares, that is, by giving misleading signals as to the trade in these shares. When assessing the above facts and explanations provided by the persons involved, the Commission decided to impose a penalty on eight persons, namely, one bank, one brokerage firm and six individual investors.

The Commission examined five cases arousing suspicion of the purchase and sale of public company shares with a view of creating a misleading impression of their turnover. When assessing the volume of said transitions, which, in fact, was insignificant, and its actual effects on the financial instruments market, the Commission took a decision to issue warnings to five investors for breaches of the requirements of Latvian law. The said penalty encompassed also an essential preventive function aimed at precluding other investors from giving orders to execute manipulative transactions and intermediary companies from executing such transactions.

As a result of the amendments to the Criminal Law, which were made in connection with the adoption of the Law on the Financial Instruments Market, the use of inside information and market manipulations are subject to criminal penalty as from 1 January 2004.

Operation of Issuers

In the reporting year, in total, 84 issues of public securities, 4 bond and mortgage bond issues and 16 investment certificate issues were registered with the Commission. At the end of 2003, shares issued by three issuers and debt securities issued by three issuers were admitted to the official list of the Riga Stock Exchange. During 2003, the share market capitalisation peaked at 608.3 million lats, or 10.4% of the GDP.

26 September of 2003 was the deadline for acquirers of the controlling interest of privatised issuers to decide upon making a mandatory share buyout offer to minority shareholders. Consequently, the attention was focussed on establishing whether the shareholders of these issuers having acquired at least 50% of the voting capital of joint stock companies had met the requirements of Latvian law, with respect to minority shareholders, by the specified date. The Commission staff verified the compliance of operations of shareholders from all privatised companies with the requirements of law to ascertain whether the shareholders, directly or indirectly, had not acquired such an amount of voting shares as required a mandatory buyout offer and whether the shareholders had not avoided making such an offer.

When assessing the compliance of shareholder operations with law, the Commission conducted a total of 49 examinations and determined that shareholders in seven joint stock companies had not made a mandatory share buyout offer within the time limit prescribed by the Law on Securities, i.e. before 26 September 2003. Out of these seven joint stock companies, shareholders in five joint stock companies owned more than one-half of the voting shares directly, for these shares were recorded in the name of the acquirer of the controlling interest, whereas in two joint stock companies the Commission had to carry out additional examinations to establish that the shareholders owned more than one-half of the voting shares indirectly. During these examinations, the Commission ascertained that, in six cases, the shareholders did not intend to avoid making a mandatory buyout offer and, therefore, this authorised the offer to be made after 26 September 2003. In one case, a shareholder did not make a mandatory buyout offer and reduced its participating interest in the voting share capital to less than 50% and, thus, avoided making a mandatory buyout offer. Considering the fact that the shareholder reduced its participating interest in the company after the date it was obliged to make a mandatory buyout offer, the Commission issued an administrative act documenting the violation of law. The administrative act was not appealed. Thus, it has become effective and the minority shareholders have been given an opportunity to use this administrative act as an argument to recover damages from the shareholder if they consider that the damages have been caused by the shareholder's failure to make a mandatory share buyout offer.

Likewise, the Commission conducted five additional examinations to ascertain whether persons had not avoided making a mandatory buyout offer by indirectly acquiring at least 50% of the voting capital of a joint stock company. During these examinations, the Commission determined two cases where persons had indirectly acquired more than one-half of the voting capital. Therefore, the Commission issued an administrative act, thereby imposing sanctions for the failure to make a mandatory share buyout offer. In both cases, the administrative acts issued by the Commission were appealed.

In each particular case, in order to determine that the respective person had directly or indirectly acquired at least one-half of the voting capital, the Commission had to study the way, whereby the share acquirers had acquired shares (market or off-market trade), and to analyse decisions taken at general shareholders' meetings over an extended period of time, joint activities with other shareholders and business transactions with share issuers in particular. In addition to the above, in one case, the Commission had to cooperate with foreign supervisory authorities and to study the economic activity of the issuer within a three-year period as well as transactions entered into between the issuer and its shareholders. Finally, as a result of all such activities, the Commission obtained convincing proof serving as the basis for the issue of a relevant administrative act.

In supervising the activities of issuers, particular attention was paid to potential misuse of insider information in securities transactions on the stock exchange. The Commission also verified whether shareholders promptly disclosed material events and published annual accounts with a view to protect the rights of minority shareholders, and to provide timely information on recent developments in the activities of public joint stock companies.

Audits of Information System Security

In 2003, the Commission continued conducting on-site and off-site security audits of market participants' information systems (hereinafter – IS) and analysing IS security documents. In total, 13 comprehensive security audits of information systems were conducted and the Commission continued its cooperation with the Bank of Latvia in performing credit institution audits.

Particular attention was paid to the management of the security of specific IS and electronic services and to the cooperation between market participants and outsource service providers. As of 2003, Latvian regulatory enactments precisely define obligations of market participants to their clients in cases where the service partially or fully is provided by an outsource service provider.

IS security management encountered deficiencies in IS security organisation and, to a lesser extent, technological problems. Therefore, the Commission prepared extensive explanatory notes to raise market participant and client awareness of IS security. The overall IS security of the Latvian financial market is characterised by the fact that the Commission saw no necessity to impose any sanctions on market participants owing to the lack of suitable IS security.

International Cooperation

Cooperation with Institutions of the European Union

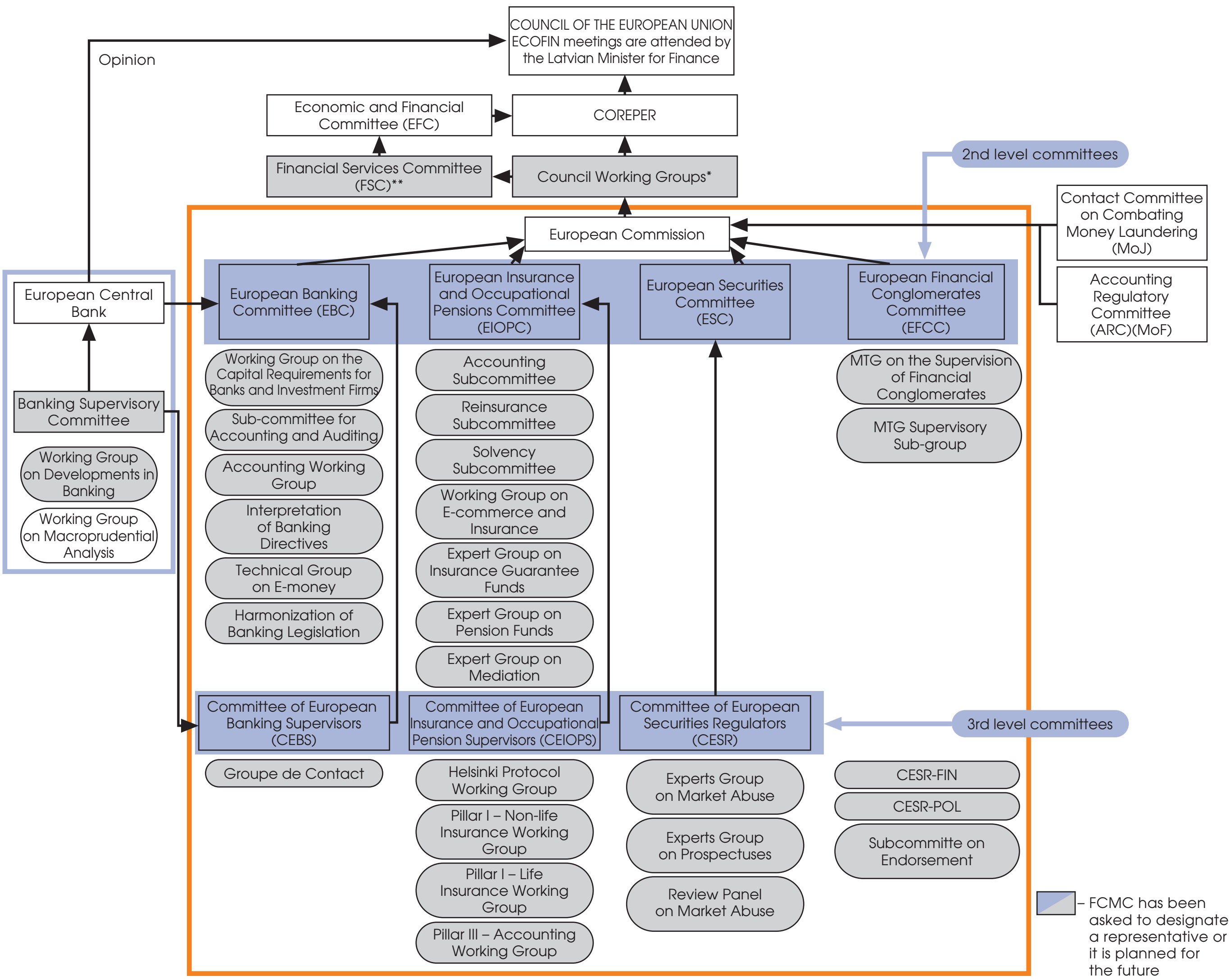
In the reporting year, representatives of the Commission participated as observers in meetings of several committees of the European Commission, namely, the Financial Services Committee, the Banking Advisory Committee, the Insurance Committee, the UCITS Contact Committee and the Banking Supervision Committee of the European Central Bank, as well as in working groups set up by these committees.

Upon accession to the EU, Latvia will participate in these committees already as a full member, which will enable Latvia not only to follow first-hand the latest developments in regulatory requirements for financial market activities and in supervisory practice but also to take part in the decision-making process.

In the reporting year, the Commission prepared positions and instructions for Latvian representatives to EU Council and COREPER meetings to voice Latvia's interests and opinion on proposals for directives and other issues related to the financial and capital market.

At the EC's request, a transposition table regarding the capital adequacy of investment firms and credit institutions (Directive 93/6/EEC) was prepared by comparing the Latvian legislation with relevant EU requirements, which enabled EU experts to evaluate the compliance of Latvia's regulatory enactments with the EU *acquis communautaire* in the field of finances.

Chart of Committees and Working Groups of the Council of the European Union, the European Commission and the European Central Bank



* – currently working – Working Party on Investment Services and Working Party on Transparency

** – currently working Expert Group on Indicators in Financial Services

Peer Review of Financial Service Supervision in Latvia

On 5 and 6 May 2003, a group of experts from the European Commission paid a repeated visit to Latvia to assess the tasks accomplished with respect to the supervision practice and legal drafting following the first peer review, which took place in 2002. During this visit, the group of experts held meetings with both the Commission staff and financial and capital market participants, discussing matters related to the implementation of proposals expressed during the first peer review. After this visit, the Commission received a report providing a positive evaluation of the Latvian financial sector supervision.

International Organisations and Foreign Financial Supervisory Authorities

During the reporting year, the Commission was engaged in active cooperation with major international organisations operating in the financial and capital market: the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, the International Organization of Securities Commissions, the International Network of Pensions Regulators and Supervisors, the World Bank, the International Monetary Fund and the International Commercial Crime Bureau. Likewise, active cooperation was effected with the European Committee on Crime Problems in order to jointly combat the involvement of financial and capital market participants in money laundering. In connection with Latvia's accession to the EU, the Commission took a decision to, as from 2004, discontinue its membership of the International Organisation of Securities Commission (IOSCO), while simultaneously ensuring its continued compliance with all the recommendations of this organisation and closely following its activities.

The Commission increased its number of cooperation partners among foreign financial supervisory authorities. Memoranda of Understanding (MoUs) on the mutual exchange of information were signed with the Central Bank of Cyprus and the National Bank of Ukraine. The Commission has concluded a total of 18 MoUs with financial supervisory authorities of various countries. In addition, the Commission has reached agreement with the US Office of the Comptroller of the Currency on the exchange of information between both organisations.

In the reporting year, the Commission started preparatory work for becoming a party to several multilateral cooperation agreements to ensure the exchange of information between EU supervisory authorities, for example, the Multilateral Memorandum of Understanding on the Exchange of Information and Surveillance of Securities Activities of the Committee of European Securities Regulators, the Helsinki Protocol and the Siena Protocol of the Committee of European Insurance and Occupational Pension Supervisors.

Operation of the Guarantee System

Deposit Guarantee Fund

Deposits of natural persons with Latvian credit institutions have been guaranteed since 10 October 1998, when the Law on Natural Person Deposit Guarantees came into effect. Since 1 January 2003, under the law's new amendments, assets accumulated by the Deposit Guarantee Fund (hereinafter – the Guarantee Fund) must guarantee the deposits not only of natural persons, but also of legal persons up to the limit specified by law. In 2003, the guaranteed compensation per person (both natural and legal) per credit institution was 3 000 lats. The law stipulates that this limit will gradually rise to 13 000 lats per person (both natural and legal) per bank or credit union during the next four years, which equals the minimum amount specified in the relevant European Community directive (see Figure 1).

As the information compiled by the Commission shows, more than 95% of all accounts opened within the Latvian banking system in 2003 had balances that did not exceed 3 000 lats.

The assets of the Guarantee Fund are accumulated and managed by the Commission. On 31 December 2003, the Guarantee Fund had assets of 14.3 million lats (see Figure 2):
1) payments by deposit takers in the amount of 12.5 million lats;
2) a single payment from the State budget in the amount of 0.5 million lats;
3) a single payment by the Bank of Latvia in the amount of 0.5 million lats; and
4) income gained from the management of the Guarantee Fund's assets in the amount of 0.8 million lats.

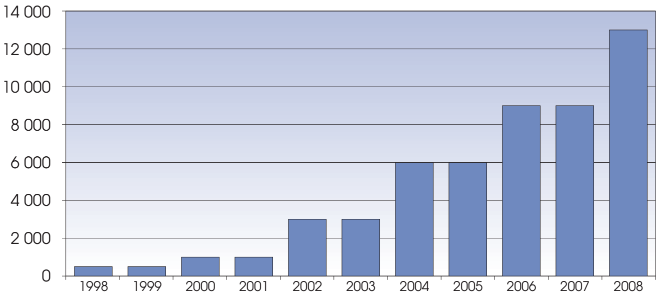
The accumulation of the Guarantee Fund's assets and guaranteed compensation payments are supervised by the Consultative Council of the Commission. If the Guarantee Fund lacks the resources to make guaranteed compensation payments to depositors, then, in accordance with Latvian law, such payments shall be paid from the State budget.

In cases when deposits become unavailable (according to court adjudication regarding the liquidation of a deposit taker or the initiation of bankruptcy proceedings), the Commission exercises the creditors' right to effect claims against deposit takers – banks or credit unions – and effects guaranteed compensation payments to depositors no later than three months from the day the case of unavailability of deposits has occurred. To date the Guarantee Fund's assets have not been used for guaranteed compensation payments, as no such unavailability of deposits has occurred in the system of Latvian banks and credit unions since the Guarantee Fund's establishment.

Fund for the Protection of the Insured

In order to protect the interests of the insured in the case of an insurer's bankruptcy, a Fund for the Protection of the Insured (hereinafter – Protection Fund) was set up in 1999.

Figure 1
INCREASE IN THE GUARANTEED COMPENSATION PER DEPOSITOR IN 1998-2008
(at beginning of period; lats)



The assets of the Protection Fund are made up of deductions from insurance companies amounting to one per cent of the total of gross insurance premiums received from natural persons for specific classes of insurance as provided by law. The Protection Fund had accumulated 1.1 million lats by 31 December 2003. The part of the Protection Fund comprising payments of life insurance companies accounted for 231.8 thousand lats, while the part comprising payments of non-life insurance companies accounted for 874.5 thousand lats on 31 December 2003 (see Figure 2).

Indemnity payments could be received only by insurance policy holders who were natural persons:
1) for life insurance – 100% of the insurance indemnity, but not more than 2 000 lats per insurance policy holder;
2) for other classes of insurance provided by law – 50% of the insurance indemnity, but not more than 2 000 lats per insurance policy holder.

The accumulation of the Protection Fund's assets and guaranteed compensation payments are organised by the Commission, whereas the Consultative Council of the Commission is responsible for the oversight of the accumulation of the Protection Fund's assets and guaranteed compensation payments. A guaranteed insurance indemnity from the Protection Fund is only paid following the initiation of bankruptcy proceedings against an insurance company. The creditors' right to effect claims against insurers is exercised by the Commission. An insured person must submit an insurance indemnity application to the administrator of the insurance company within three months after the insurer has been declared insolvent.

In 2003, for the first time since the start of operation of the Protection Fund, its resources were used for guaranteed indemnity payments in the amount of 6 671 lats.

Protection of Securities Market Clients (Investors)

Since 1 January 2002, the Investor Protection Law has been in force in Latvia, ensuring the implementation of an investor protection scheme that complies with EU requirements. In cases where investment service providers (banks and brokerage firms) are not capable of meeting their obligations, investors have the right to receive compensation. The compensation for the default on obligations is stipulated in the amount of 90% of the value of irreversibly lost financial instruments, or losses caused by a non-executed investment service.

In 2003, each investor (natural person) was guaranteed compensation amounting to 90% of the value of irreversibly lost financial instruments, or losses caused by a non-executed investment service, but not more than 3 000 lats per person in total. In 2004 and 2005, the maximum guaranteed compensation amount will rise to 6 000 lats, increasing further to 9 000 lats in the years 2006 and 2007 and to 13 000 lats in 2008 (see Figure 3).

Figure 2
STRUCTURE OF THE FUND FOR THE PROTECTION OF THE INSURED
(at end of 2003; %)

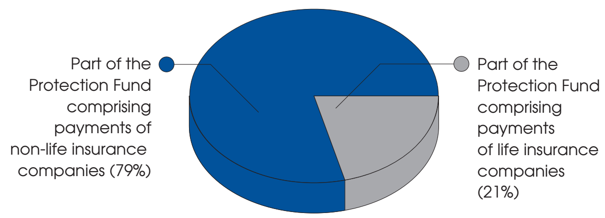
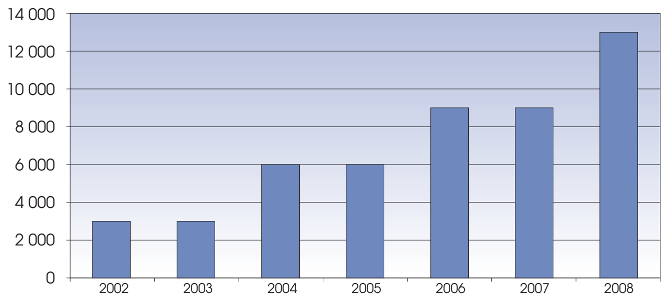


Figure 3
INCREASE IN THE GUARANTEED COMPENSATION PER DEPOSITOR IN 2002-2008
(at beginning of period; lats)



In contrast to the accumulation of assets in the Deposit Guarantee Fund and the Fund for the Protection of the Insured, the mechanism established for the protection of the insured stipulates that assets intended for the compensation of investors are not accumulated in a fund. In cases where an investment service provider is unable to meet its obligations, the Commission – based on the quarterly financial reports submitted by other investment service providers – calculates the proportionate payments to be made by each market participant (investment service provider) into an account opened with the Bank of Latvia for guaranteeing compensations by the defaulter.

If required, the Commission organises and supervises compensation payments made by market participants, verifies the validity of applications for compensation, and ensures compensation payments. An application for compensation shall be submitted within one year after the investor has become aware that the investment service provider has not met its obligations, but not later than five years from the date of default on obligations. Compensation shall be paid within a three-month period from the Commission's acknowledgment of an application for compensation as reasonable. By the end of the reporting year, the Commission had not received any such applications.

Major Tasks of the Financial and Capital Market Commission for the Year 2004

1. In 2004, the Commission plans to formulate and amend several regulatory enactments in order to transpose the following 10 EU directives regarding the financial and capital market and specific market sectors into Latvian legislation:
- general:
  - on the supervision of financial conglomerates (Directive 2002/87/EC);
  - on the operation of electronic money institutions (Directive 2000/46/EC);
  - on consolidated accounts and evaluation of certain assets (Directive 2001/65/EK);
  - on distance marketing of consumer financial services (Directive 2002/65/EC);
- in the field of credit institution business:
  - on the taking up and pursuit of the business of credit institutions (Directive 2000/12/EC);
- in the field of insurance business:
  - on insurance mediation (Directive 2002/92/EC);
  - on the supplementary supervision of insurance undertakings in an insurance group (Directive 98/78/EC);
  - on the reorganisation and winding up of insurance companies (Directive 2001/17/EC);
  - on reinsurance (the Directive is scheduled for adoption in the second half of 2004);
- in the field of the financial instruments market:
  - on insider dealing and market manipulation (market abuse) (Directives 2003/124/EC and 2003/6/EC);
  - on the fair presentation of investor recommendations and the disclosure of conflicts of interest (Directive 2003/125/EC).

In 2004, the work on the transposition of the new capital adequacy directive will be launched.

2. In 2004, the Commission will introduce a set of changes to regulatory enactments governing the Latvian financial and capital market in order to monitor and enforce the compliance with requirements of law:

- regulations for consolidated supervision of banks will be supplemented;
- new regulations for preparing reports will be formulated to more efficiently control credit risks run by banks;
- regulations for managing interest rate risk will be formulated. As a result, all 25 Basel Committee Core Principles for Effective Banking Supervision will be fully introduced into the Latvian financial market;
- regulations on the preparation of reports on operations for both life and non-life insurance companies will be amended;
- new regulations on the preparation of quarterly reports for investment management companies, as well as on the calculation of performance indicators for both investment management companies and management funds, will be drafted in order that investors may receive information on the performance indicators of investment companies and funds calculated by employing uniform methods;
- regulations regarding source documents associated with financial instrument transactions, as well as recommendations for conducting the accounting of publicly traded financial instruments not registered with the Latvian Central Depository, will be formulated to reduce risks relating to trade in securities not registered with the Latvian Central Depository;
- recommendations for entering into a business relationship with financial instrument market participants from other countries will be drafted to mitigate risks inherent in holding financial instruments and conducting transactions therein;
- methods for IS security audits of market participants will be supplemented with developed IS security management to more efficiently reduce IS security risks during operations of major market participants.

3. In 2004, a system for evaluation of operational risks run by Latvian banks and insurance companies will be set up in Latvia to ensure efficient performance of supervisory functions, based upon uniform principles for risk assessment, comparing them to risks faced by other market participants and determining priorities for supervision. The Commission will develop this risk evaluation system for internal use and discuss rating results with each particular market participant.

4. To implement the renewed 40 recommendations of the Financial Action Task Force, the Commission will effect improvements to the requirements of the Recommendations for the Procedures for Identifying Clients and Unusual and Suspicious Financial Transactions.

Operations of Market Participants

In 2003, Latvia retained a high gross domestic product (GDP) growth rate. The increase in gross domestic product constituted 7.5%. The inflation rate was only one percentage point higher than in 2002 and was still comparatively low (2.9%). In 2003, the average monthly gross wage for the employed rose by 11.4%[12] as compared to the year before. The economic development positively influenced also the Latvian financial and capital market. At the end of 2003, the volume of assets of the financial sector reached 101% of the gross domestic product, or 5. 94 billion lats (see Table 1). Traditionally, banking assets constituted the largest share of total assets (96%).

Banks

During the reporting period, the number of banks in Latvia remained unchanged at 22, along with one foreign bank branch.

The total paid-up share capital of banks grew by 8.5%, reaching 307.9 million lats by the end of the year. In 2003, there were no substantial changes in the structure of shareholders of banks. Foreign shareholders owned more than 50% of the share capital of nine banks, whose market share accounted for 45% of total banking assets. At the end of the year, foreign shareholders owned 54% of the total paid-up share capital of banks, i.e., most part was owned by residents of Estonia (15%) (the Estonian capital represented the capital of Swedish origin), Sweden (12%), and Germany (11%). Seven banks were subsidiaries of foreign banks (their market share in total banking assets comprised 41.8% while in loans, 53.9%); among these, four were subsidiaries of banks of EU Member States and acceding countries (Germany, Sweden and Estonia) (their market share in total banking assets accounted for 38.5% while in loans, 53.6%).

In 2003, the privatisation of the JSC *Latvijas Krājbanka* was completed. On 17 May 2003, the Latvian Government-owned share in the JSC *Latvijas Krājbanka* in the amount of 25.01% was sold at an auction organised by the non-profit organisation State joint stock company Privatisation Agency. The staff of the JSC *Latvijas Krājbanka*, in turn, were offered 6.6% of the shares, while the privatisation reserve constituted 0.5%. As a result, the Government-owned share in the JSC *Latvijas Krājbanka* decreased from 32.1% at the beginning of 2003 to 0.7% at the end of the year. The Latvian Government was still the only shareholder of the State JSC L*atvijas Hipotēku un zemes banka*, whose assets made up 4.1% of Latvia's total banking assets at the end of 2003.

During the reporting year, the market share of Latvia's five largest banks did not substantially change and amounted to 63.1% of total banking assets, 73.4% of loans and 66.6% of

[12] Data published in the Internet home page of the Central Statistics Board of the Republic of Latvia.
[13] Latvia's GDP in 2003 was 5 872.1 million lats, according to data published in the Internet home page of the Central Statistics Board of the Republic of Latvia.
[14] Data of the European Central Bank as of 31 December 2002.

Table 1
FINANCIAL AND CAPITAL MARKET PARTICIPANTS

Market participants	31.12.2002			31.12.2003		
	Number	Assets	Share of total assets, %	Number	Assets	Share of total assets, %
Banks	23	4 423	96.17	23	5 717	96.1
Insurance companies	20	124	2.7	19	141	2.37
Investment management companies	6	1	0.02	8	4	0.04
Investment funds	9	12	0.26	16	27	0.5
Investment plans[13]	1	12	0.26	17	26	0.48
Private pension funds	4	16	0.37	5	21	0.38
Credit unions	26	3	0.06	28	4	0.04
Insurance brokerage firms[14]	29	3	0.06	30	3	0.03
Investment brokerage firms	8	3	0.06	6	4	0.04
Riga Stock Exchange	1	1	0.02	1	1	0.01
Latvian Central Depository	1	1	0.02	1	1	0.01
Issuers	89	-	-	86		-
Insurance brokers – natural persons	185	-	-	195	-	-
Professional securities market specialists – natural persons	567	-	-	620	-	-
Total	969	4 599		1 055	5 949	

deposits at the end of the year (compared to 65.3%, 73.7% and 68.4%, respectively, a year earlier).

In 2003, Latvian bank assets grew by 29%, reaching 5.71 billion lats by the end of the reporting period. The rapid growth in borrowing continued. As the former rate of increase in the bank loan portfolios (41%) was maintained, the banking asset structure changed and the share of loans in total banking assets rose from 48.1% to 52.5% (see Figure 4).

Though the ratio of bank loans to residents as compared to Latvia's GDP[15] grew and amounted to 45.1% by the end of 2003 (compared to 36.4% on 31 December 2002), it was still significantly lower than the EU average, which was 132.8%[16] at the end of 2002.

In 2003, the national economy was actively engaged in borrowing. By the end of the reporting year, 88% of total loans had been granted to domestic borrowers. For the most part, loans were issued to the following national economy sectors: trade, financial intermediation and manufacturing, which received 20%, 16% and 15%, respectively, of a total of loans issued (compared to 22%, 17% and 16%, respectively, on 31 December 2002). In the reporting year, the amount of loans issued by banks to such sectors as agriculture, hunting and forestry rose, i.e. by 48%, while the amount of loans issued for real estate transactions, lease and other commercial activity rose by as much as 78%. As a result, their share in total loans issued for the national economy development amounted to 6% and 12% on 31 December 2003, compared to 5% and 9%, respectively, a year earlier (see Figure 5).

In 2003, mortgage lending developed rapidly and grew by 96%. Consequently, the share of mortgage loans in Latvia's bank loan portfolios increased to 28%, totalling 806 million lats at the end of the year (see Figure 6). The reporting year saw a particularly rapid increase in the amount of loans issued for housing (105%) and their share in the bank loan portfolios amounted to 16% at the end of 2003. The ratio of loans issued for housing to GDP grew from 4.6% at the end of 2002 to 8.3% % by the end of the reporting year. At the end of 2003, the EU average was 32%[17].

In 2003, the term structure of loans changed. The volume of long-term loans (5 years or more) rose by 59%, and their share in bank loan portfolios increased from 37% at the beginning of the year to 42% by the end of the year.
It is significant that with the increase in the volume of lending, the loan quality did not deteriorate during the reporting year. The share of non-performing loans (substandard, doubtful, or lost) in the total of loans granted to non-banks dropped from 2% to 1.4%. At the end of 2003, the ratio of specific provisions for non-banks to the total of loans granted to non-banks was 1.2% (see Figure 7). At the end of the reporting year, specific provisions for loans to non-banks covered 89.4% of the amount of non-performing loans.

[15] Data published in the Internet home page of the European Central Bank.
[16] Non-audited profit.
[17] Return on equity – the ratio of profit/loss (after tax) of the reporting year to average equity.

Figure 4
ASSET STRUCTURE
(at end of period; %)

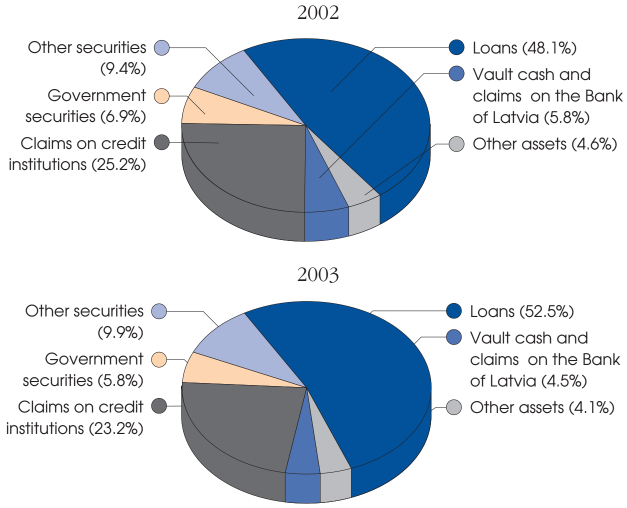


Figure 5
SHARE OF LOANS ISSUED TO NATIONAL ECONOMY SECTORS IN BANKING ASSETS AND ANNUAL GROWTH RATE OF SUCH LOANS
(31.12.2003; %)

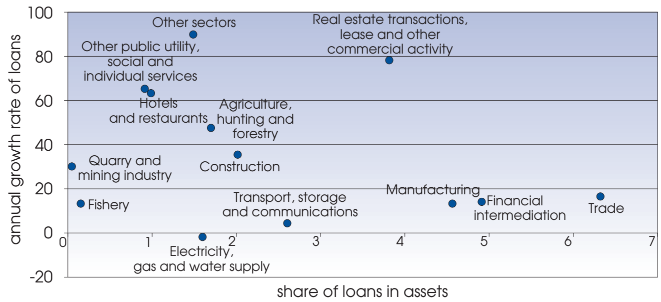
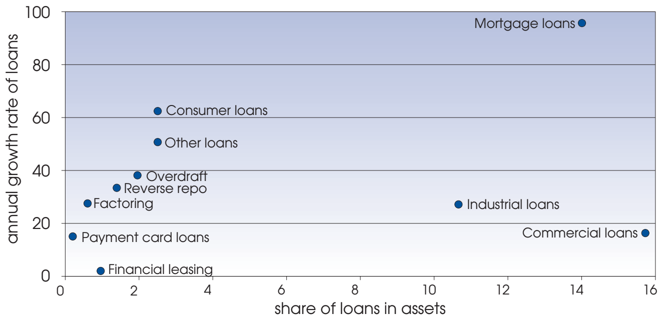


Figure 6
SHARE OF LOANS, BROKEN DOWN BY TYPE, IN BANKING ASSETS AND ANNUAL GROWTH RATE OF SUCH LOANS
(31.12.2003; %)



The amount of deposits in 2003 grew by 660 million lats, or 22%, and totalled 3.73 billion lats at the end of the year. In the reporting year, resident deposits saw a higher growth rate (24%) than non-resident deposits and amounted to 46.4% of total non-bank deposits on 31 December 2003 (compared to 45.7% a year earlier). At the end of the reporting year, deposits by private persons (53%) and deposits by private undertakings (32%) constituted the largest share of the total deposits made by residents (compared to 52% and 33%, respectively, on 31 December 2002). The amount of deposits by non-residents in 2003 increased by 20%. Deposits by private undertakings comprised 90% of total non-resident deposits. Demand deposits still retained the largest share of total deposits, i.e. 73%, whereas their share in deposits by residents constituted 58%.

In 2003, the profit of the banking sector[18] reached 71.5 million lats, i.e. 27% more than in 2002, when total profits were 56.3 million lats. The return on equity (ROE)[19], in turn, was 16.7% at the end of 2003, a 0.3 percentage point increase compared to the previous year. During the reporting period, the return on assets (ROA)[20] ranged from 1.3% to 1.5%, and was 1.4 at the end of the year, a 0.1 percentage point drop compared to the previous year. In 2003, the main sources of profit in the banking sector were income from interest on loans issued to non-banks (39% of total bank income), fee and commission income (26%), and interest on debt securities (10%).

In the reporting year, as the capital requirement for credit risk increased more rapidly than banks' equity, the capital adequacy ratio decreased and comprised 11.7% at the end of 2003 (compared to 13.1% a year earlier) (the regulatory requirement is 10.0%) (see Figure 8).

In 2003, though the liquidity ratio[21] of the banking sector was somewhat reduced from 62.1% at the end of 2002 to 57.9% on 31 December 2003 (the minimum regulatory requirement is 30.0%), Latvia's banks still maintained high liquidity.

At the end of the reporting year, one financial holding company group and seven banking groups (hereinafter – consolidation group) which in total had 37 subsidiaries, including 10 leasing companies, four investment companies, two banks, one pension fund, two insurance companies, four auxiliary undertakings and 14 other financial institutions (investment brokerage firms, etc.), were subject to consolidated supervision. The market share of responsible consolidation group banks in the Latvian banking sector assets constituted 65.8%.

Figure 7
NON-PERFORMING LATVIAN NON-BANK LOANS
(at end of period)

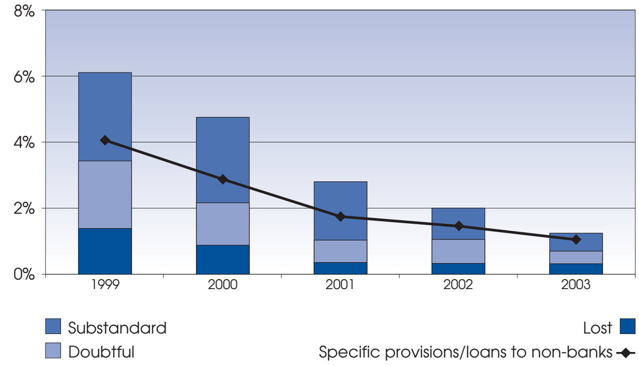
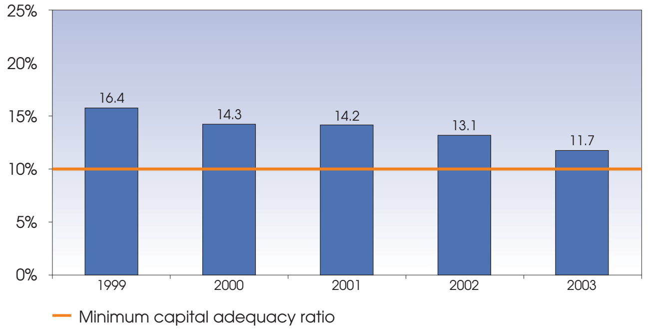


Figure 8
CAPITAL ADEQUACY RATIO OF LATVIAN BANKS
(at end of period)



18 Non-audited profit.
19 Return on equity – the ratio of profit/loss (after tax) of the reporting year to average equity.
20 Return on assets – the ratio of profit/loss (after tax) of the reporting year to total average assets.
21 Capital adequacy ratio – capital requirement for credit risk and market risks that is expressed as the ratio of equity to the sum of risk-weighted assets and off-balance sheet items and the notional risk-weighted assets and off-balance sheet items.

At the end of the reporting year, the balance sheet total of subsidiaries (non-banks) of consolidation groups reached only 14.4% of the banking assets subject to consolidated supervision.

Subsidiaries of Latvian consolidation groups were registered mainly in Latvia and Lithuania, as well as in Cyprus, Ukraine, the USA, the United Kingdom, Estonia and Russia.

At the end of 2003, the average capital adequacy ratio calculated based on individual financial bank statements (15.4%) for all Latvian banks under consolidated supervision was only slightly higher than the ratio calculated based on financial statements of consolidation groups (15.2%).

Credit Unions

At the end of 2003, there were 28 cooperative credit unions in Latvia. On 31 December 2003, the market share of the two largest credit unions comprised 78% of credit union assets, 76% of loans, and 83% of deposits (compared to 79%, 77%, and 84%, respectively, a year earlier).

The total assets of Latvia's credit unions rose by 44%, and reached 3.9 million lats (0.07% of all banking sector assets). This increase resulted largely from an influx of credit union member deposits, which grew by 47% in 2003 and amounted to 2.63 million lats (see Figure 9).

The main type of credit union activity was lending to credit union members. In 2003, the amount of such loans increased by 54% and totalled 3.2 million lats on 31 December 2003. These formed the largest share of total credit union assets, i.e. 83% (compared to 77% at the end of 2002).

Short-term loans (up to one year) accounted for the largest share of the aggregate loan portfolio of Latvia's credit unions, or 58%. In 2003, as the volume of long-term loans (more than 5 years) grew more than threefold, the share of such loans in the loan portfolio of credit unions rose by 8.4 percentage points, reaching 16% by the end of the reporting year.

In 2003, the amount of mortgage loans issued to credit union members increased almost fourfold and amounted to 806.1 thousand lats, or 25% of Latvia's total credit union loan portfolio (compared to 10% on 31 December 2002). Notwithstanding the increase in mortgage loans, 70% of the loans contained in the credit union loan portfolio were comprised of loans for the purchase of consumer goods (compared to 86% on 31 December 2002).

In 2003, the share of non-performing loans in credit union loan portfolios slightly increased and totalled 2.5% at the end of the year (compared to 2.4% a year earlier). Specific provisions made up 5.6% of the total loan amount (See Figure 10).

In 2003, three new credit unions launched their operations. The paid-up share capital of Latvia's credit unions rose by

Figure 9
LATVIAN CREDIT UNION ASSETS, DEPOSITS AND LOANS
(at end of period; in thousands of lats)

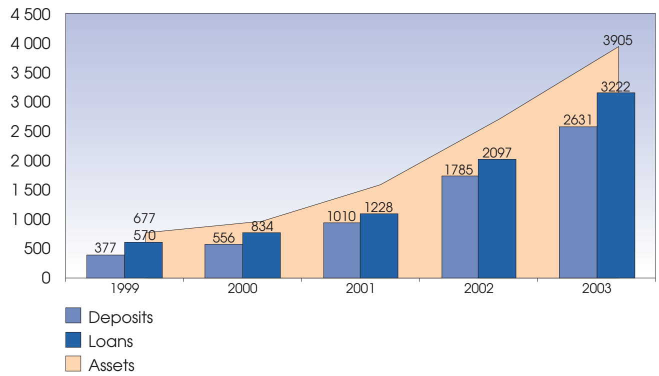
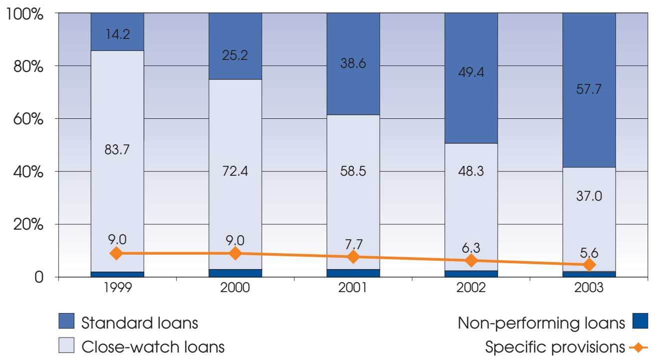


Figure 10
QUALITY OF THE LOAN PORTFOLIO OF LATVIAN CREDIT UNIONS
(at end of period)



37% to 684.5 thousand lats on 31 December 2003, as a result of an increase in the number of credit union members. The aggregate amount of credit union capital and reserves increased by 34.0% to 912.2 thousand lats, or 23% of liabilities.

In 2003, Latvia's credit unions showed a total profit of 58.6 thousand lats[23], which is 1.5 times more than in 2002. This could be related to an increase in administrative expenses (66.6%) in the reporting year, which was more rapid than the increase in the profit on financial activities of credit unions (46.3%).

During the reporting year, the main source of income for credit unions, or 69% of all credit union income, was interest on loans issued to members. The administrative expenses, in turn, accounted for the largest share of the credit union expense structure, i.e. 42%.

On 31 December 2003, the return on equity (ROE) of credit unions was 7.3% (compared to 10.6% a year earlier), while the return on assets (ROA) was 1.7% (compared to 3.3% on 31 December 2002).

On 31 December 2003, the capital adequacy ratio for the credit union sector was 23.3% (the minimum requirement specified by law is 10%).

Insurance Companies

At the end of 2003, there were 19 insurance companies operating in Latvia, of which six were involved in life insurance and 13 in non-life insurance operations.

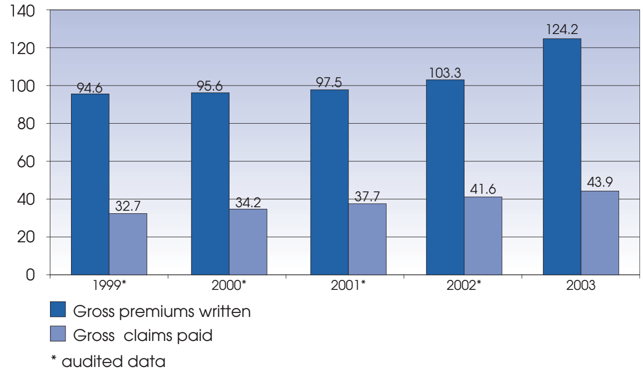
At the end of 2003, the total direct investments made by non-residents in the share capital of Latvian insurance companies comprised 20.1 million lats, or 52.8% of their paid-up share capital. Five insurance companies were operating as subsidiaries of foreign insurers, while foreign insurance companies partially owned two insurance companies. In 2003, the market share of insurance companies which were subsidiaries of EU insurers or the share capital of which was provided by foreign insurance companies amounted to 43%.

In 2003, the gross premiums written by insurance companies in Latvia[24] accounted for 124.2 million lats, or 20% more than in the year 2002, while gross claims paid[25] accounted for 43.9 million lats, or 5% more than in 2002 (See Figure 11).

At the end of 2003, there were 30 insurance brokerage firms in the Latvian market, which intermediated 21.4 million lats worth of insurance services. The share of gross premiums written through these firms constituted 16% of total gross premiums written by insurance companies (compared to 14% in 2002).

[23] Non-audited profit.
[24] Gross premiums are all premiums written during the reporting year on insurance contracts taking effect in the reporting year, irrespective of whether or not these premiums have been received.
[25] Gross claims are all claims paid during the reporting year, less values paid for life assurance and claims handling expenses.

Figure 11
GROSS INSURANCE PREMIUMS WRITTEN AND GROSS CLAIMS PAID
(at end of period; in millions of lats)



At the end of 2003, the insurance penetration ratio was 0.1 percentage point higher than a year earlier – 2.1%.[26] At the end of 2002, the EU average was 8.7%, while in the new EU Member States, 3.5%. During the reporting year, the second major indicator characterising the importance of the insurance industry for the national economy – insurance density ratio – rose by 9.2 lats, or 22%, to 53.6 lats.

The year 2003 experienced no significant changes in the portfolio of gross premiums written by insurance companies. Various types of risk insurance still prevailed (96%) and the share of gross premiums written for life insurance remained the same as in 2001 and 2002 – 4% (see Figure 12). In 2003, most part of the portfolio of gross premiums written by insurance companies traditionally comprised premiums written for motor vehicle third party liability compulsory insurance and land vehicle insurance, i.e. 22% and 21%, respectively, of total gross premiums written.

The combined ratio[27] slightly rose from 98.4% in 2002 to 99.3% in 2003 (see Figure 13). Taking into account the fact that the net return on investments[28] in 2003 was 4.0%, the actual ratio of aggregate insurance operational expenses[29] to proceeds amounted to 95.3% (compared to 91.8% in 2002).

By 31 December 2003, the available solvency margin of insurance companies had decreased by 6.3% to 38.8 million lats as compared to the year before. The solvency ratio[30] was 215%, compared to 313% in 2002. The lowest permissible level specified by law for this ratio is 100%.

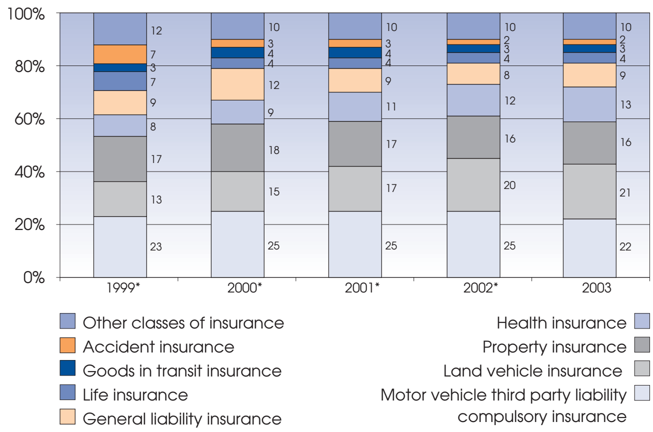
On 31 December 2003, the net technical reserves of Latvian insurance companies totalled 62.8 million lats. These reserves were fully covered by investments and 96% of these investments were placed in Latvia. The investment portfolio was invested in low-risk assets, i.e. the bulk of investments consisted of time deposits with credit institutions (34%), as well as securities issued and guaranteed by national or local governments (32%) (see Figure 14).

Financial Instruments Market

At the end of 2003, the Latvian financial instruments market operators were the Riga Stock Exchange (hereinafter referred to also as the RSE), the Latvian Central Depository (hereinafter referred to also as the LCD), six investment brokerage firms and 20 banks involved in providing investment services, as well as eight investment management companies managing 16 investment funds (ten open-end funds and six closed-end funds).

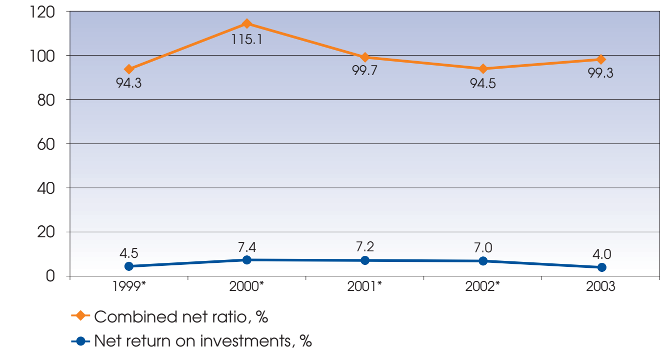
26 Latvia's GDP in 2003 was 5 872.1 million lats, according to data published in the Internet home page of the Central Statistics Board of the Republic of Latvia.
27 The combined ratio characterises the ratio of insurance companies' direct insurance operational expenses to premiums earned.
28 Net return on investments is net investment income to average investment value.
29 The actual ratio of insurance operational expenses is the combined ratio decreased by the net return on investments.
30 The solvency ratio shows the adequacy of own funds for meeting the minimum solvency requirements. The minimum solvency or solvency margin is a calculable figure expressing the quantitative amount of risks related to insurance contracts concluded.

Figure 12
GROSS INSURANCE PREMIUMS WRITTEN BY CLASS
(at end of period)



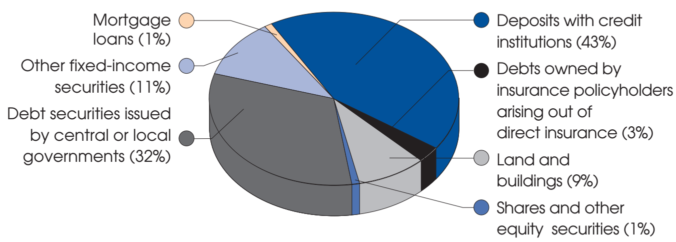
* audited data

Figure 13
NET RETURN ON INSURANCE INVESTMENTS AND COMBINED RATIO OF OPERATIONAL EXPENSES



* audited data

Figure 14
STRUCTURE OF INSURANCE INVESTMENTS COVERING NET TECHNICAL RESERVES
(31.12.2003; %)



Investment Management Companies and Investment Funds

In 2003, total assets of Latvian investment management companies increased more than twofold and comprised 3.6 million lats at the end of the year.

In 2003, total assets of investment funds managed by Latvian investment management companies rose more than twofold, reaching 26.5 million lats, or 0.5% of the gross domestic product[31] (compared to 0.2% in 2002), by the end of the year (see Figure 15).

Investments in securities formed the largest share of total investment fund assets. In the reporting year, upon an increase in the amount of securities investments by 72% to 15.2 million lats, the share of such investments in total assets reached 57% by the end of the year. Also, the amount of deposits made by investment funds in credit institutions rose, i.e. 2.9 times, and amounted to 9.6 million lats at the end of 2003. As a result, these deposits accounted for the second largest share of total assets (36%).

On 31 December 2003, debt securities of central and local governments as well as of companies constituted the largest share of the securities portfolio of Latvia's investment funds, i.e. 64% and 31%, respectively (compared to 74% and 22%, respectively, a year earlier) (see Figure 16). At the end of the reporting period, 89% of central and local government debt securities, in turn, were bonds of the Republic of Latvia. Equity investments made up only 5% of the securities portfolio of investment funds and 3% of total investment fund assets.

The year 2003 witnessed changes in the country breakdown of the securities portfolio of investment funds. In 2003, the share of investments in securities issued by Latvian issuers in the aggregate securities portfolio dropped by 22.4 percentage points to 69% by the end of the reporting year. At the end of 2003, the securities portfolio of investment funds was constituted by securities of issuers coming from various countries, that is, 7%, or 1.0 million lats, were constituted by securities of Russian issuers while 4%, or 0.6 million lats, by securities of Lithuanian issuers, 3%, or 0.5 million lats, by securities of German issuers, each 3%, or 0.4 million lats, by securities of Finnish and Dutch issuers, each 2%, or 0.37 million lats, by securities of Luxembourgan and Estonian issuers, and the other 7% were constituted by securities of issuers of 13 other countries as well as of one international financial institution (Nordic Investment Bank) (see Figure 17).

In 2003, as a result of investment income, the increase in net assets amounted to 561.4 thousand lats, i.e. 18% less than in 2002 (compared to 682.1 thousand lats in 2002).

The annual rate of return for open-end investment funds was 9.1%.

[31] Latvia's GDP in 2003 was 5 872.1 million lats, according to data published in the Internet home page of the Central Statistics Board of the Republic of Latvia.

Figure 15
INVESTMENT FUND ASSETS
(at end of period; in millions of lats)

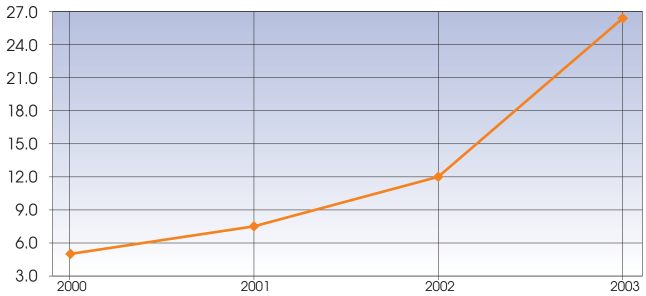


Figure 16
SECURITIES PORTFOLIO OF INVESTMENT FUNDS, BROKEN DOWN BY TYPE OF SECURITY
(at end of period; %)

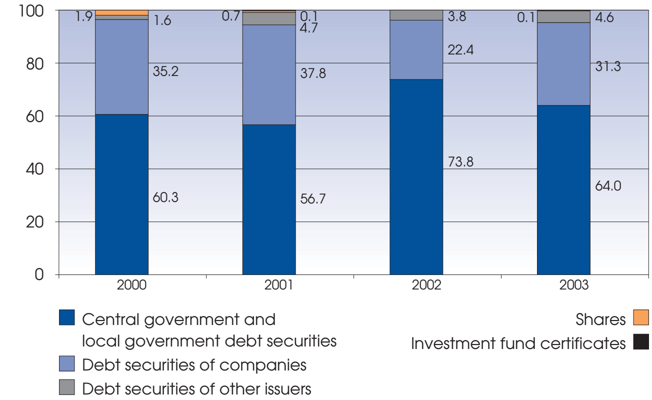
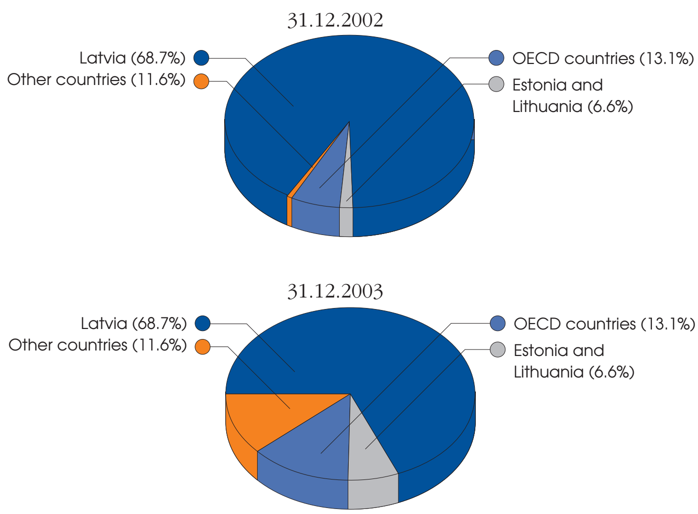


Figure 17
SECURITIES PORTFOLIO OF INVESTMENT FUNDS, BROKEN DOWN BY TYPE OF SECURITY
(%)



The Riga Stock Exchange and the Latvian Central Depository

In the autumn of 2003, Finland's HEX Group – owner of the RSE and the LCD – merged with the Sweden's OM Group – owner of the Stockholm Stock Exchange, establishing the OMHEX group as a result.

During the reporting year, the total turnover of the RSE accounted for 230 million lats, or 26% less than in 2002. In 2003, the stock market capitalisation grew by 45.4% to 608.3 million lats, whereas the turnover velocity[32] shrank from 26.5% to 13.9%[33]. In 2003, the market value of securities held with the LCD continued to increase, reaching 1 072.8 million lats at the end of the year (compared to 796.4 million lats at the end of 2002), including company shares (49.9%,), government debt securities (35%), corporate debt securities (12.4%), and investment fund certificates (2.7%). During the reporting year, the value of publicly traded securities held in custody at the LCD totalled 1 019.7 million lats (in market value), or 95% of the amount of securities held by the LCD. The number of holders of securities accounts decreased from 104 thousand to 103.5 thousand at the end of 2003[34].

Issuers

At the end of 2003, securities issued by 86 issuers were publicly tradable in Latvia, including securities of five banks, two insurance companies and 79 other companies, as well as investment certificates of 10 open-end investment funds and four foreign investment funds. In the reporting year, five issues of public securities totalling 23 million lats were registered, including three mortgage bond issues at a face value of 13 million lats and two corporate bond issues at a face value of 10 million lats. Also, shares in the amount of 7 million lats were traded publicly. There was no registration requirement for government securities issues.

Investment Brokerage Firms

At the end of the reporting year, total amount of assets of investment brokerage firms amounted to 3.6 million lats. In 2003, investment brokerage firms showed a total profit of 109.3 thousand lats. In the reporting period, the main sources of profit were income from fees and commissions and similar income from services provided to clients (56.4%), as well as interest income (23.5%). Administrative expenses, in turn, took the largest share of the expense structure (56.5%).

Operations of Investment Service Providers

During the reporting year, the volume of the securities portfolio held in custody and held for their own account by investment service providers (six investment brokerage firms and 20 banks) grew by 23.7% and amounted to 1 622.7 million lats at the end of the year, including corporate debt securities (38.7%), government debt securities (26.1%), equity securities (30%), investment fund certificates (2.3%), and derivatives (2.9%) (see Figure 18).

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32 The stock market turnover velocity is the stock market turnover/capitalisation ratio.
33 Data of the Riga Stock Exchange.
34 Data of the Latvian Central Depository.

At the end of 2003, securities not traded publicly in Latvia constituted 53.0% of the aggregate securities portfolio. The share of Latvian issuers in the aggregate securities portfolio made up 48%.

The value of securities transactions in 2003 increased by 73%, reaching 4.0 billion lats. The most significant contributor to the turnover of public securities was government debt securities, which made up 63.7% of the total turnover of public securities. Corporate debt securities were the second largest contributor to the turnover of public securities (23.2%) (see Figure 19).

Management of State-Funded Pension Scheme Assets

The year 2003 was the first year that private investment managers – investment management companies – were involved in the management of State-funded pension scheme (se-cond-tier pension system) assets. At the end of 2003, State-funded pension scheme assets were managed by six investment management companies and the State Treasury[35].

On 31 December 2003, investment management companies and the State Treasury, which continued to manage investment plans, offered a total of 17 investment plans to investors in second-tier pension plans. Before 31 December 2003, 495 062, or 21% of Latvian residents[36] had joined the second-tier of the State pension system.

In 2003, assets of investment plans for the State-funded pension scheme grew twofold as compared to the year before and reached 25.5 million lats, or 0.5% of the gross domestic product[37] (compared to 0.2% in 2002).

At the end of 2003, 18.4 million lats, or 73% of total investments, were invested in debt securities (compared to 75% of total investments in 2002) and 6.6 million lats, or, 26% of total investments, were invested in time deposits with credit institutions (compared to 25% a year earlier).

Marked changes occurred in the country breakdown of investments, that is, compared to 31 December 2002, when all the State-funded pension scheme assets were invested in Latvia, on 31 December 2003, of total investments, 89%, or 22.5 million lats, were made in Latvia, whereas 2.9 million lats were invested in 17 other countries, including Germany, Poland, Russia and the United Kingdom, and also in securities issued by international financial institutions.

The average weighted annual return on investment plans was 0.3%[38].

[35] Pursuant to the State-funded Pension Law, until 31.12.2002, State-funded pension scheme assets were managed by the State Treasury only, while, as of 2003, also by investment management companies.
[36] Data published in the Internet home page of the Central Statistics Board of the Republic of Latvia.
[37] Latvia's GDP in 2003 was 5 872.1 million lats, according to data published in the Internet home page of the Central Statistics Board of the Republic of Latvia.
[38] The return is calculated as the ratio of the investment plan unit value change during the period to its value at the beginning of the period, expressed in annual percentage terms.

Figure 18
STRUCTURE OF THE SECURITIES PORTFOLIO
(%)

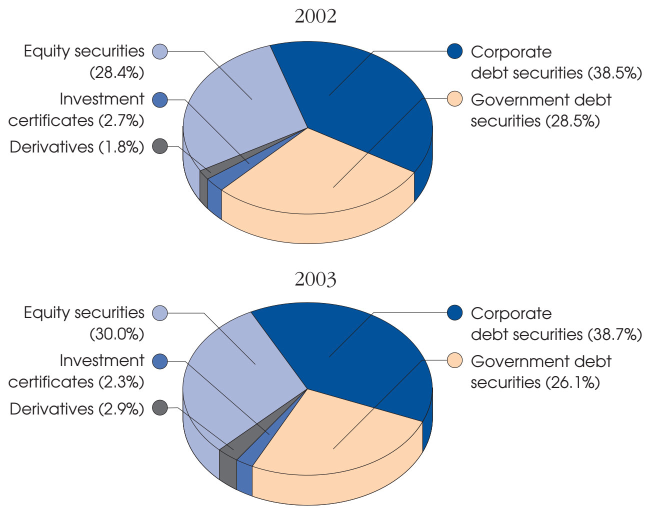
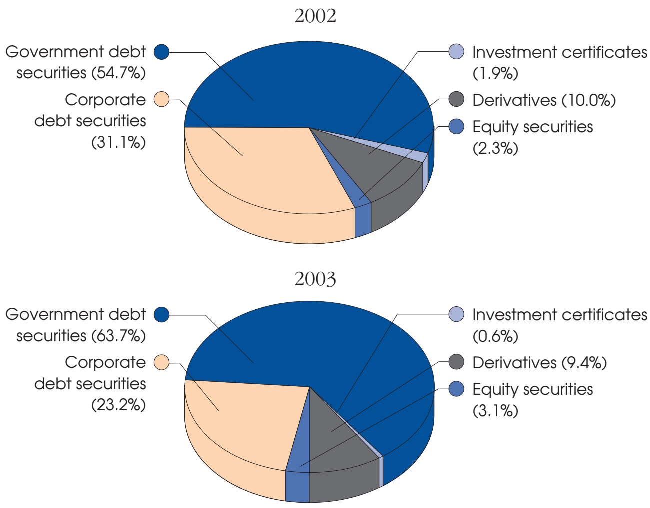


Figure 19
STRUCTURE OF SECURITIES TRANSACTIONS, BROKEN DOWN BY AMOUNT OF TRANSACTIONS
(%)



Private Pension Funds

On 31 December 2003, there were five private pension funds in Latvia: four open pension funds and one closed pension fund. At the end of the year, private pension funds offered a total of 12 pension plans.

On 31 December 2003, the number of pension plan participants amounted to 26 610, which was by 33% more than the year before.

In 2003, contributions to pension plans were made in the amount of 4.7 million lats (compared to 3.9 million lats a year earlier). Of these, 96% were made by employers (compared to 99% in 2002). In the reporting period, individual pension plan participants showed a relatively higher level of activity as compared to the year before. Contributions to pension plans by individual pension plan participants increased fourfold, as the amount of contributions made by employers rose by 19%.

At the end of the reporting period, the pension capital accrued in pension plans accounted for 19.2 million lats, or 37% more than on 31 December 2002.

In 2003, the amount of paid-out pension capital grew twofold as compared to the year before. By the end of the reporting year, the pension capital had been paid out in the amount of 391.5 thousand lats, i.e. 91% of total payments had been paid upon retirement to pension plan participants, while 9% had been allocated upon the participants' death.

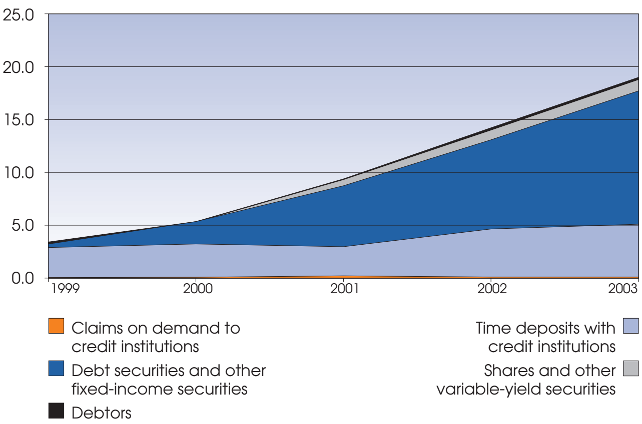
In 2003, pension plan assets rose by 38% as compared to the previous year to 19.3 million lats, or 0.3% of the GDP[39] (the same as in 2002).

Pension plan assets were mainly invested in debt securities, i.e. such investments reached 12.2 million lats, or 64% of total pension plan assets on 31 December 2003 (see Figure 20). In the reporting period, investments in time deposits with credit institutions increased by 17% as compared to the year before. Their share in pension plan assets slightly dropped and comprised 29% on 31 December 2003 (compared to 34% a year earlier).

In 2003, investments abroad rose 1.6 times as compared to 2002 and accounted for 2.7 million lats on 31 December 2003. Of pension plan assets, 16.3 million lats, or 86%, were invested in Latvia (compared to 88% on 31 December 2002). In the reporting year, four percent of investments were made in Lithuania while 3%, in Estonia, 2%, in securities issued by one international financial institution, and the other 5%, in 10 other countries.

The average weighted annual return on pension plans was 6.1%[40].

Figure 20
STRUCTURE OF PENSION PLAN ASSETS
(at end of period; in millions of lats)



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39 Latvia's GDP in 2003 was 5 872.1 million lats, according to data published in the Internet home page of the Central Statistics Board of the Republic of Latvia.
40 Return on investment plans is calculated as the ratio of the pension plan operational result to the arithmetical average of the pension plan for the reporting year, expressed in annual percentage terms.

FINANCIAL STATEMENTS
OF THE FINANCIAL AND CAPITAL MARKET COMMISSION FOR 2003

Management Report on the Budget's Performance

The Financial and Capital Market Commission (hereinafter referred to also as the Commission) has already been operating for two and a half years. It commenced its activities on 1 July 2001 in accordance with the Law on the Financial and Capital Market Commission.

On 6 December 2002, based on Article 7 of the Law on the Financial and Capital Market Commission, by Decision No. 321, the Commission's Board approved the budget of the Financial and Capital Market Commission for 2003, thereby specifying the financing for activities of the Commission and the use of these funds. Pursuant to Article 5 of the Transitional Provisions of the Law on the Financial and Capital Market Commission and Decision No. 320 of the Commission's Board, On the Approval of the Regulations on the Amount of Payments by Financial and Capital Market Participants for Financing the Financial and Capital Market Commission and on the Procedures for Submission of Reports for the Year 2003, adopted on 6 December 2002, financial and capital market participants made payments for financing the Commission; in addition, in 2003, the activities of the Commission were also financed by the Bank of Latvia and the State budget.

The Commission conducted accounting in accordance with the Law on Accounting and, as an autonomous public institution possessing State property, complied with the basic principles set out in the instructions issued by the State Treasury.

During the reporting year, pursuant to Article 6 of the Law on the Financial and Capital Market Commission, the Commission managed the Deposit Guarantee Fund and the Fund for the Protection of the Insured (hereinafter referred to also as the Funds). For the purposes of a clearer presentation, assets of the Funds managed by the Commission are disclosed separately in the balance sheet.

In 2003, assets of the Funds were invested in accordance with the investment policies and investment procedures specified for the Deposit Guarantee Fund and the Fund for the Protection of the Insured, approved by the Commission's Board on 7 February 2003, which envisage investments only in the primary securities market and in the same currency as payments from the Deposit Guarantee Fund and the Fund for the Protection of the Insured should be made. The said investment policies provide for keeping of at least 30% of each Fund's assets in an account held with the Bank of Latvia or in debt securities whose term of redemption does not exceed one year. In 2003, assets of the Funds managed by the Commission were invested in government debt securities issued in compliance with the requirements of the Regulations on the Issue of Latvian State Treasury Securities, approved by Instruction No. 87 issued by the Ministry of Finance on 23 January 2002, as well as in compliance with the provisions of the Agreement on Investing Assets of the Deposit Guarantee Fund and the Fund for the Protection of the Insured in Latvian State Treasury Securities, entered into between the Commission and the State Treasury.

As the Commission falls within the definition of a contracting authority provided by the Law on Procurement for State and Local Government Needs, all procurements were made in accordance with the norms of the said law.

On 1 December 2003, an agreement on the audit of the Commission's financial statements for 2003 was entered into with Ernst & Young Baltic SIA, which was represented by Certified Auditor Diāna Krišjāne. In 2003, the State Audit Office did not perform any audits relating to activities of the Commission.

Funds of the Commission

At the end of 2003, assets of the Commission totalled 16 499 515 lats, of which 15 417 322 lats were managed trust assets, i.e. assets of the Deposit Guarantee Fund and the Fund for the Protection of the Insured. In 2003, activities of the Commission were financed from three sources, i.e. from payments made by the State budget, the Bank of Latvia and financial and capital market participants, except for credit institutions. In 2003, the Commission's equity or net assets accounted for 1 064 683 lats, which had decreased by 75 132 lats compared to the year before. This is related to the fact that initially funds allocated for the establishment of the Commission and commencement of its activities were used for long-term investments and prepaid expenses but the amortisation of these investments in the periods following their recognition is recorded as an expense, thereby reducing the equity. However, the Commission's current and capital expenditure, as well as its financing during the period of transition to the full financing by financial and capital market participants was planned according to the principle of cash flow, which was positive in the said period. Namely, in 2003, the Commission had a positive cash flow in the amount of 192 861 lats and 101 080 lats in the previous year. At the end of 2003, the Commission had a cash balance of 607 113 lats.

Ensuring Activities of the Commission in 2003

Based on the forecasts made for the economic activity of financial and capital market participants for 2003, the Commission had planned its revenues precisely. In 2003, the actual revenues of the Commission were 2 089 579 lats, or 3% more than the planned revenues, as laid down in the budget for 2003 approved by the Board of the Commission on 6 December 2002 (2 027 122 lats). Expenses of the Commission were 2 132 063 lats, or 3.3% less than the planned ones (2 204 871 lats). The largest expense items were comprised of the staff remuneration and compulsory contributions for the State social insurance (69.7% of expenses). The actual excess of expenses over revenues in 2003 was 42 484 lats. This is related to the fact that the Commission's budget was planned according to the principle of cash flow, which was positive in 2002 and 2003. In 2002 and 2003, the revenues of the Commission were lower than the expenses, which can be attributed to the fact that the funds allocated for the establishment of the Commission and commencement of its activities were invested in long-term assets and prepaid expenses, the effect of the amortisation of which, while not affecting the cash flow, reduced the Commission's equity. In 2003, amortisation and depreciation expenses made up 296 773 lats.

Management of the Deposit Guarantee Fund and the Fund for the Protection of the Insured

In the reporting period, revenues of the Deposit Guarantee Fund from credit institution and credit union payments constituted 6 263 766 lats while revenues of the Fund for the Protection of the Insured from payments of insurers, 215 915 lats. Revenues from investments made by the Deposit Guarantee Fund were 402 260 lats while by the Fund for the Protection of the Insured, 39 412 lats. Total assets of these Funds increased by 6 914 765 lats, or 81.3%, that is, assets of the Deposit Guarantee Fund rose by 6 666 026 lats, or 87.2%, while assets of the Fund for the Protection of the Insured, by 248 739 lats, or 29%. At the end of 2003, net financial assets of the Deposit Guarantee Fund comprised 14 311 005 lats while net financial assets of the Fund for the Protection of the Insured, 1 106 317 lats.

In the reporting period, the Commission invested assets of the Funds in both short-term and long-term Latvian State Treasury debt securities. In 2003, the return on assets of the Deposit Guarantee Fund reached 3.66%, while the return of the Fund for the Protection of the Insured, 4.01%. Return on assets was calculated by dividing the sum of investment revenues (received and accrued) of the relevant Fund in 2003 by the average asset value of the relevant Fund in 2003.

Chairman of the Financial
and Capital Market Commission — Uldis Cērps

2 April 2004

Balance Sheet (in Lats)

ASSETS

	Note	31.12.2003	31.12.2002
ASSETS OF THE FUNDS			
LONG-TERM INVESTMENTS		**5 695 626**	**1 036 514**
Investments by the Funds in securities	4	5 695 626	1 036 514
CURRENT ASSETS		**9 721 696**	**7 466 043**
Receivables		**1 779 290**	**686 804**
Due from market participants to the Funds	5	1 779 207	686 804
Settlements related to guaranteed compensation payments from the Funds	2	83	-
Investments by the Funds in securities	4	**7 942 148**	**6 739 069**
Cash		**258**	**40 170**
TOTAL ASSETS OF THE FUNDS		**15 417 322**	**8 502 557**
ASSETS OF THE COMMISSION			
LONG-TERM INVESTMENTS	3	**258 284**	**400 747**
Intangible assets		45 476	75 048
Fixed assets		145 196	236 468
Leasehold improvements		36 870	59 662
Prepayments for long-term investments		30 742	29 569
CURRENT ASSETS		**823 909**	**755 623**
Stock		**45**	**370**
Accounts receivable		**204 626**	**156 494**
Due from market participants to the Commission	6	199 014	152 951
Other receivables		4 107	2 159
Due from the personnel		782	1 384
Overpaid taxes	7	723	-
Prepaid expenses	8	**12 125**	**184 507**
Cash		**607 113**	**414 252**
TOTAL ASSETS OF THE COMMISSION		**1 082 193**	**1 156 370**
TOTAL ASSETS		**16 499 515**	**9 658 927**

The accompanying notes on pages 37 to 43 form an integral part of these financial statements.

Balance Sheet (in Lats)

LIABILITIES

	Note	31.12.2003	31.12.2002
LIABILITIES OF THE FUNDS			
EQUITY	9	**15 417 322**	**8 502 557**
Net financial assets of the Funds (budget result)		15 417 322	8 502 557
PAYABLES		-	-
TOTAL LIABILITIES OF THE FUNDS		**15 417 322**	**8 502 557**
LIABILITIES OF THE COMMISSION			
EQUITY	9	**1 064 683**	**1 139 815**
Net assets of the Commission (budget result)		1 064 683	1 139 815
PAYABLES		**17 510**	**16 555**
Accounts payable to suppliers	10	17 341	16 522
Accounts payable for remuneration and deductions		69	-
Taxes		-	33
Prepayments for financing the Commission		100	-
TOTAL LIABILITIES OF THE COMMISSION		**1 082 193**	**1 156 370**
TOTAL LIABILITIES		**16 499 515**	**9 658 927**

The accompanying notes on pages 37 to 43 form an integral part of these financial statements.

Chairman of the Financial and
Capital Market Commission — Uldis Cērps

Head of
the Accounting Division — Rita Vanaga

2 April 2004

Statement of Income and Expenses (in Lats)

	Note	2003	2002
REVENUES			
REVENUES RELATED TO SUPERVISION OF CREDIT INSTITUTIONS AND CREDIT UNIONS		1 204 567	1 202 957
Payments by the Bank of Latvia		1 200 000	1 200 000
Payments by credit unions	11	4 567	2 957
REVENUES RELATED TO SUPERVISION OF INSURANCE		649 453	543 699
Payments by life insurance companies		32 944	26 873
Payments by other insurance companies	11	616 509	516 826
REVENUES RELATED TO SUPERVISION OF THE SECURITIES MARKET AND PENSION FUNDS		235 558	248 962
State budget		150 000	198 962
Payments by securities market participants and private pension funds		85 558	50 000
Securities market participants		66 605	35 791
Private pension funds		18 953	14 209
Other[41]		1	3
TOTAL REVENUES		**2 089 579**	**1 995 621**
EXPENSES			
Staff remuneration and other payments		(1 485 469)	(1 541 487)
Staff remuneration and other payments	12	(1 225 698)	(1 259 303)
State social insurance compulsory contributions		(259 771)	(282 184)
Staff insurance	13	(82 960)	(69 493)
Improvements of professional skills and business trips		(67 381)	(60 114)
Telecommunication and information		(35 820)	(37 832)
Public awareness and external and internal communications		(17 615)	(28 223)
Maintenance expenses		(71 147)	(67 936)
Professional services		(41 682)	(24 353)
Participation in international organisations		(9 195)	(9 489)
Depreciation/amortisation/write-off of capital investments	3	(24 021)	(19 051)
TOTAL EXPENSES		**(1 835 290)**	**(1 857 978)**
Excess of revenues over expenses		**254 289**	**137 643**
Expenses for the establishment of the Commission and commencement of its activities	3, 14	**(296 773)**	**(300 358)**
BUDGET RESULT		**(42 484)**	**(162 715)**

The accompanying notes on pages 37 to 43 form an integral part of these financial statements.

Chairman of the Financial and
Capital Market Commission — Uldis Cērps

Head of
the Accounting Division — Rita Vanaga

2 April 2004

[41] Income from interest on the balance of debit cards of the Commission.

Cash Flow Statement (in Lats)

	Note	2003	2002
RECEIPTS			
RECEIPTS RELATED TO SUPERVISION OF CREDIT INSTITUTIONS AND CREDIT UNIONS		1 204 177	1 202 042
Payments by the Bank of Latvia		1 200 000	1 200 000
Payments by credit unions		4 177	2 042
RECEIPTS RELATED TO SUPERVISION OF INSURANCE		623 964	530 097
Payments by life insurance companies		32 100	24 532
Payments by other insurance companies		591 864	505 565
RECEIPTS RELATED TO SUPERVISION OF THE SECURITIES MARKET AND PENSION FUNDS		215 374	241 067
State budget		150 000	198 962
Payments by securities market participants and private pension funds		65 374	42 105
Securities market participants		48 507	33 382
Private pension funds		16 867	8 723
Other		100	-
TOTAL RECEIPTS		**2 043 615**	**1 973 206**
PAYMENTS			
Staff remuneration and other payments		(1 486 148)	(1 542 426)
Staff remuneration and other payments		(1 226 376)	(1 260 280)
State social insurance compulsory contributions		(259 772)	(282 146)
Staff insurance		(82 962)	(54 585)
Improvements of professional skills and business trips		(70 767)	(64 053)
Telecommunication and information		(30 940)	(42 249)
Public awareness and external and internal communications		(20 770)	(24 674)
Maintenance expenses		(71 086)	(70 445)
Professional services		(38 142)	(25 041)
Participation in international organisations		(9 159)	(9 837)
TOTAL PAYMENTS		**(1 809 974)**	**(1 833 310)**
INVESTMENT ACTIVITIES			
Capital expenditure		(40 780)	(38 816)
TOTAL INVESTMENT ACTIVITIES		**(40 780)**	**(38 816)**
Net change in cash during the reporting period		**192 861**	**101 080**
Net change in cash from the cash flow of establishment of the Commission and commencement of its activities	14	-	**(61 885)**
Cash balance at the beginning of the reporting period		**414 252**	**375 057**
Cash balance at the end of the reporting period		**607 113**	**414 252**

The accompanying notes on pages 37 to 43 form an integral part of these financial statements.

Chairman of the Financial and
Capital Market Commission — Uldis Cērps

Head of
the Accounting Division — Rita Vanaga

2 April 2004

Statement of Changes in Equity (in Lats)

	Note	Result of Commission establishment and commencement of activities budget	Result of Commission financing budget	**Equity (net assets) of the Commission**	Net financial assets of the Deposit Guarantee Fund	Net financial assets of the Fund for the Protection of the Insured	**Equity (net financial assets) of the Funds**
Budget result 31.12.2001		**739 262**	**610 982**	**1 350 244**	**5 099 690**	**656 279**	**5 755 969**
Fixed asset depreciation/ write-off charged to the budget result	1, 3	-	(47 714)	**(47 714)**	-	-	-
Budget result of the reporting period		(300 358)	137 643	**(162 715)**	2 545 289	201 299	2 746 588
Budget result 31.12.2002		**438 904**	**700 911**	**1 139 815**	**7 644 979**	**857 578**	**8 502 557**
Fixed asset depreciation/ write-off charged to the budget result	1, 3	-	(32 648)	**(32 648)**	-	-	-
Budget result of the reporting period	3, 14	(296 773)	254 289	**(42 484)**	6 666 026	248 739	**6 914 765**
Budget result 31.12.2003		**142 131**	**922 552**	**1 064 683**	**14 311 005**	**1 106 317**	**15 417 322**

The accompanying notes on pages 37 to 43 form an integral part of these financial statements.

Chairman of the Financial and Capital Market Commission — Uldis Cērps

Head of the Accounting Division — Rita Vanaga

2 April 2004

Notes to the Financial Statements

The Financial and Capital Market Commission (hereinafter – the Commission) was established and operates under the Law on the Financial and Capital Market Commission.
The objective of activities of the Commission is to promote the protection of interests of investors, depositors and the insured as well as the development and stability of the financial and capital market.

1. Accounting Policies of the Commission

Basis for Preparation of the Financial Statements
The financial statements were prepared based on the principles set out in Instruction No. 3 issued by the State Treasury on the Preparation of Semi-annual Reports, Nine-month Reports, Annual Reports for State Budget Institutions and Annual Reports for Local Government Budget Institutions.

The accounting principles applied were consistently used also when preparing the financial statements for the previous years.

The Commission presented all assets and liabilities, including those of the Deposit Guarantee Fund and the Fund for the Protection of the Insured, in a single balance sheet. The Commission reflected all revenues and expenses related to its financing as well as revenues and expenses of the Deposit Guarantee Fund and the Fund for the Protection of the Insured in a single statement of income and expenses.

Also, the cash flow statement and the statement of income and expenses of the Deposit Guarantee Fund and the Fund for the Protection of the Insured were prepared as separate notes to the financial statements.

The financial statements prepared regarding the result of the budget of the Commission's establishment and commencement of its activities include separate notes. The assets acquired at the launch of the Commission's activities were used to ensure activities of the Commission; consequently, these assets were included in the consolidated balance sheet of the Commission.

Accounting Principles Applied
The financial statements were prepared in compliance with the following accounting principles:
- Accounting is performed on an accrual basis providing for recognition of revenues and expenses in the financial statements at the date of occurrence, irrespective of the related cash flows. Revenues are calculated on the basis of payments of the Bank of Latvia and the State budget specified by law as well as on the basis of business operations performed by financial and capital market participants, which are reported in the submitted financial statements and from which payments to be made are calculated. Expenses are recognised at the date of occurrence, with the exception of vacation reserves, which are not included in salary payments. Taking into account the procedure prescribed by the By-law of the Commission regarding the calculation of bonus and material assistance payments and funds provided for such purposes, vacation reserves are not calculated, and the management of the Commission does not regard the setting up of such reserves as efficient.
- Assets are recognised at historic cost. Assets are booked on the date of their acquisition in the amount of paid cash or cash equivalents, or at the fair value of other consideration provided plus any other costs related directly to the acquisition.
- Transactions and other events are reflected by taking into account the principle of substance over form stating that transactions and events should be recognised and disclosed according to their contents and economic substance and not only according to their legal form.
- The financial statements have been prepared on a going concern basis.

Fixed assets
Long-term investments are recognised in accordance with the basic principles as set out in the Instructions of the Ministry of Finance for the Accounting of State (Local Government) Budget Institutions and Local Government Budgets. Depreciation rates for long-term investments are applied in compliance with Regulation No. 96 issued by the Cabinet of the Republic of Latvia on 6 March 2001, On Fixed Asset Depreciation Rates for Budget Institutions, which stipulates the following annual depreciation rates:

• computers and equipment	35%;
• other fixed assets	20%.

The Commission applied such depreciation rates to fixed assets acquired after 31 December 2000, as well as to those assets acquired before 31 December 2000 whose residual useful life on 29 August 2001 was more than half of the useful life determined for a new fixed asset.

An annual 50% depreciation rate was applied to fixed assets taken over from budget institutions (the Insurance Supervision Inspectorate, the Securities Market Commission and the Deposit Guarantee Fund Administration) on 1 July 2001 which were acquired before 31 December 2000 and the residual useful life of which on 29 August 2001 was less than half of the useful life determined for a similar new asset. The amount of depreciation for these fixed assets at the date of preparing the financial statements is not calculated any more, since it has reached the fully amortised value. The residual value of these fixed assets remains unchanged up to the end of their use – 5 lats per each fixed asset. The Commission does not charge the amount of depreciation for fixed assets acquired before 31 December 2000 to the statement of income and expenses, instead the book value of fixed assets in the Commission's balance sheet and the Commission's equity (net assets) is decreased by this amount. Such a method is provided by the Regulations on Fixed Asset Depreciation Rates for Budget Institutions, for in the respective budget institutions fixed assets were expensed in their full value at the date of acquisition and a corresponding fixed asset fund for this amount was credited to equity. The amount of depreciation calculated for other fixed assets, i.e. those acquired after 31 December 2000, was charged to the Commission's statement of income and expenses.

The following annual depreciation rates were applied to leasehold improvements:

- security systems 33%;
- fixings 20%.

Depreciation/amortisation of leasehold improvements was charged to the statement of income and expenses.

Securities
Securities in the possession of the Commission are being held to maturity. The valuation of long-term securities was performed using the effective interest rate amortisation method. The valuation of short-term securities was performed using the straight-line discount amortisation method.

Accounts Receivable
The Commission as a State institution constantly makes sure that payments by market participants are made on a timely basis. In case of a doubtful debtor, the debtor will be excluded from the balance sheet item *Accounts receivable* by decreasing revenues of the Commission in that reporting period in which the debtor has been excluded.

2. Actual Result of Revenues and Expenses and Cash Flows of the Deposit Guarantee Fund and the Fund for the Protection of the Insured (in Lats)

	Actual result of revenues and expenses in 2003	Actual result of revenues and expenses in 2002
REVENUES		
Payments to the Deposit Guarantee Fund	6 263 766	2 340 149
Payments by credit institutions	6 258 796	2 340 149
Payments by credit unions	4 970	-
Payments to the Fund for the Protection of the Insured	215 915	173 940
Payments by life insurance companies	34 674	25 273
Payments by other life insurance companies	181 241	148 667
Income from investments	441 672	232 499
In the Deposit Guarantee Fund	402 260	205 140
In the Fund for the Protection of the Insured	39 412	27 359
TOTAL REVENUES	**6 921 353**	**2 746 588**
EXPENSES		
Guaranteed compensation payments from the Fund for the Protection of the Insured	(6 588)	-
TOTAL EXPENSES	**(6 588)**	-
RESULT	**6 914 765**	**2 746 588**

	Cash flow in 2003	Cash flow in 2002
RECEIPTS		
Payments to the Deposit Guarantee Fund	5 182 573	2 187 194
Payments by credit institutions	5 179 138	2 187 194
Payments by credit unions	3 435	-
Payments to the Fund for the Protection of the Insured	204 706	156 175
Payments by life insurance companies	35 362	24 399
Payments by other insurance companies	169 344	131 776
Income from investments	377 933	192 702
In the Deposit Guarantee Fund	341 328	171 075
In the Fund for the Protection of the Insured	36 605	21 627
TOTAL RECEIPTS	**5 765 212**	**2 536 071**
INVESTMENT ACTIVITIES		
Investments in securities	**(13 357 349)**	**(7 601 540)**
Investments by the Deposit Guarantee Fund	(12 335 904)	(6 851 449)
Investments by the Fund for the Protection of the Insured	(1 021 445)	(750 091)
Investments by the Fund for the Protection of the Life Insured	(215 461)	(174 654)
Investments by the Fund for the Protection of Other Insured	(805 984)	(575 437)
Repayment of securities	**7 558 896**	**5 105 609**
Repayment of investments by the Deposit Guarantee Fund	6 812 129	4 493 227
Repayment of investments by the Fund for the Protection of the Insured	746 767	612 382
Repayment of investments by the Fund for the Protection of the Life Insured	175 363	145 581
Repayment of investments by the Fund for the Protection of Other Insured	571 404	466 801
RESULT OF INVESTMENT ACTIVITIES	**(5 798 453)**	**(2 495 931)**
EXPENSES		
Guaranteed compensation payments from the Fund for the Protection of the Insured	(6 671)	-
TOTAL EXPENSES	**(6 671)**	-
RESULT	**(39 912)**	**40 140**
Cash balance at the beginning of the reporting period	**40 170**	**30**
Cash balance at the end of the reporting period	**258**	**40 170**

In order to protect the interests of the insured, by 6 December 2002 Decision No. 322, On the Procedure for Making Payments from the Fund for the Protection of the Insured in *AK Alianse's* Case of Bankruptcy, the Board of the Commission established the procedure for the administration of payments from the Fund for the Protection of the Insured to the administrator of the joint stock insurance company *AK Alianse* in liquidation. In protecting the interests of the insured, the insurance indemnity payments from the Fund for the Protection of the Insured in this company's bankruptcy case made up 6 671 lats. In 2003, 6 588 lats of this money were paid out in insurance indemnities.

In the statement of income and expenses, revenues from payments by other insurance companies to the Fund for the Protection of the Insured have been decreased by 110 lats in connection with the liquidation process of one insurance company.

3. Long-term Investments

	Intangible assets	Fixed assets					
	Licences and software	Computers and office equipment	Transport vehicles	Other fixed assets	Leasehold impro-vements	Prepayments for long-term investments	Total
Book value 31.12.2002	**75 048**	**115 732**	**20 942**	**99 794**	**59 662**	**29 569**	**400 747**
Additions	19 631	19 256	-	1 466	-	1 173	41 526
Revaluated	-	925	-	(873)	-	-	52
Write-offs and disposals	(6 882)	(36 531)	-	(7 279)	-	-	(50 692)
On 31.12.2003	**87 797**	**99 382**	**20 942**	**93 108**	**59 662**	**30 742**	**391 633**
Depreciations							
Charge	48 143	69 965	5 906	31 309	22 792	-	178 115
Reversal due to disposals	(5 822)	(33 243)	-	(5 701)	-	-	(44 766)
On 31.12.2003	**42 321**	**36 722**	**5 906**	**25 608**	**22 792**	**-**	**133 349**
Book value 31.12.2003	**45 476**	**62 660**	**15 036**	**67 500**	**36 870**	**30 742**	**258 284**

On 31 December 2003, prepayments for long-term investments were made in the amount of 30 742 lats, i.e. for the development of the statistical information system in electronic format, which is provided for the compilation, storage and processing of statistical information regarding financial and capital market participants, in the amount of 30 048 lats and for the computer facilities in the amount of 694 lats.

	Charge	Write-offs or disposals	Revaluated	Additions (exchange during the warranty period)	Total
Depreciation/amortisation/ write-off of capital investments	150 987	908	(554)	(408)	150 933[42]
Fixed asset depreciation/ write-off charged to the budget result	27 128	5 018	502	-	32 648
	178 115	5 926[43]	(52)	(408)	183 581

[42] A total of the Commission's depreciation/amortisation/write-off of capital investments is made up of long-term investments made from the funds of the budget for the Commission's establishment and commencement of its activities (see Note 14), depreciation in the amount of 126 912 lats and depreciation of other fixed assets, changes in their value and write-off in the amount of 24 021 lats (see the Commission's statement of income and expenses).

43 The value of write-offs and disposals for long-term investments is made up of the difference between historic cost write-offs and depreciation write-offs.

4. Investments in Securities

This item contains purchased Latvian Government debt securities. The value of long-term debt securities was disclosed in the balance sheet at amortised cost. The value of short-term debt securities was disclosed in the balance sheet at the present value.

Securities of the Funds were placed in the following issues of Latvian Government debt securities:

Term Structure for Investments by the Funds on 31 December 2003

Issue No.	Issue date	Maturity date	Annual rate of return (%)	Nominal value (in lats)	Book value (in lats)
LV0000580017	14.02.2003	14.02.2013	4.89	3 785 000	4 004 740
LV0000570034	08.05.2002	08.05.2007	5.18	1 618 300	1 651 449
LV0000560035	29.08.2003	29.08.2006	3.97	38 900	39 437
LV0000540755	03.12.2003	03.12.2004	3.62	717 800	694 272
LV0000540748	24.09.2003	24.09.2004	3.49	1 047 100	1 020 811
LV0000540730	06.08.2003	06.08.2004	3.14	1 590 300	1 560 681
LV0000540722	07.05.2003	07.05.2004	3.18	3 000 700	2 967 612
LV0000532026	22.10.2003	23.04.2004	3.31	1 680 500	1 663 181
LV0000532018	02.07.2003	02.01.2004	2.85	35 600	35 591
				13 514 200	13 637 774

Term Structure for Investments by the Funds on 31 December 2002

Issue No.	Issue date	Maturity date	Annual rate of return (%)	Nominal value (in lats)	Book value (in lats)
LV0000570034	08.05.2002	08.05.2007	5.50	1 028 000	1 036 514
LV0000531986	07.08.2002	07.02.2003	3.68	928 500	924 749
LV0000540698	17.04.2002	17.04.2003	4.61	5 252 800	5 180 720
LV0000540714	05.12.2002	05.12.2003	3.33	653 500	633 600
				7 862 800	7 775 583

At the end of the reporting period, the breakdown of the accrued income included in the book value of securities was as follows:

	31.12.2003	**31.12.2002**
Accrued income of the Deposit Guarantee Fund	402 260	163 784
Accrued income of the Fund for the Protection of the Insured	39 412	20 332
	441 672	184 116

5. Due from Market Participants to the Funds

This item contains amounts due from financial and capital market participants to the Deposit Guarantee Fund and the Fund for the Protection of the Insured for the fourth quarter ended 31 December 2003 and the fourth quarter ended 31 December 2002, respectively. At the end of 2003, there was an overdue payment in the amount of 127 lats from three market participants for the third quarter ended 30 September 2003. In 2003, the amount of 110 lats overdue at the end of 2002 was excluded from the amount due from market participants to the Fund for the Protection of the Insured and the revenues for the reporting year were reduced by this amount in connection with the liquidation process of the respective insurance company (see Note 2).

	31.12.2003	**31.12.2002**
Due from market participants to the Deposit Guarantee Fund	1 720 032	638 838
Due from credit institutions	1 718 502	638 838
Due from credit unions	1 530	-
Due from market participants to the Fund for the Protection of the Insured	59 175	47 966
Due from life insurance companies	7 219	7 907
Due from other insurance companies	51 956	40 059
	1 779 207	686 804

6. Due from Market Participants to the Commission

This caption contains amounts due from financial and capital market participants to the Commission on the date set out in the statement for the fourth quarter ended 31 December 2003 and the fourth quarter ended 31 December 2002, respectively. At the end of 2003, there was an overdue payment in the amount of 213 lats from one market participant for the third quarter ended 30 September 2003. On 10 February 2004, the market participant settled its liabilities with the Commission. At the end of 2002, the amount of 4 224 lats overdue at the end of 2003 was excluded from the amount due from market participants to the Commission and the revenues for the reporting year were reduced by this amount in connection with the liquidation process of the respective insurance company (see Note 11).

7. Taxes

Type of tax	Balance on 31.12.2002	Calculated for the reporting period	Decreased compulsory contribution result	Paid in the reporting period	Balance on 31.12.2003
Liabilities for State social insurance compulsory contributions/(overpayment)	-	358 303	(1 078)	(357 225)	-
Resident income tax liabilities/(overpayment)	33	281 008	-	(281 764)	(723)
	33	639 311	(1 078)	(638 989)	(723)

Including:	**31.12.2003**	**31.12.2002**
Tax liabilities/(overpayment)	-	-
Resident income tax liabilities/(overpayment)	(723)	33

The amount of compulsory contribution was decreased according to the data of the State Revenue Service.

8. Prepaid Expenses

	31.12.2003	**31.12.2002**
Prepayment for rent of premises until 9 January 2004	4 110	173 971
Software subscription fee	3 164	-
Periodic literature	2 177	2 557
Membership dues	1 499	1 535
Other prepaid expenses	1 175	6 444
	12 125	184 507

9. Equity

This item represents net assets of the Commission (total budget result) and net financial assets of the Funds managed by the Commission (budget result). Changes thereof are disclosed in the statement of changes in equity and notes thereto.

10. Accounts Payable to Suppliers and Contractors

This item contains payables for the materials and services supplied to the Commission in the reporting year on the date indicated in the statement.

11. Revenues of the Commission

Revenues from credit union payments have been reduced by two lats in connection with the liquidation process of one credit union. Revenues from payments by other insurance companies have been reduced by 4 244 lats in connection with the liquidation process of one insurance company.

12. Staff Remuneration and Other Payments

This line contains remuneration to the staff of the Commission, including remuneration to the Board in the amount of 211 215 lats, or 17.23% of total remuneration expenses. At the end of 2003, 87 employees were employed by the Commission and there were 88 positions at the Commission by the end of the year.

13. Staff Insurance

The actual expenses related to the Commission' s staff insurance are as follows:

	2003	**2002**
Endowment life insurance	60 399	47 940
Health insurance	17 051	11 770
Accident insurance	5 510	9 783
	82 960	69 493

In 2003, in accordance with the Procedure for Health Insurance, Accident Insurance and Endowment Life Insurance for the Commission's Staff, approved by the Board of the Commission, the Commission effected insurance for its staff, namely, endowment life insurance for those employees who had been employed by financial and capital market supervisory authorities for at least five years, as well as endowment life insurance for the Commission's Board members.

14. Expenses Related to the Budget for the Commission's Establishment and Commencement of its Activities

In 2002, the Commission finished utilising the funds provided for its establishment and commencement of its activities. The expenses related to the establishment of the Commission and commencement of its activities, as shown in the statement of income and expenses for 2003, were made up of the payment for the rent of premises, which was effected from the funds allocated for the establishment of the Commission and commencement of its activities, of amortisation in the reporting period in the amount of 169 861 lats and the depreciation calculated for fixed assets and leasehold improvements, which were effected from the funds allocated for the establishment of the Commission and commencement of its activities, in the amount of 126 912 lats. These expenses in the amount of 296 773 lats were disclosed separately in the statement of income and expenses for the reporting period, and its result was included in the Commission's budget result.

15. Significant Contracts

On 5 December 2000, a contract between the Bank of Latvia and *SIA Drave* was concluded for the rent of premises at 1 Kungu Street, Riga, for 10 years, which was renewed between the Commission and *SIA Drave* on 2 August 2001. The expenses related to the rent of the Commission's premises totalled USD 68 493 per quarter (USD 273 972 per year). Upon agreement in writing between the Commission and the lesser, the contract may be terminated before its expiry date. The Commission has no intention to terminate the contract.

On 16 August 2002, the Commission entered into an agreement with *SIA Datorikas institūts DIVI* on the development of a system for statistical information in electronic form, which stipulates settling of liabilities for the remaining operations related to the system development in the amount of 19 310 lats.

16. Court Proceedings and Claims

When performing functions specified by the Law on the Financial and Capital Market Commission, the Commission may become involved in court proceedings related to supervisory activities. In the reporting period, as a defendant, the Commission was involved in twelve court proceedings contesting administrative acts or decisions adopted, or actual actions performed, by the Commission. At the moment of signing the financial statements, the Commission, as a defendant, was involved in one court proceeding of property nature. On 18 March 2004, based on an application submitted by a natural person to the Administrative District Court requesting the cancellation of Decision No. 4 of the Commission's Board taken on 16 December 2003 and recovery of 19 027.28 lats from the Commission in favour of the said natural person, a court proceeding was initiated at the Administrative District Court. The management of the Commission is of the opinion that the said decision is unfounded and the application to the court should be completely rejected.

AUDITORS' REPORT

To the Parliament of the Republic of Latvia

We have audited the accompanying financial statements of the Financial and Capital Market Commission (hereinafter – the Commission) for the year ended 31 December 2003, set out on pages 32 through 43, which comprise the balance sheet, the statements of income and expense, cash flows and changes in equity and the related notes. These financial statements are the responsibility of the Commission's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing issued by the International Federation of Accountants. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

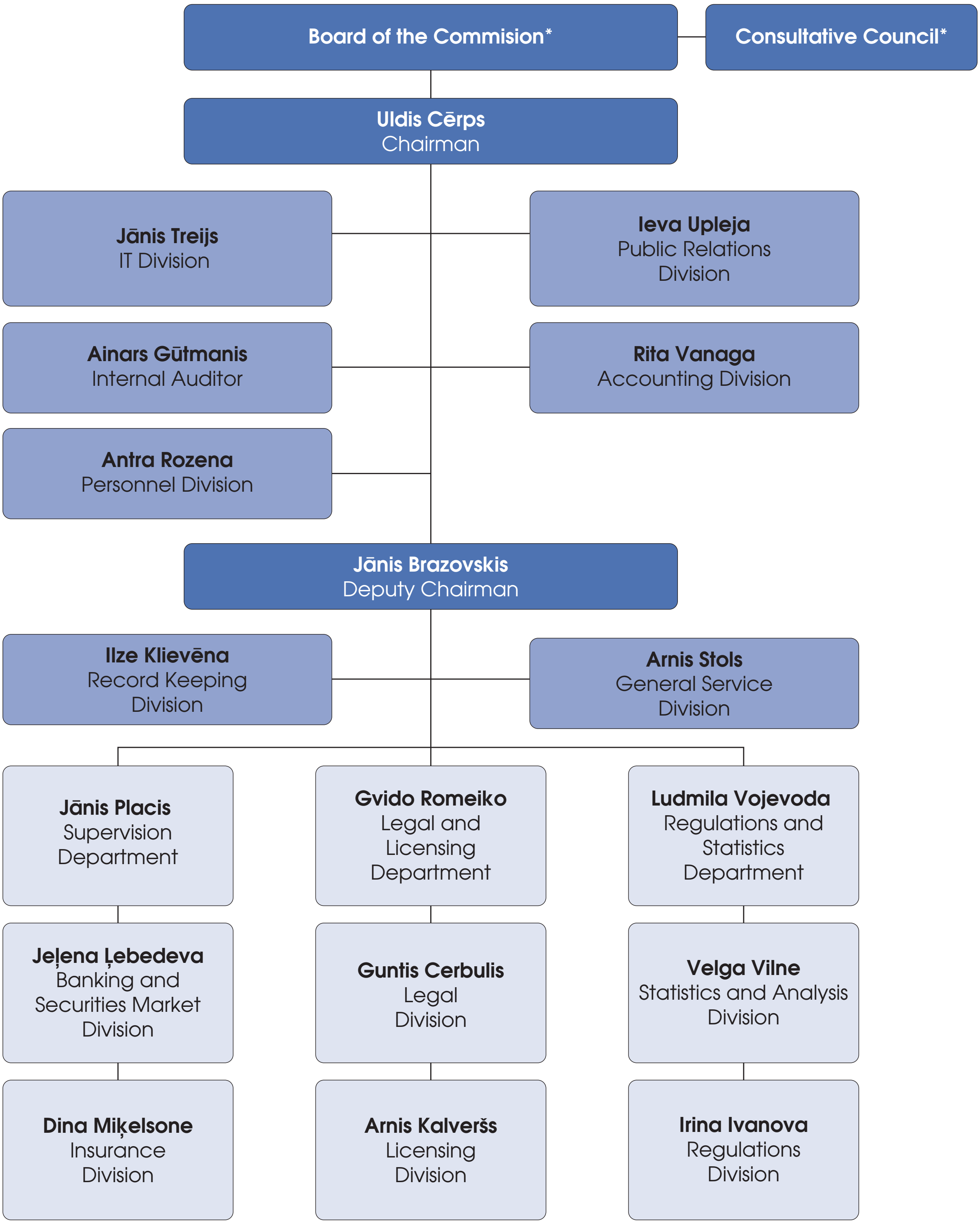
In our opinion, the financial statements referred to above give a true and fair view of the financial position of the Financial and Capital Market Commission as of 31 December 2003, and of the results of its operations and its cash flows for the year then ended in accordance with the accounting policies of the State Treasury instructions of the Republic of Latvia as adopted by the Financial and Capital Market Commission.

Ernst & Young Baltic SIA
License No. 17

Diāna Krišjāne
Personal ID code: 250873-12964
Chairperson of the Board
Latvian Sworn Auditor
Certificate No. 124

Riga,
2 April 2004

Structure of the Financial and Capital Market 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 the departments of the Commission.
** The Consultative Council of the Financial and Capital Market is formed on a parity basis from representatives of the Commission and heads of professional organisations of financial and capital market participants.

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A complete list of financial and capital market participants is available on the Internet home page of the Commission.