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List of Abbreviations

Capital requirements directive – Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast)
Commission – the Financial and Capital Market Commission
Consultative Council – the Consultative Council of the Financial and Capital Market Commission
DGF – Deposit Guarantee Fund
EEA – European Economic Area
EU – European Union
Financial Intelligence Unit – Office for the Prevention of Laundering of Proceeds Derived from Criminal Activity
FPI – Fund for the Protection of the Insured
ICAAP – internal capital adequacy assessment process
LFIM – Law on the Financial Instruments Market
Stock Exchange – JSC "NASDAQ OMX Riga"

Year 2008 in Latvia and in the World

In 2008, there were notable shocks and complicated challenges in financial and capital markets. It was a year of the crisis and changes. In parallel with the global financial crisis Latvia experienced a rapid economic downturn and recession. Though the interaction of these conditions notably affected the Latvian financial system, especially the banking sector, overall the stability of the Latvian financial sector was maintained during 2008 and compliance with all key banking regulatory requirements was ensured due to the ongoing supervisory activity, regular monitoring of the recent data as well as a more prudent banking in those conditions.

During the year, the volume of assets of Latvian banks grew by 6% or 1.3 billion lats. At the end of the year, the average liquidity indicator of Latvian banks was 52.8% (regulatory minimum requirement was 30%) and capital adequacy was 11.8% (regulatory minimum requirement was 8%). In general, Latvian banks finished the year with a profit of 78 million lats. At the same time, profitability of Latvian banks diminished significantly and profit was 79% less than in the previous reporting year.

Where during the previous five years the volume of deposits with Latvian banks grew on average by 21%–37% annually, as of autumn 2008 total deposits were decreasing gradually and reached a level that was 4% lower than at the end of 2007. As well, at the end of 2008 the total credit portfolio of banks started to shrink as a result of both unavailable financial resources on financial markets and the economic situation in the country – deteriorating solvency of households triggered by the fall in GDP, persistently high inflation, unemployment and diminishing incomes that notably restricted the possibilities to receive and to repay loans. Therefore, banks' provisions for non-performing loans were four times larger at the end of the year than in the previous year representing an increase of 262 million lats. In accordance with the forecasts of the Financial and Capital Market Commission (hereinafter, the Commission), total bank provisions for non-performing loans at end-2008 were 2.1% of the credit portfolio and the share of overdue loans in all types of lending had grown from 6.8% at the end of 2007 to 15% at end-2008.

In that situation, the most important task was to stabilise the system and project the possible future development. For this reason, when one of the largest Latvian commercial banks experienced an extensive ebbing of deposits and liquidity problems, the authorities applied an unprecedented mechanism for the stabilisation of the Latvian banking sector – taking over of the bank by the state and providing the bank with the necessary financial support. On 8 November 2008, the Latvian government took a decision on the takeover of the JSC "Parex banka" (for a full description of the takeover, please see the Chapter "Takeover of JSC "Parex banka" by the State for Controlling").

Both the Commission's experts and the management were actively involved in the takeover; they worked out the respective documentation (including the Law on Bank Takeover) and provided operative financial analysis to the government and international investors about the real situation of the JSC "Parex banka". The Commission's staff was working under very tense schedules; they participated in negotiations for attracting the funding, prepared the documentation for the European Union (EU) bodies for receiving the European Commission's permission for the takeover and took part in developing the restructuring plan of the bank. The Commission's staff demonstrated a high-level competence and professionalism in 2008, having an exceptional workload and performing the functions that were beyond the Commission's responsibility. In 2008, supervision was carried out also in the form of an active dialogue with the professional associations of market participants and effective solutions for various issues were searched in a close and regular cooperation with the Association of Latvian Commercial Banks, Latvian Insurance Association, Latvian Chamber of Commerce and Industry, Employers' Confederation of Latvia and Latvian-American Financial Forum. Moreover, once a quarter the Commission's management informed foreign ambassadors and embassy representatives about the topical events on the financial market.



Irēna Krūmane

Chairwoman, Financial and
Capital Market Commission

In 2008, Chairwoman of the Commission together with Prime Minister, Minister of Finance and Governor of the Bank of Latvia signed a letter to the Managing Director of the International Monetary Fund whereby an international loan to Latvia was ensured. This work is ongoing: regular reports and summary analysis about the Latvian banking sector are prepared for the International Monetary Fund and the tasks as set out in the letter for stabilising the sector and improving the regulation are carried out.

At various stages of the crisis problem issues were uncovered and innovative solutions searched. The above-mentioned financial turmoil and slowdown of economic activity throughout the European Economic Area (EEA) triggered a conclusion about the necessity to reform the regulation of the financial sector and supervision thereof. In October 2008, the European Commission requested establishment of a high-level group of senior officials whose activity was aimed at analysing the causes of the crisis and developing proposals for a new regulation, stronger supervision and global cooperation to ensure financial stability. A novelty was the formation of a joint supervisory system and establishment of a completely new strategic body, the European Systemic Risk Board. That Board together with the national supervisory authorities of all Member States will ensure an efficient early warning system for addressing probable risks.

An important aspect was increasing the capacity of national supervisory authorities and ensuring their complete independence on any political influence or direct subordination. For strengthening the supervisory authorities, the working group urged the authorities to ensure that the respective staff received appropriate salaries and necessary training and to implement an efficient staffing policy. All in all, the report of the working group made 31 proposals for enhancing cross-border supervision, coordinating the activities of national supervisory authorities, exchanging information and ensuring an early warning system for addressing the potential financial risks.

We still have many tasks to accomplish and we will cooperate closely with market participants and international institutions to ensure stability in the sector by implementing reforms in the financial sector supervision and following the structural changes in the Latvian economy that would ensure opportunities for development and growth at a new level already in a foreseeable future.

Chairwoman, Financial and
Capital Market Commission



Irēna Krūmane

Report of the Board of the Financial and Capital Market Commission

In accordance with the Law on the Financial and Capital Market Commission, the Commission supervised and issued regulations governing the activities of banks, credit unions, insurance undertakings and insurance intermediaries, participants of the financial instruments market as well as private pension funds.

The Commission had been operating as a full-fledged and autonomous public institution as of 1 July 2001.

The activities of the Commission were fully funded from the payments by the participants of the financial and capital market.

The Commission was managed by its Board. On 28 April

2008, the Saeima (Parliament) approved Irēna Krūmane Chairwoman of the Commission. Uldis Cērps, the previous Chairman of the Commission, was released from the position upon his own volition. The membership of the Board remained the same in the reporting year and was as follows: Deputy Chairman Jānis Brazovskis and Board members Ludmila Vojevoda, Jānis Placis and Gvido Romeiko.

In 2008, 57 Board meetings were held during which 186 decisions were taken. In parallel, nine meetings of the Consultative Council of the Financial and Capital Market Commission (hereinafter, the Consultative Council) took place during which draft regulations binding on the financial and capital market were discussed. The Consultative Council was notified, on a regular basis, on the funds accumulated in the Deposit Guarantee Fund and in the Fund for the Protection of the Insured and the management of these funds. The Consultative Council assessed and approved draft budget of the Commission for 2009 and the Commission's work programme for 2009.

During the reporting year, within its supervision function the Commission carried out 29 inspections in banks and one inspection in a cooperative credit union. Moreover, two inspections of investment service providers and one on-site inspection of a private pension fund were carried out. The Commission also performed five full-scope inspections of non-life insurance undertakings and reviewed 110 applications by natural persons and legal entities regarding the activities of insurance undertakings.

In order to assess the anti-money laundering measures, in 2008 the Commission carried out nine inspections in banks and 10 inspections in other financial institutions of which nine were related to the supervision of an insurance intermediary that provided life insurance services and one with the supervision of an investment management company.

To uncover and prevent any possible market manipulation and, consequently, foster sound performance of the financial instruments market, in 2008 the Commission supervised trading in financial instruments on a regular basis by following the orders submitted to the stock exchange and the operations performed therein, analysing them and, where necessary, taking decisions on the sanctions to be applied.

Within its supervision function, the Commission carried out eight on-site inspections of the security of the information systems of market participants.

To adapt to the situation in the financial sector, in 2008 a new strategy of the Commission was worked out and approved by the Commission's Board; it determined essential tasks for extending the analytic work of the Commission, improving the protection of the interests of market participants and of customers and efficiently informing the public about the developments on the financial and capital market.

In 2008, the Commission's experts participated in drafting three new laws that became effective during the year, namely, Law on the Prevention of Laundering the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing, Reinsurance Law and Law on Bank Takeover, in making 11 amendments to seven other laws (including amendments to the Deposit Guarantee Law and in preparing five new Commission's regulations and 13 amendments to the effective Commission's regulations.



Finanšu un kapitāla tirgus komisijas padome

In the reporting year, the Commission continued to maintain and improve its quality management system in accordance with the requirements of ISO 9001:2000 standard. The Commission's internal control system was well-functioning and in 2008 the Commission's performance was inspected by internal auditors and also the certification company "Bureau Veritas Latvia" that issued a certificate to the effect that the Commission's quality management systems complied with ISO 9001:2000 standard.

To ensure carrying out of the measures to implement the strategic goals determined by the Commission, efficient participation in the EU bodies and timely notification of the public about the developments on the financial and capital market, in 2008 the Commission introduced structural changes and established new structural units: EU and International Affairs Division, Banking and Institutional Investors Division and Issuers Division (splitting the former Banking and Securities Market Division), the Chairman's Office (as a result of reorganisation of the Public Relations Division and Record Keeping Division), Internal Audit and Quality Management Division (increasing the number of internal auditors from one to two), Personnel Division and Financial Division (splitting the former Resource Management Division). In view of the changing structure of the Commission, 29 positions were either revised or opened (in general, the Commission's staff was 110 employees at the end of 2008), of which 16 positions were taken by the existing employees and for 13 positions new employees were hired.

During the year, the Commission's staff improved their knowledge in the workshops on credit risk management systems in commercial banks and in the seminars on new capital requirements for banks or Basel Capital Accord II and on other issues related with financial supervision.

To ensure more complete and comprehensive information to the public, in 2008 the Commission distributed 51 statements to mass media and held two press conferences in which the Commission's senior management explained the topical statistical information on bank performance indicators in the 3rd and the 4th quarters of the reporting year and provided its comments, and gave answers and explanations to mass media about other issues that were topical to the financial sector and the public.

In the reporting year, the Commission received and reviewed 247 complaints about market participants. Of them, 109 referred to insurance undertakings, 109 were about banks, 11 about issuers, three about private pension funds, one about the regulated market organizer and one about a provider of investment services and auxiliary investment services; as well, 13 complaints concerned various financial market issues. All complaints were reviewed by the Commission's staff in due course of law and either an answer was provided to the author or, where the content was beyond the Commission's competence, the complaint was transferred to the respective public administration body.

Institutional Cooperation for the Purpose of Developing Regulatory Requirements

In view of the situation in international financial markets and the trends in the Latvian banking sector, at the end of 2008 the Commission cooperated with the Ministry of Finance of the Republic of Latvia, the Treasury and the Ministry of Justice to improve the legal framework governing the supervision of the financial and capital market in line with the International Monetary Fund's recommendations; particular attention was paid to strengthening depositors' confidence.

Deposit Guarantee Law

Substantial amendments to regulatory requirements were aimed at strengthening depositors' confidence and were made in the Deposit Guarantee Law; consequently, the amount guaranteed by the state to each depositor was increased from 20 000 euro to 50 000 euro (the respective amendments took effect on 18 October 2008) and was due where a deposit was not available. During the reporting year, new amendments to the same law were drafted whereby the term for paying the compensation was reduced, the definition of unavailability of deposits was specified, the procedure for recognition of the claims of depositors was supplemented and the principles whereby the Government budget was used to cover the deficit of funds were established. It is planned that in 2009 further amendments will be made whereby the term for paying the guaranteed compensation will be reduced from three months to 20 days and the Commission will be entitled to establish a ratio for a deposit taker's payments in the Deposit Guarantee Fund that will range from 75% to 140% of the basis rate (0.05% of the average balance of guaranteed deposits in the previous quarter) and will depend on the deposit taker's capital adequacy, liquidity and large exposures as well as quality of the credit portfolio in the previous calendar year. A detailed cooperation procedure with the banking supervisory authorities of EU Member States will be established in respect of the payments by cross-border banks and their branches in the guarantee fund as well as in respect of the payment of the guaranteed compensation to Latvian residents from a deposit guarantee fund of another Member State. The guaranteed compensation will not be paid to shareholders of a credit institution who have a qualifying holding in the institution, as well as to the management and the employees who have been authorised to plan, manage and control the activity of the credit institution. Also, the guaranteed compensation will not be paid to the depositors whose deposits have an individually established interest rate or have other conditions whose fulfilment would contribute to aggravating the financial standing of the deposit taker. These amendments aim at stabilising the banking sector and restricting the outflow of deposits, at the same time increasing confidence in the banking sector.

Credit Institution Law

In addition to the above mentioned, separate measures were carried out to ensure stability of the financial system in general; they were directly aimed at enhancing supervision of the financial sector. To develop supervision of credit institutions, amendments to the Credit Institution Law were prepared that were aimed at extending the executive powers of the Commission so that they included taking over the management of a credit institution not only in cases when a credit institution was in financial difficulties but also when there was a reason to project the beginning of such problems.

Law on the Financial and Capital Market Commission

Amendments to the Law on the Financial and Capital Market Commission were prepared according to which the right to take a decision on restricting the rights, meeting the obligations and the activity of a participant of the financial and capital market could be delegated to the Board of the Commission.

The Civil Procedure Law

According to the amendments to the Civil Procedure Law, the term during which the court revised insolvency and liquidation cases of credit institutions was reduced from 15 days to seven days so that an administrator or a liquidator could take over the management of a credit institution in difficulty as quickly as possible.

Law on Bank Takeover

Developments in the Latvian financial market in the reporting year supported a conclusion that in specific cases when there were threats to the stability of the Latvian banking system and the smooth operation of payment systems, as well as in cases of a possible financial crisis when other supervisory mechanisms for stabilising the activity of a credit institution were not available, it would be necessary to take radical measures of a takeover of a credit institution by the state for controlling. For this purpose, the Law on Bank Takeover was worked out in 2008.

Takeover of JSC "Parex banka" by the State for Controlling

On 8 November 2008, the Cabinet of Ministers took a decision to the effect that the Latvian state took over JSC "Parex banka" through the state joint-stock company (SJSC) "Latvijas Hipotēku un zemes banka" (Mortgage and Land Bank of Latvia); it was an unprecedented case in the Latvian financial sector.

Due to unwinding global recession, in the second half of 2008 it was increasingly difficult to make forecasts regarding the financial situation in Latvia and its economy and adverse changes in the financial sector could stem in a comparatively short time. In the framework of its supervisory activity, the Commission had been carrying out a number of various supervisory measures at JSC "Parex banka" as of summer 2008. During 18 August 2008 – 3 October 2008, the Commission performed an inspection of JSC "Parex banka" aimed at revising and assessing the bank's lending procedure in which it had detected material weaknesses: in view of the changing economic situation in Latvia and in the world and the deteriorating solvency of borrowers, the bank had failed to make adequate provisions for its credit portfolio (the deficit of provisions was 40 million lats) and there were deficiencies in credit risk management. The Commission notified JSC "Parex banka" of the uncovered deficiencies.

In autumn 2008, the liquidity of JSC "Parex banka" dropped sharply and the bank needed support to remain solvent. On 22 October, a meeting of the representatives of the Ministry of Finance, the Commission, the Treasury and JSC "Parex banka" was held to discuss the possibility for JSC "Parex banka" to receive state support. In its letter to the Ministry of Finance, the bank requested that the funds of the Treasury amounting to 300 000 000 euro be placed as a deposit with JSC "Parex banka" for one year.

Deposits were increasingly withdrawn from JSC "Parex banka" due to various reasons. On 27 October, the Commission requested that JSC "Parex banka" submit a capital restoration plan because, as a result of a run on the bank on that day, the bank had lost about 29 million lats. On 28 October, capital adequacy of JSC "Parex banka" was 7.89% that was below the regulatory threshold of 8%. On 29 October, the representatives of the Commission and of the JSC "Parex banka" met to discuss mainly the bank's provisioning policy. Deposit outflow continued and amounted to around 14 million lats on that day.

During 29 October – 7 November, the Commission carried out an inspection at JSC "Parex banka" to assess the bank's financial instruments portfolio as at 31 October 2008. The inspection showed that the bank had to revalue its financial instruments portfolio for 28 million lats (revaluation and provisions). Another inspection that was carried out during 31 October – 21 November uncovered that JSC "Parex banka" had insufficient provisions (there was a deficit of 5 million lats).

By 31 October, the performance indicators (capital adequacy, liquidity) of JSC "Parex banka" had deteriorated rapidly and the run on the bank was continuing. On 29 October, the liquidity indicator was 33.41% (according to the Commission's "Regulations for the Compliance with Liquidity Requirements", the threshold was 30%). During 31 August – 31 October 2008, the amount of withdrawn deposits exceeded 191 million lats. Capital adequacy was fluctuating around the critical margin of 8%. In view of that, the Board of the Commission took a decision to impose an enhanced control on the performance of JSC "Parex banka" by prohibiting the bank from issuing new loans and acquiring new financial instruments. As well, JSC "Parex banka" had to take immediate measures to increase its equity capital. The shareholders of JSC "Parex banka" invested 3 million lats in the bank's subordinated capital.

Despite the measures taken, at the beginning of November it was clear that JSC "Parex banka" was facing very serious problems, the Cabinet of Ministers had to be involved to solve them and a takeover by the state of JSC "Parex banka" could be one of the most efficient measures to ensure stabilisation. It was concluded that the assets and financial instruments of JSC "Parex banka" were sufficient to stabilise its activity upon its takeover by the state for controlling and when applying the necessary support instruments because the bank would inevitably be exposed to insolvency without state support.

Granting state support while the former shareholders were still exercising control over JSC "Parex banka" gave rise to doubt whether the state funds would be properly utilized and recovered. Therefore, in view of the experience of other countries, it was decided that the state would take over the majority stake of JSC "Parex banka". It was also possible to take over the bank's shares without shareholder's consent, in accordance with the provisions of Article 105 of Satversme (The Constitution), but in this case complex legal procedures would apply that would considerably delay the process and, as a result, bailout would be too late. For this reason it was decided to discuss takeover with Valērijs Kargins and Viktors Krasovickis, the majority shareholders of JSC "Parex banka" who jointly owned 84.83% of the share capital of JSC "Parex banka".

On 3 November, negotiations of the representatives of the Commission, the Ministry of Finance, the Bank of Latvia and JSC "Parex banka" were held during which an agreement was reached with V. Kargins and V. Krasovickis about selling a stake of 51% of JSC "Parex banka" to the state for 2 lats (each shareholder received 1 lats). On 8 November, the Cabinet of Ministers

decided to take over a stake of 51% of JSC "Parex banka" through SJSC "Latvijas Hipotēku un zemes banka". For the acquired shares, after the fulfilment of the conditions precedent, the Latvian state undertook to support JSC "Parex banka" by issuing a surety to the bank to refinance its syndicated loans and by ensuring funds to the bank as the basis for establishing its subordinated capital (granting a loan up to 200 million lats during two years). Thereby the liquidity of the bank was supported.

On 10 November, the Investment Agreement was signed by the SJSC "Latvijas Hipotēku un zemes banka", JSC "Parex banka", the Republic of Latvia, V. Kargins and V. Krasovickis about selling a stake of 51% of JSC "Parex banka" to the SJSC "Latvijas Hipotēku un zemes banka" for 2 lats. In the agreement, V. Kargins and V. Krasovickis, the former shareholders of JSC "Parex banka", committed to receiving an unconditional consent of two thirds of all lenders of syndicated loans to the share takeover. It was decided to seek a strategic investor for JSC "Parex banka" that would contribute to stabilising the bank's financial standing.

On 12 November, the Ministry of Finance instructed the Treasury to place a term deposit of 100 000 000 lats with JSC "Parex banka" maturing on 19 November 2008. A commercial pledge agreement was signed with JSC "Parex banka" about the collateral for the funding. The maturity was extended later. JSC "Parex banka" had to provide a financial pledge, a mortgage or a commercial pledge as collateral for the benefit of the Treasury. On the basis of this basic agreement, the Treasury made several term deposits after that.

On 25 November, the European Commission issued its consent to the takeover of JSC "Parex banka". When the decision on the takeover by the Latvian state of the majority stake of JSC "Parex banka" was disclosed to the public, the public and depositors of JSC "Parex banka" reacted differently. Part of the society supported the actions of the state, whereas part of depositors was concerned that the takeover of JSC "Parex banka" indicated an inevitable bankruptcy of the bank and withdrew their deposits. To ensure stability of JSC "Parex banka" and of the Latvian financial system in general as quickly as possible, an active involvement to normalise the situation of JSC "Parex banka" and to decide on its further status was required.

V. Kargins and V. Krasovickis failed to obtain the consent of two thirds of the lenders of syndicated loans to the takeover of JSC "Parex banka"; therefore, the Investment Agreement in its existing wording could not be fulfilled. The lenders of syndicated loans mentioned during the negotiations that agreement on refinancing credits could have been possible provided that the SJSC "Latvijas Hipotēku un zemes banka" owned all shares of JSC "Parex banka" belonging to V. Kargins and V. Krasovickis. Also the negotiations for possible assistance with the central bank of Sweden, the International Monetary Fund and the European Commission revealed that it was necessary that the state controlled at least 85% of the shares of JSC "Parex banka" and the bank's management was replaced completely. Increasing the state control of JSC "Parex banka" was also necessary to mitigate the likely risks related with the granted state support, i.e., to eliminate the possibility that the state support would be used in the interests of several private persons. As a result, a discussion about amendments to the Investment Agreement was started to the effect that all shares belonging to V. Kargins and V. Krasovickis would be taken over and the necessity to obtain consent of the lenders of syndicated loans was excluded.

On 1 December, the Cabinet of Ministers and the Commission took a decision to restrict the meeting of the liabilities by JSC "Parex banka" in view of the excessive outflow of deposits and other attracted funds after disclosing to the public the information about the takeover of the bank. The liquidity indicators of the bank were still on a decline. A joint decision of the Cabinet of Ministers and of the Commission on imposing restrictions on meeting the liabilities of JSC "Parex banka" was taken according to which the bank was prohibited from carrying out debit operations with customers, natural persons, in excess of 35 000 lats per month and with legal entities in excess of 35 000 lats, equal to 35 000 lats or unlimited amount per month, depending on the number of employees. The restrictions were effective by 30 June 2009. The restriction on meeting the liabilities was the most acceptable solution to prevent further outflow of assets from the bank and from today's perspective it could be assessed as successful.

On 3 December, the Cabinet of Ministers decided to acquire all shares of JSC "Parex banka" that belonged to former major shareholders V. Kargins and V. Krasovickis without changing the total purchase price of 2 lats. An agreement on amendments to the Investment Agreement was signed as a result of which SJSC "Latvijas Hipotēku un zemes banka" got ownership of the shares of the former major shareholders V. Kargins and V. Krasovickis that amounted to 84.83%. The rights of former shareholders to repurchase the shares were deleted from the Investment Agreement. The residual part of shares of JSC "Parex banka" in the amount of 15.17% remained in the ownership of the former minority shareholders.

The Cabinet of Ministers requested that the SJSC "Latvijas Hipotēku un zemes banka" alienate the investment in JSC "Parex banka" not later than within 12 months of the closing date of the Investment Agreement. By 15 January 2009, at the shareholders meeting SJSC "Latvijas Hipotēku un zemes banka" had to approve the mandated lead adviser for organising the alienation process and to start seeking an investor without delay. SJSC "Latvijas Hipotēku un zemes banka" also had to arrange in-depth analysis of the financial standing and legal analysis of JSC "Parex banka".

On 5 December, the council of JSC "Parex banka" elected the following board members of JSC "Parex banka": Nils Melngailis, Guntis Beļavskis, Vladimirs Ivanovs and Valters Ābele. After assessing the professionalism and experience of the candidates, Nils Melngailis was elected chairman of the board of JSC "Parex banka". The former shareholders of JSC "Parex banka" V. Kargins and V. Krasovickis were removed from the board. The new board members were elected in accordance with the provisions of the Investment Agreement stipulating that JSC "Parex banka" had to follow a decision of the council of JSC "Parex banka" to elect the persons indicated by SJSC "Latvijas Hipotēku un zemes banka" to the bank's board.

The Cabinet of Ministers decided to increase the holding of SJSC "Latvijas Hipotēku un zemes banka" in JSC "Parex banka" by acquiring all shares of JSC "Parex banka" belonging to Svenska Handelsbanken AB. Svenska Handelsbanken AB was one of the largest minority shareholders of JSC "Parex banka" that on 5 December had already offered to repurchase 200 000 shares of JSC "Parex banka" belonging to the Latvian state for 1 euro cent.

In accordance with the instruction issued by the Cabinet of Ministers to ensure liquidity of JSC "Parex banka", on 16 December the Ministry of Finance mandated the Treasury to place a deposit of 43 386 275.94 euro with JSC "Parex banka" for the acquisition of euro denominated Treasury bills issued for 44 391 700 euro. JSC "Parex banka" used the acquired securities as a pledge to borrow the funds necessary for ensuring liquidity from the Bank of Latvia.

On 16 December, sworn auditors *PricewaterhouseCoopers* started an in-depth due diligence of finances, taxes and information technologies of JSC "Parex banka" as at 30 November 2008. In addition, they assessed authenticity of the financial statements submitted by V. Kargins and V. Krasovickis, the former majority shareholders of JSC "Parex banka", in accordance with the Investment Agreement.

On 19 December, a new council of JSC "Parex banka" was elected. According to the Investment Agreement, not later than on the next business day after the request from the SJSC "Latvijas Hipotēku un zemes banka" a statement to the effect that a shareholders meeting was convened would be issued. The main issue on the agenda was the election of a new council that would represent the interests of the Republic of Latvia as the indirect majority shareholder.

On 22 December, the Cabinet of Ministers decided to place the funds of the Treasury as a deposit of 287 074 548 euro with JSC "Parex banka" for the acquisition of euro denominated Treasury bills issued for 300 000 000 euro. JSC "Parex banka" used the acquired securities as a pledge to borrow the funds necessary for ensuring liquidity from the Bank of Latvia. Therefore, by taking over JSC "Parex banka" in the state ownership, the activity of the bank was stabilised.

The Reasons of the Crisis of JSC "Parex banka" and Possible Consequences

The main reasons for the crisis of JSC "Parex banka" were as follows:

- global shocks in the financial markets;
- run on JSC "Parex banka" as a result of rumours and insufficient financial resources of customers of JSC "Parex banka" (especially in respect of the residents of neighbouring countries);
- as a result of the global crisis, the quality of foreign securities portfolio of JSC "Parex banka" deteriorated; JSC "Parex banka" did not have a parent bank that would commit to issuing either additional guarantees or another collateral to the bank's creditors;
- JSC "Parex banka" had signed two agreements with the lenders of syndicated loans: one on 29 June 2007 for 500 million euro and another on 21 February 2008 for 275 million euro. The loan repayment was due to start at the beginning of 2009, but as a result of impaired securities portfolio JSC "Parex banka" would not be in a position to repay them.

If the Cabinet of Ministers had not implemented the takeover of JSC "Parex banka", the bank would have faced inevitable insolvency. Later the possible bankruptcy would have affected adversely the overall financial system, in particular:

- in accordance with the Deposit Guarantee Law, the state would have had to pay about 660 million lats to depositors within three months. The funds accrued at the Deposit Guarantee Fund at that time amounted to 82.9 million lats and the difference would have had to be covered from the state budget that did not have the necessary amount because at that time the Latvian government had not yet reached an agreement with international lenders, the European Commission and the International Monetary Fund about opening a credit line;
- many central and local government institutions would face default as they had settlement accounts and salary accounts of employees with JSC "Parex banka". As at 30 September 2008, deposits by central and local governments with JSC "Parex banka" totalled 143 million lats;
- the business environment would experience significant losses due to delayed mutual settlement; as a result, economic activity would drop even further and GDP decrease would continue creating liquidity problems in the whole economy and possible shrinking of deposits, including those of non-residents;
- the operation of the interbank payment system would be notably impeded.

Therefore, when taking over JSC "Parex banka", the Latvian state provided support to the financial sector as a whole rather than only one bank because deepening problems of JSC "Parex banka" could create far-reaching adverse consequences: deeper mistrust in the financial sector that would trigger extensive withdrawal of deposits and flow of funds to foreign banks and the resulting unavailability of funds could have an adverse effect on the Latvian economy in general.

In accordance with the information provided by the Bank of Latvia, the bankruptcy of JSC "Parex banka" would have affected adversely both the Latvian financial sector and the payment system and diminished confidence of foreign investors in Latvia due to the following reasons:

- at the end of September 2008, due to the volume of assets JSC "Parex banka" was the second largest bank in Latvia and the share of its assets in total banking sector assets was 13.8%. JSC "Parex banka" had an important place in servicing private persons and commercial companies in Latvia.
- In the total national payment system, in the first half of 2008 JSC "Parex banka" ranked third in terms of the number of opened settlement accounts for customers (646 thousand) and of the issued payment cards (448 thousand); JSC "Parex banka" ranked third largest bank in terms of the number of credit transfers of customers made in Latvia (4.5 million transactions) and of card payments (6.5 million transactions); JSC "Parex banka" ranked fourth largest bank in terms of the number of credit transfers (16.5 billion lats); JSC "Parex banka" ranked second largest bank in terms of card payment volumes (167.7 million lats).
- In the Bank of Latvia's interbank automated payment system for lats, JSC "Parex banka" ranked fourth in terms of transactions made and fifth in terms of transaction volumes.
- In the electronic clearing system for lats, JSC "Parex banka" ranked second in terms of the number of payments made and third in terms of the volume of transactions.
- In the Bank of Latvia's euro payments system *TARGET2-Latwija*, JSC "Parex banka" ranked second in terms of the number of transactions made and third in terms of the volume of transactions. In the electronic clearing system for euro, JSC "Parex banka" ranked second in terms of both number and volume of payments.
- During 16 October – 23 October 2008, the transactions of JSC "Parex banka" on the Latvian money market accounted for 2% of the total turnover on the domestic interbank money market; the share of JSC "Parex banka" in the domestic foreign exchange market was 23% in September 2008.
- As at the end of September 2008, JSC "Parex banka" had attracted 13.6% of total Latvian resident deposits, of which 14.5% were of total private person deposits and 11.8% of the deposits by commercial companies.
- The share of JSC "Parex banka" was 7.4% in crediting resident commercial companies and 8.8% in lending to private persons. JSC "Parex banka" was the leading bank in attracting non-resident deposits. It had attracted 26.2% of total non-resident deposits placed in Latvia.

By taking over JSC "Parex banka" the Latvian state prevented insolvency of a leading Latvian credit institution, stabilised the whole Latvian financial system and certified to the depositors that the state is ready to support them. The loss to the financial system as a result of the collapse of a bank like JSC "Parex banka" would have exceeded the funds invested to stabilise the operations of JSC "Parex banka" because customers – residents, non-residents, natural persons and legal entities – would have no longer believed in Latvian banks and consequently would undermine their activity. It must be stressed that ebbing of deposits in September, October and November 2008 was noted in several Latvian banks, not only in JSC "Parex banka". At the same time, the volume of deposits increased in several other banks considered safe by customers. On October 2008, total deposits in the banking sector decreased month-on-month, but already in November deposits started to increase evidencing a high depositor confidence in the banking sector in general.

A detailed survey of the takeover of JSC "Parex banka" and further developments is available on the Commission's web page at www.fktk.lv (see "Publications/Other publications/12.05.2009; Overview of JSC "Parex banka" Takeover").

Development of Regulatory Requirements

Following essential changes in the regulatory requirements governing the financial sector in 2007 that were due to the introduction of the new capital requirements directive (Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) Basel II and of the financial instruments market directive (MiFID), comparatively minor amendments to legal acts were made in 2008 and they were aimed at fine-tuning and enhancing the effective requirements to facilitate their practical implementation and ensure uniform interpretation.

The most important new requirements concerned the criteria for assessing a planned acquisition of a qualifying holding in a commercial company and a prudential assessment procedure that were introduced into several laws governing the financial and capital market in order to ensure the necessary legal certainty, clarity and predictability of the assessment procedure and results thereof. These criteria and procedures would be applied when carrying out prudential assessment regarding the acquisition or increasing a holding in a credit institution, an insurance undertaking, a reinsurance company, an investment management company, a regulated market organizer (stock exchange), the Latvian Central Depository and an investment firm.

With the adoption of the **Law on the Prevention of Laundering the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing** the scope of the persons subject to that law was extended and the requirements thereof applied also to pawnshops and persons providing money collection services. The law establishes that a person subject to that law has an obligation to identify a customer before or at the establishment of business relationship and carry out due diligence to identify the beneficial owner, obtain information about a customer's economic or personal activity and origin of a customer's funds, and an obligation to monitor customer's transactions after the establishment of business relationship as well as to notify the Office for the Prevention of Laundering of Proceeds Derived from Criminal Activity (Financial Intelligence Unit, FIU) whenever an unusual or a suspicious transaction is identified. Under the risk-based approach in combating money laundering and terrorist financing, a person subject to law carries out risk assessment regarding money laundering and terrorist financing and, in line with the assessment, establishes the degree of customer due diligence in the internal control system (the greater the risk, the more attention has to be paid to the customer). Within 14 days the FIU shall take a decision whether there is a basis for starting an inspection about the fact of money laundering or terrorist financing. Where a positive decision is made, FIU is entitled to suspend a transaction for up to 30 days. During that time, FIU obtains additional information about the transaction and the parties thereof and, where the information obtained evidences that there were grounds for initiating a criminal proceeding, a decision is taken to suspend the transaction for up to 45 days and the materials are submitted to law enforcement bodies.

Taking into account the importance of reinsurance as a financial activity because it promotes global diversification of risks and thereby the direct insurance undertakings can have higher underwriting capacity, offer better insurance coverage as well as decrease their capital costs, and reinsurance also has an important role in ensuring financial stability, the **Law on Reinsurance** was developed; it establishes the supervision of re-insurers and set the requirements for taking up and pursuing the activity of re-insurers.

The staff of the Commission's Regulations Division cooperated actively with attorneys at law "Liepa, Skopiņa/BORENIUS" that, on instruction of the Belgian law office "DLA Piper" and according to the order of the European Commission, performed an independent **assessment of the transposition of the capital requirements directive into Latvian laws** and issued a statement to the effect that the respective Latvian regulatory requirements comply with the requirements of the directive.

In parallel, the staff of the Commission's Regulations Division also took part in a research initiated by the European Commission for measurement of the administrative burden in Member States and reviewed the proposals and the examples of the best practice of some Member States for reducing the administrative burden. In accordance with the results of the research, administrative costs in Latvia were one of the lowest in Member States. The research was carried out on instruction of the European Commission by a consortium of companies Capgemini, Deloitte and Ramboll Management.

In compliance with the requirements set out in the capital requirements directive and in view of the guidelines "Technical aspects of the management of interest rate risk arising from non-trading activities under the supervisory review process" of the Committee of European Banking Supervisors, the **"Regulations on the Management of Interest Rate Risk, Preparation of a Report on the Calculation of Economic Value Decline and of a Report on the Term Structure of Interest Rate Risk"** were developed. The regulations establish the procedure whereby the economic value decline caused by sudden and unexpected changes in interest rates in non-trading portfolio is calculated. In accordance with the delegation set out in Part 5 of Article 101³ of the Credit Institution Law, the Commission determined unexpected parallel changes in interest rates (interest rate shock parameters) at 200 basis points.

The capital requirements directive introduced notable changes in banking regulation, supervision and information disclosure. Though Latvian banks started applying the directive only on 1 January 2008 and it is premature to make a full-fledged impact assessment, the first results showed that the new approach to assessing capital adequacy is more risk-sensitive. Due to the global crisis that hit also Latvia the advantages of the standards of the new regulation could not be enjoyed fully. The crisis highlighted certain deficiencies in the concept of the capital requirements directive and the European Commission developed amendments to the directive. The most relevant amendments for the Latvian banking sector are the establishment of a college of supervisors for cross-border groups to ensure efficient cross-border supervision of the market participants, changes in the definition of a group of related clients and restrictions on large exposures. A college has to be established also by an authority that supervises a bank that has systemically important branches in other Member States but does not have subsidiary undertakings in any Member State. The Commission notified banks in advance about the foreseen amendments to the directive.

In response to the global financial crisis, the Commission was active in initiating amendments to laws and, in line with the proposals of the Economic and Financial Affairs Council (ECOFIN Council), the first thing was to make amendments to the **Deposit Guarantee Law** (for detailed information, please see Chapter "Institutional Cooperation for the Purpose of Developing Regulatory Requirements").

Licensing

After the Commission's Licensing Division revised the applications by the participants of the financial and capital market for registering a company, receiving a licence and receiving a permission and assessed the compliance of the application with the regulatory requirements, the following companies started their operation in Latvia in 2008: investment management company Nordea Pensions Latvia, BIGBANK plc Latvia branch, Danske Bank A/S Latvia branch, Coface Austria Kreditversicherung AG branch, Länsförsäkringar International Försäkringsaktiebolag (publ) Nordicia Insurance branch, AS If Eesti Kindlustus Latvia branch, Groupama Transport S.A. Latvia branch "GT BALTICS" and Swedbank Varakindlustus AS Latvia branch. In view of the application by commercial companies for terminating their activities, the licences of investment firms LLC "Axio Capital" and LLC "Evli Securities IBS" were withdrawn.

	as at the beginning of 2008	as at the end of 2008	new market participants in 2008
Banks	21	21	0
Branches of banks of EU MS	4	6	+2
Cooperative credit unions	35	35	0
Providers of banking services from EEA	181	221	+40
Electronic money institutions from EEA	6	10	+4
Insurance undertakings	15	15	0
Branches of insurance undertakings of EU MS	7	12	+5
Providers of investment services from EEA	319	368	+49
Investment management companies	14	15	+1
Providers of investment management services from EEA	11	14	+3
Investment firms	7	5	-2
Providers of investment brokerage services from EEA	628	920	+292
Agents attracted by service providers	0	1	+1
Private pension funds	6	6	0
Insurance brokerage firms	69	98	+29
Insurance agents	713	740	+113

Supervision Credit Institutions

As at the end of the reporting year, **21 banks and seven branches of foreign banks** were operating in Latvia.

In 2008, supervision of the financial sector was notably influenced by the following two factors:

- continuing crisis in the global financial system that triggered freezing of the financial instruments market, liquidity problems of financial institutions and problems in the real estate market;
- changes in the regulatory environment of financial institutions linked with the introduction of the capital requirements directive on 1 January 2008.

All in all, neither the supervision methods nor the existing practice changed in 2008 and, as in previous years, they were based on assessing operational risks of market participants using closely interrelated methods:

- analysis of financial accounts/reports. This analysis enabled the assessment of the financial stability of market participants, their operational risks and trends thereof and their compliance with the requirements set out in law. The results of assessments were submitted on a regular basis to the Board of the Commission that, in its turn, established further tasks and priorities of supervision;
- on-site inspections. The main task was to assess the financial stability of the supervised institution, its capital adequacy and whether its internal control system ensured sufficient risk assessment and management. When the reasons of a problem were uncovered and solutions offered in good time, a market participant's default as well as spillover of its problems to the financial and capital market in general was less likely. The Commission issued reports to all inspected institutions indicating the deficiencies and the trends uncovered during the inspections.

In light of the events in the global financial system, in 2008 the Commission also performed off site inspections; thereby it could immediately receive the latest information and respond swiftly to the rapid changes in the financial market.

During the reporting year, the Commission performed 29 inspections in banks during which it paid particular attention to assessing capital adequacy, lending procedure and risk management functions for managing credit risk, operational risk, interest rate risk, foreign exchange risk, liquidity risk and compliance.

In relation with the global financial crisis the task of the supervision strategy was to maintain public confidence in the Latvian financial system, to identify, within a possibly short time period and with utmost precision, the risks relevant to banking in the financial crisis conditions and to take immediate measures to mitigate the influence of these risks and stabilise the financial market.

To accomplish these tasks, the Commission took measures to ensure that banks appropriately identified and prudently managed risks and were in a position to maintain sufficient capital and to ensure going concern and timely meeting of their liabilities.

Capital Adequacy

As of 2008, in line with the capital requirements directive that was also incorporated in the Credit Institution Law, all banks registered in Latvia had to start using the new procedure for calculating capital adequacy and the Commission had to introduce the so-called second pillar or the supervisory review process. The second pillar included two interrelated processes – internal capital adequacy assessment (ICAA), performed by the institution itself, and the supervisory review and assessment, performed by the supervisory authority.

(The key principles of the second pillar are established in part 3 "The Second Pillar – Supervisory Review Process" of a document "International Convergence of Capital Measurement and Capital Standards" by the Basel Committee on Banking Supervision and they are as follows:

Principle 1: banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

Principle 2: supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process

Principle 3: supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

Principle 4: *supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.)*

In order to implement the functions of the Commission as established in the Credit Institution Law in line with the second pillar, i.e., to assess whether the strategy, procedures and measures carried out by an institution ensured appropriate risk management and own funds were adequate to cover the inherent and the potential risks, in 2008 the Commission performed two interrelated reviews – it assessed the volume of an institution’s risk and the quality of the risk management system and assessed an institution’s ICAAP. When assessing the volume of risk, the quality of risk management and ICAAP, the Commission used off-site analysis and also carried out inspections of banks.

At the beginning of 2008, the Commission received information from banks on the made and planned changes in their internal control systems for the introduction of the second pillar and analysed that information. On the basis of that information, the Commission carried out 13 inspections of the capital adequacy assessment process during which it established whether:

- a bank had chosen an approach to the capital adequacy assessment process that was adequate to its size, type and complexity of its activities;
- a bank was aware of the risks inherent in its activities and the methods whereby it managed risk and established the capital necessary to cover the risks were sufficient.

The results of inspections uncovered areas in which banks needed improvements, including the capital planning process, the procedure whereby the capital that was needed to cover the material risks inherent in its current and planned activity was established, the methods used for stress tests and for analysing the results.

When summarising the results of ICAAP assessment and taking into consideration the experience of supervisory authorities of other countries in determining the appropriate regulatory requirements, as well as the principles for establishing the capital adequacy assessment process included in the EU directives and other international documents, in 2008 the Commission started developing regulatory requirements for evaluating the capital adequacy assessment process that were aimed at providing guidelines to banks for establishing the capital adequacy assessment process and were approved at the beginning of 2009.

Credit Risk

In the reporting year, 17 inspections were carried out during which the Commission’s staff assessed the quality of banks’ credit portfolios and credit risk management systems (whereby credit risk was identified, measured, supervised and controlled) to establish, in a timely manner, the deficiencies and the possible problems related with loan repayment. The banks’ strategy, policy and procedures for issuing loans and implementation thereof were assessed.

In 2008, the total balance of granted loans started to diminish and the quality of separate credit portfolio segments started to deteriorate. The volume of loans to private enterprises grew by 13.1% while loans to households increased by only 7.0%. It was a notable change in 2008 because in 2003 - 2006 loans to households exceeded the loans to private enterprises by 25%–42% and the two lending types reached nearly the same level only in 2007 (increasing by 39.5% and 41%, respectively). These changes were triggered by the economic situation in the reporting year (high inflation, unemployment, shrinking GDP) and suggested that the deteriorating solvency of households restricted their ability to receive loans.

In 2008, banks notably increased provisions for non-performing loans and at the end of the year the volume of provisions was 345 million lats. Overall the volume of provisions at the end of 2008 quadruplicated year-on-year and was 314% representing 262 million lats. According to the Commission's forecasts, total bank provisions for non-performing loans were 2.1% of the credit portfolio at the end of the year and all in all the share of overdue loans in the credit portfolio increased from 6.8% at end-2007 to 15% at end-2008. The data differed notably bank by bank and branch by branch.

The Commission considered that the rapid deterioration of the credit portfolio, especially in respect of the loans to enterprises and private persons that were secured with a real estate collateral (loans for real estate operations, for buying housing, other loans to private persons), was not followed by an appropriate increase in provisions. Even though this could be explained by a sufficient value of the real estate collateral, the Commission was of the opinion that banks should have also taken into account market liquidity of real estate because the slowdown of the development of the real estate market and the falling real estate prices were having an adverse effect on the banks’ credit portfolios.

In view of the above said, during inspections the Commission paid more attention to the provisioning policy, real estate valuation procedures and the conditions for granting new loans.

In most cases the Commission pointed out deficiencies in assessing creditworthiness of real estate developers and private persons because they increased the risk incurred in loans to buying housing. The Commission established and controlled the measures for eliminating these deficiencies and, where appropriate, assessed a bank's capital adequacy relative to its credit portfolio quality.

During inspections, the Commission uncovered that, taking into account the negative economic developments, in 2008 several banks introduced changes to their lending and credit risk management policies and procedures to maintain the quality of their existing credit portfolios. It meant that banks established more prudent lending limits, enhanced the requirements for the creditworthiness of borrowers and for the quality and content of information submitted to banks to prove creditworthiness and collateral.

In light of the adverse developments in the quality of banks' credit portfolios, in 2008 the Commission extended the scope of reported information and requested more frequent reporting. In reports, it paid more attention to the trends for the increasing number of problem loans and banks' policy for managing those loans.

The Commission maintained regular communication with chartered auditors to discuss the trends for the changes of loan quality and their implications for the financial indicators of banks.

In 2008, a fine of 1000 lats was applied to one credit institution for breaching the regulatory requirements for managing credit risk.

Liquidity Risk

Turmoil in the global financial market and the resulting unusually large ebbing of deposits from the Latvian banking system as of September 2008 were the reasons for the Commission to pay particular attention to the supervision of bank liquidity. In order to continuously monitor banks' cash flows in emergency, in September 2008 the Commission changed the procedure whereby banks submitted liquidity reports and banks were required to report, on a daily basis, the dynamics of deposits. The Commission also enhanced the monitoring of liquidity management in a group including subsidiaries of foreign banks because, for maintaining liquidity, such banks often relied on the funds allocated by parent banks.

The Commission was in a continuous close contact with banks' management and discussed, on a regular and timely basis, topical liquidity issues. The Commission also carried out extraordinary inspections to assess the quality of liquidity management at banks and its appropriateness for liquidity risk.

All the above mentioned activities helped the Commission to daily manage the liquidity risk in the banking system in general and, where necessary, to request that banks take corrective measures to improve their liquidity.

Cooperative Credit Unions

As at end of the reporting year, **35 cooperative credit unions** were operating in Latvia and the Commission carried out one inspection. The inspection aimed at assessing a union's credit portfolio and management performance. In view of the unfavourable macroeconomic situation in Latvia that affected adversely the quality of credit portfolio, the Commission paid particular attention to prudential assessment of credit quality and to timely provisioning during these inspections as well.

Investment Service Providers and Investment Management Companies

At the end of the reporting year, **15 investment management companies and seven investment service providers** were operating in Latvia. Investment services were also provided by 19 banks registered in Latvia and two branches of foreign banks whose share dominated this area.

In 2008, two inspections of investment service providers were carried out. During the inspections, the Commission assessed the methods developed by the investment service provider for identifying manipulative transactions as well as the quality and efficiency of the procedures for preventing such transactions. Taking into account the uncovered weaknesses of the procedures, the Commission established and followed the measures to be taken to improve the internal regulations of the providers of investment brokerage services and implementation of their requirements.

As at the end of 2008, the assets of the state-funded pension schemes were managed by **10 investment management companies that offered 27 investment plans**. During the reporting year, one inspection was carried out to assess the volume of an investment by a manager of the state-funded pension scheme assets in an investment plan that had been made in a foreign currency unmatched to the obligations.

Private Pension Funds

As at the end of 2008, **six private pension funds were operating in Latvia, of which five were open end (subsidiaries of Latvian banks) and one was closed end pension fund.** At the end of the reporting year, six private pension funds offered **19 pension plans.**

In the reporting year, one on-site inspection was carried out in a private pension fund. During the inspection, the fund's financial situation, management performance, asset quality, income and expenditure structure as well as compliance of its operations with the Republic of Latvia's laws, the Commission's regulations and instructions and other regulatory requirements were assessed. In the reporting year, a one-stop agency was established for private pension funds for annual reporting purposes.

Insurance Undertakings

As at the end of 2008, **11 non-life insurance undertakings and four life insurance undertakings** were operating in Latvia.

The Commission's staff carried out five full-scope inspections of the performance of non-life insurance undertakings and reviewed 110 applications by natural persons and legal entities about the activities of insurance undertakings.

The Commission's staff took part in Qualitative Impact Study 4 that was organised upon request of the European Commission by the Committee of European Investment and Occupational Pension Supervisors and provided consultations to insurance undertakings and prepared summary results for submission to the Committee of European Insurance and Occupational Pension Supervisors.

On the basis of numerous proposals made by the Latvian Insurers Association for the inclusion of revaluation reserve in the calculation of available solvency margin of insurance undertakings and taking into account the recommendations of the Committee of European Insurance and Occupational Pension Supervisors regarding the impact that the introduction of the International Financial Reporting Standards and the International Accounting Standards would have on prudential supervision of insurance undertakings (CEIOPS-DOC-05/05 "Recommendations regarding the Implications of the IAS/IFRS Introduction for the Prudential Supervision of Insurance Undertakings"), the Commission elaborated draft amendments to the regulations on the calculation of the required solvency margin and the available solvency margin of insurers. On 5 September 2008, the Board of the Commission approved the prepared amendments to the regulations and stipulated that they would take effect on 1 January 2009.

The Commission followed, on a regular basis, that insurance undertakings complied with the required solvency margin set out in the Law on Insurance Companies and Supervision Thereof, assessed the implications of amendments to laws and regulations on the performance of insurance undertakings and warned insurance undertakings in advance of the possible failure to comply with the required solvency margin to enable them to take appropriate measures to ensure compliance with the requirements of the Law on Insurance Companies and Supervision Thereof and, where appropriate, cooperated with shareholders and sought solutions.

In 2008, breaches of the regulatory requirements were uncovered and the sanctions set out in the Law on Insurance Companies and Supervision Thereof were applied, i.e., fines were imposed on two insurance undertakings for non-compliance with the deadline for preparing the annual report for 2007 as set in the Law on Insurance Companies and Supervision Thereof and on three insurance undertakings for violating the requirements of the Insurance Contract Law.

Additional supervision

In 2008, the Commission cooperated with the insurance supervisory authorities of EU Member States that according to regulatory requirements performed additional supervision; the Commission submitted to them information on the operational risks and ability to fulfil the liabilities of the insurance group undertakings registered and authorised in the Republic of Latvia.

Guarantee Fund for the Compulsory Third Party Liability Insurance for Owners of Inland Motor Vehicles

In 2008, the Commission performed an inspection of the guarantee fund administered by the society "Latvijas Transportlīdzekļu apdrošinātāju birojs" (*Motor Insurers' Bureau of Latvia*) regarding the procedure for establishing, making accruals and managing the fund and notified the Ministry of Finance and the society itself of the inspection results.

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

In view of the economic situation in Latvia and around the globe, in particular in the financial sector, trading activity was on a decline on the Latvian financial instruments market as well in 2008. Trading turnover on the share market at the joint-stock company "NASDAQ OMX Riga" (the former stockholding company "Rīgas Fondu birža" or *Riga Stock Exchange*) decreased more than threefold compared with 2007.

When supervising the financial instruments market, the Commission paid particular attention to the following:

- whether the issuers whose financial instruments were admitted to trading on the regulated market in Latvia disclosed information in a timely manner, in due course of the Law on the Financial Instruments Market (LFIM), took into account the scope of disclosed information and complied with other duties set out in LFIM;
- whether shareholders notified the Commission and the stockholding company itself in a timely manner and in compliance with LFIM of the acquisition or disposal of a holding whose amount was established in the LFIM and fulfilled other duties set out therein;
- whether holders of inside information disclosed information about their transactions in a timely manner and full amount in compliance with the LFIM;
- whether trading in financial instruments did not imply market manipulation and/ or was not done using inside information.

In 2008, the Commission supervised trading on a regular basis by monitoring the submitted orders and performed transactions and analysing them to identify and prevent market manipulation and foster sound activity of the financial instruments market. For this purpose, as of 2005 it had been using information of the joint-stock company "NASDAQ OMX Riga" on the orders submitted and completed in the stock exchange trading system regarding transactions with instruments admitted to trading on the markets regulated by the stock exchange. As of November 2007, the Commission had been using information from EEA countries on the transactions that their market participants were doing with the financial instruments admitted to trading on the regulated market in Latvia. During the reporting year, the Commission also cooperated with the authorities of other countries that supervised the financial instruments market, exchanged information about transactions with financial instruments and also cooperated with law enforcement bodies in initiated court cases.

In 2008, when inspecting whether the issuers whose financial instruments were admitted to trading on the regulated market complied with the LFIM requirements for preparing and maintaining a list of inside information holders, the Commission detected violations and issued three administrative rulings to this effect as a warning. In five cases the Commission communicated with issuers in writing to eliminate the uncovered deficiencies and drawbacks.

In 2008, when inspecting whether the persons listed as inside information holders had complied with the LFIM requirements about notifying the Commission of the transactions made, the Commission uncovered violations and in seven cases issued administrative rulings to this effect as a warning (one case was completed and an administrative ruling in it was issued in 2009).

An issuer whose financial instruments were admitted to trading on the regulated market had to disclose mandatory information (e. g., information on shareholder meetings, notifications received from shareholders on acquiring or disposing a holding, financial statements, information on material events) in due course of the LFIM. In 2008, the Commission carried out 35 inspections to determine whether issuers had disclosed information in full amount and in a timely manner in due course of the LFIM. The Commission uncovered violations and, depending on the graveness of the violation, in 21 cases it requested that the issuers take measures to eliminate the violations when disclosing mandatory information in the future, instituted 14 administrative processes for violations when disclosing mandatory information in which administrative rulings to this effect were issued, applied a fine of 1000 lats to each of two issuers and issued warnings to eight issuers, in two cases an administrative ruling served to detect a violation (without any sanctions) and two administrative cases were closed because under the particular circumstances it was not beneficial to issue an unfavourable administrative ruling to the addressee (in two cases the administrative case was closed and the decision was taken in 2009).

In 2008, the Commission carried out inspections in 15 cases when receiving factual information that a person had probably failed to report acquisition or disposal of a qualifying holding in the issuer's voting rights whose amount was set out in the LFIM. In 12 administrative cases administrative rulings that were unfavourable to shareholders were issued and a warning was issued for a failure to report changes in a qualifying holding, whereas two administrative cases were closed because under the particular circumstances it was not beneficial to issue an unfavourable administrative ruling to the addressee. In one administrative case where a shareholder had failed to report an acquisition of a holding in excess of 50% of the total number of company's shares and also had failed to comply with the LFIM and to make a mandatory share buyout offer, the Commission applied a fine of 5000 lats. In 2008, the Commission initiated one more administrative case where a person failed to report an acquisition of a holding in excess of 50% and to make a mandatory share buyout offer; the decision in that case was taken in 2009 and a fine of 6000 lats was imposed on that person.

Trends

To enhance understanding about amendments to the legal framework governing the activity of the financial instruments market, in the reporting year the Commission sent information letters to market participants whereby it informed them on the recent amendments to the regulatory requirements for the financial instruments market and explained the amendments.

In line with the requirements of the Committee of European Securities Regulators, in 2008 the Commission improved the system for reporting transactions by introducing the newly established data reporting system and applying the alternative instrument identifier.

In Europe, the supervisors of the financial instruments market were increasingly paying attention to issuers' financial statements; therefore, in 2009 the Commission will also focus more on a detailed evaluation of issuers' financial statements, their compliance with regulatory requirements and Latvian and international accounting standards.

Preventing Money Laundering

In the area of preventing money laundering, in 2008 the Commission's staff continued to participate in the activities of the Committee on the Prevention of Money Laundering and Terrorist Financing and of the 3L3 Task Force on Anti Money Laundering (AML TF) of the three EU committees (Committee of European Banking Supervisors, Committee of European Securities Regulators and Committee of European Insurance and Occupational Pension Supervisors).

In 2008, the Commission's staff also continued to participate in the activities of the Selected Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL).

Already in 2007, the Commission started drafting a new law on preventing laundering of proceeds derived from criminal activities and terrorism financing in order to implement the requirements of the Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing and of the Commission Directive 2006/70/EC of 1 August 2006 laying down implementing measures for Directive 2005/60/EC of the European Parliament and of the Council as regards the definition of 'politically exposed person' and the technical criteria for simplified customer due diligence procedures and for exemption on grounds of a financial activity conducted on an occasional or very limited basis.

The new Law on the Prevention of Laundering the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing was approved by the Latvian Parliament on 17 July 2008, promulgated on 30 July 2008 and took effect on 13 August 2008.

The Commission developed and on 27 August 2008 approved "Regulations for Enhanced Customer Due Diligence" that were binding to credit institutions, private pension funds, investment firms and investment management companies.

These regulations stipulated the cases when an institution had to perform enhanced customer due diligence, the procedure for performing enhanced customer due diligence and the threshold when establishing business relationship and also during business relationship, risk categories of money laundering and terrorist financing and the respective risk characteristics, specific measures of enhanced customer due diligence and the procedure of enhanced supervision of customer transactions.

To assess compliance of the performance of the participants of the financial and capital market with legal requirements, in 2008 the Commission carried out nine inspections in banks and 10 inspections in other financial institutions of which nine inspections were related with the supervision of insurance intermediaries providing life insurance services and one inspection was related with the supervision of an investment management company. During inspections of banks, 15 violations of legal requirements were uncovered in 2008 in general. Violations were not uncovered in financial institutions. The Commission applied sanctions to three banks for a failure to ensure compliance with legal requirements: a fine was applied to two banks and an administrative agreement was signed with one bank for eliminating the detected violations of law.

In 2008, for information exchange purposes the Commission received two letters from foreign supervisory authorities — one from Germany and the other from the USA — and sent two information requests to the supervisory authority of Estonia.

During the reporting year, the Commission reported 51 unusual and suspicious financial transactions to the Financial Intelligence Unit (the Office for the Prevention of Laundering of Proceeds Derived from Criminal Activity).

Supervision of Information System Security

Within its supervision function, in 2008 the Commission performed eight on-site inspections of the security of information systems of market participants.

On the basis of the prevailing business development trends in the area of information system application, during the information system security inspections the Commission paid particular attention to the following aspects:

- 1) security and quality of outsourced services, possibilities for service recipients to control the service;
- 2) enhancing security function with appropriate authorisation of staff, technological tools and procedures;
- 3) security in managing incidents and problems that were supervised by help desks; help desks were established because market participants were increasingly introducing service management standards;
- 4) threats to information system security that might be caused by the actions of disloyal employees.

Information obtained during the inspections evidences that market participants were increasingly becoming aware of the role the security of information systems had in a successful business development and that they improved planning, implementation and control of the measures to ensure security of information systems.

In view of the changes in technology and their application management, in 2009 the Commission intends to update "Regulations on Security for Information Systems of Participants of the Financial and Capital Market".

Activities of Guarantee Funds

Deposit Guarantee Fund (DGF)

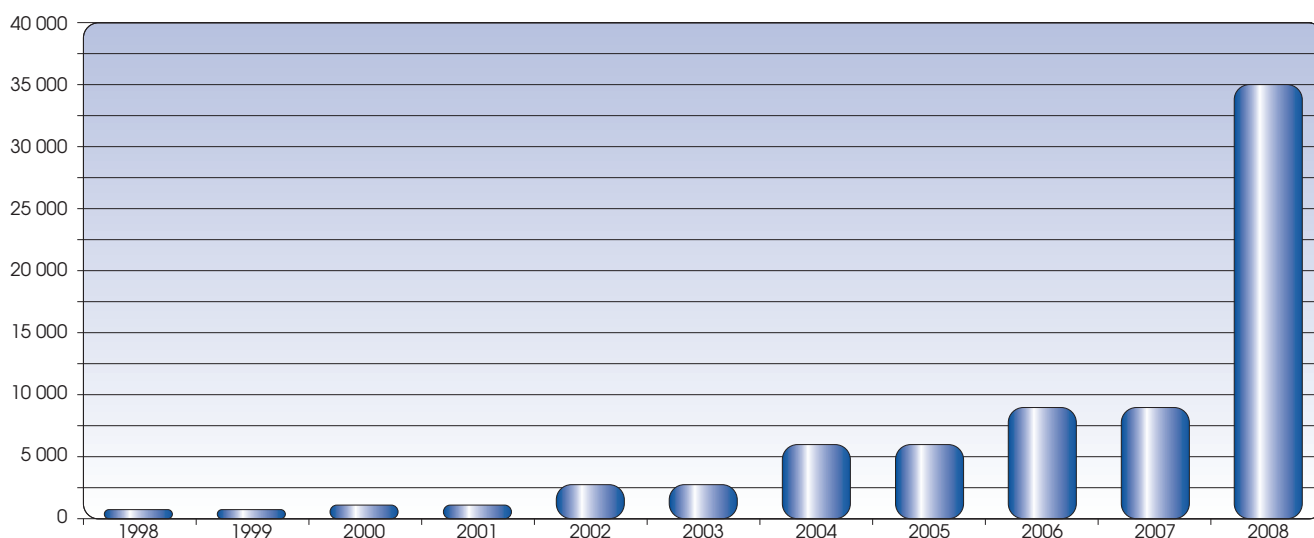
In Latvia, the operations of the deposit guarantee system complied with the requirements of the Directive of the European Parliament and of the Council on Deposit Guarantee Schemes. In accordance with the amendments to the Deposit Guarantee Law passed by the Saeima on 16 October 2008, 50 000 euro (35 140 lats) had been guaranteed to bank customers in Latvia (both natural persons and legal entities) as of 18 October 2008 (see Chart 1).

The amendments to the Deposit Guarantee Law were adopted in line with the agreement reached on 7 October 2008 at the Economic and Financial Affairs Council (ECOFIN Council) regarding a guaranteed compensation that should be increased in the EU Member States to 50 000 euro in view of the global financial turmoil. Until 18 October 2008, the guaranteed compensation in Latvia had amounted to 20 000 euro (14 056 lats) in every credit institution or credit union per person (jointly for all accounts in case of several accounts with one bank). The state guaranteed compensation referred to deposits, current account balances, salary accounts, savings accounts and other similar accounts.

Chart 1

INCREASE IN THE AMOUNT OF THE GUARANTEED COMPENSATION PER DEPOSITOR IN 1998–2008

(as at the beginning of the period; in lats)

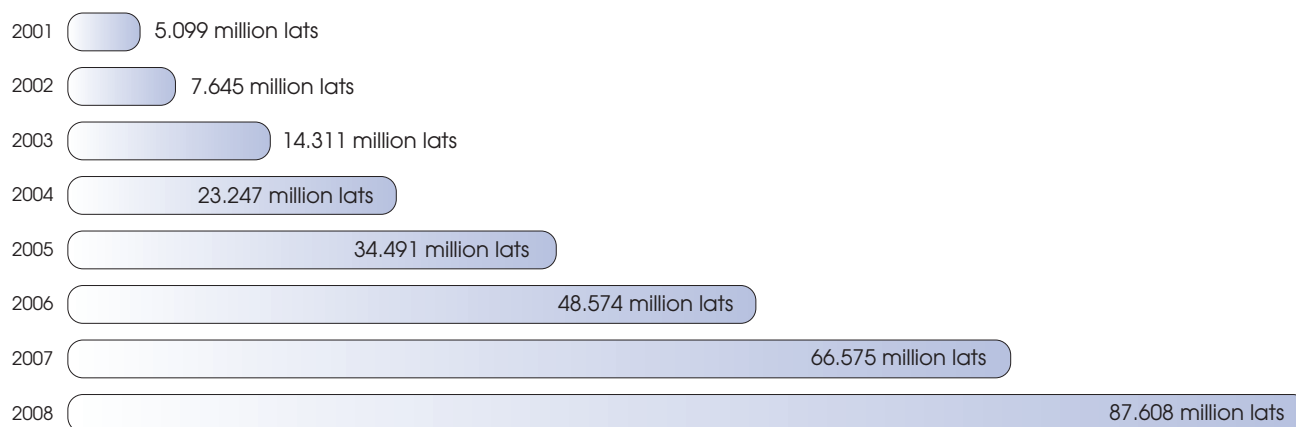


According to the information at the Commission's disposal, in 2008 of all accounts opened by depositors with the Latvian banking system in 98.7% cases the balance did not exceed 50 000 euro (35 140 lats), therefore in the reporting year repayment of the whole deposited amount was guaranteed to 98.7% depositors.

The funds at the DGF were accrued and managed by the Commission. As at the end of 2008, 87.6 million lats were accrued with the DGF. The income from managing the funds of the DGF were invested in the initial placement of the Latvian Treasury bills and during the reporting year amounted to 3.8 million lats. The total amount of the income from managing the funds of the DGF that had been gained as of the establishment of the Fund was 9.9 million lats.

Growth dynamics of DGF, 2001–2008

(as at the end of the year; lats)



The Consultative Council of the Commission monitored the accrual of funds with the DGF and the payment of the guaranteed compensation. Where deposits were unavailable (when the court had declared insolvency of a deposit taker, the Commission had cancelled a deposit taker's licence or in any other case when the Commission had detected unavailability of deposits) the Commission exercised the rights of creditors to file a claim against a deposit taker, i.e., a bank or a credit union, and paid the guaranteed compensation to depositors. As of the beginning of the operation of the DGF, the funds thereof had not been used for the payment of the guaranteed compensations, as there had not been any cases of unavailable deposits in the system of Latvian banks and credit unions during that time.

Fund for the Protection of the Insured (FPI)

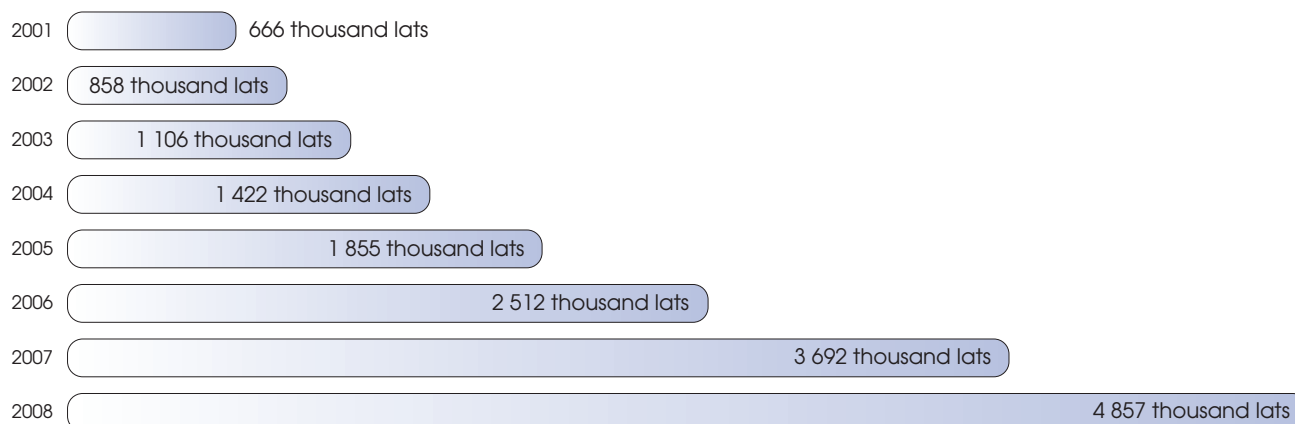
To protect the interests of the insured persons in case of a bankruptcy of an insurer, the FPI was established in 1999. The funds with the FPI had been made from deductions of 1% by insurance undertakings from total gross insurance premiums received from natural persons for the types of insurance specified in law. As at the end of 2008, 4.9 million lats were accrued with the FPI. The income gained from managing the funds of the FPI were invested in the initial placement of the Latvian Treasury bills and amounted to 221.4 thousand lats at the end of the reporting year. Total, including the income from managing the funds of the FPI as of its establishment, was 632.8 thousand lats.

In the case of an insurer's default, the compensation was paid only to a policyholder that is a natural person and the amount was as follows:

- 1) for life insurance, 100% of the insurance compensation but not more than 2000 lats per policyholder;
- 2) for other types of insurance set out in law, 50% of the insurance compensation, but not more than 2000 lats per policyholder.

FPI growth dynamics, 2001–2008

(as at the end of the year; lats)



The Commission was responsible for accruing the funds with the FPI and organising the payment of the guaranteed insurance compensation. The Commission's Consultative Council supervised the accruing of funds with the FPI and effected the payment of the insurance compensation. The guaranteed insurance compensation was paid from the FPI only after the bankruptcy procedure of the insurance company was started. The Commission also exercised creditors' rights of claim.

As of the beginning of its activities, the funds from the FPI had been used to pay the guaranteed compensation of 8 671 lats, in order to protect the interests of the insured in case of a bankruptcy of an insurance undertaking.

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

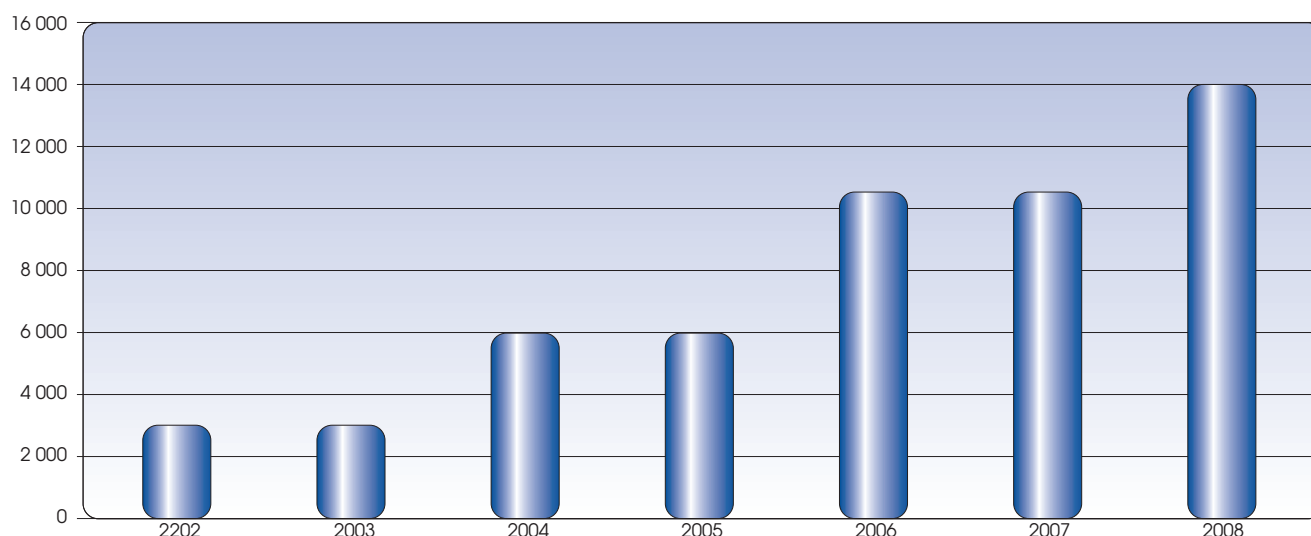
The Investor Protection Law had been effective as of 1 January 2002. Where the providers of investment services (banks, investment management companies and investment firms) were unable to meet their liabilities, investors were entitled to compensation. The compensation for default amounted to 90% of the value of irreversibly lost financial instruments or of the loss as a result of a failure to provide an investment service.

In 2008, a compensation of 90% of the value of irreversibly lost financial instruments or of the loss as a result of a failure to provide investment service was guaranteed to an investor, but not more than 20 000 euro (14 056 lats) (see Chart 2).

Chart 2

INCREASE IN THE AMOUNT OF THE GUARANTEED COMPENSATION PER INVESTOR 2002–2008

(as at the beginning of the period; lats)



In contrast to DGF and FPI, the mechanism for protecting investors established that the funds for compensations were not accumulated with the fund but, where a service provider fails to meet his liabilities, the Commission, on the basis of the quarterly reports on the financial instruments portfolio submitted by other providers of investment services, calculated the proportion of each market participant, a provider of investment services, for the provision of compensations in the account opened with the Bank of Latvia.

Where necessary, the Commission organised and supervised the payments by market participants for compensations, checked the grounds for a compensation application and ensured the payment of compensation. The Commission had received no such applications by the end of the reporting year.

International Cooperation Structural Changes

In order to ensure efficient cooperation with EU institutions, supervisory authorities of the EU Member States and of other countries as well as international organisations and in view of the decision of the Council of the European Union to ensure that the European dimension is included in the mandates of national supervisory authorities and to foster the activities aimed at convergence of the supervisory practice and cooperation in the EU, and also in light of the continuously increasing workload related to the EU issues, the EU and International Affairs Division was established at the Commission in 2008.

Convergence of the supervisory practice and cooperation in this area in the EU was also determined as a separate activity in the Commission's strategy approved in 2008.

Participation in the Work of EU Bodies

Taking into account the situation in financial markets, the issues that fell within the competence of the Commission – stability of the financial sector and issues related with financial services – were high on the agenda of various EU institutional fora, e. g., the European Council, the Economic and Financial Affairs Council (ECOFIN Council), the Economic and Financial Committee and the Financial Services Committee, and the following aspects were addressed in particular:

- situation in financial markets;
- development of legal instruments and framework for action in the financial crisis (e.g., transfer of assets, available crisis management tools in Member States, early intervention, likely state aid measures to the financial system, and others);
- strengthening of the role of the supervisory committees – Committee of European Securities Regulators, Committee of European Banking Supervisors and Committee of European Insurance and Occupational Pension Supervisors;
- the possible reform of the EU financial sector supervision;
- improved disclosure of information in the financial market;
- improving prudential supervision and risk management instruments;
- standards for valuating financial instruments.

Overall in these fora the Commission contributed to the development of about 90 national positions and instructions.

In 2008, many new draft EU legal acts were submitted for approval, in particular amendments to the directive relating to undertakings for collective investment in transferable securities, the capital requirements directive, the directive on financial collateral arrangements, the directive on settlement finality in payment and securities settlement systems, the directive on deposit-guarantee schemes and the directive on electronic money institutions.

A new directive on solvency of insurance undertakings (*Solvency II*) and a new draft regulation on credit rating agencies were prepared for a discussion. During the preparation phase, the Commission assessed the effect of the proposals on the Latvian financial market and developed proposals that represented Latvia's interests and were accordingly elaborated in the instructions and positions. A good example of protecting Latvia's interests was the result achieved during the discussion of the directive on solvency of insurance undertakings (*Solvency II*). Due to a joint action with 12 other Member States a group support regime was not included in the directive. The initial solution for the supervision of insurance groups did not offer a balanced approach to the duties and the authority of the supervisory authorities of Member States for supervising individual commercial companies in a group of commercial companies to ensure protection of policyholders in Latvia.

The Commission's staff participated in the decision-making in the EU by taking part in the work of 42 committees and working groups in the Lamfalussy framework in 2008. To ensure convergence of supervision in the EU, participation in third level supervisory committees (Committee of European Banking Supervisors, Committee of European Securities Regulators and Committee of European Insurance and Occupational Pension Supervisors) and their working groups was of utmost impor-

tance. In the reporting year, these committees performed in-depth analysis to compare the authority of the supervisory authorities of Member States and the sanction regimes, assessed the possibility of delegating the authority and the tasks as established in the directives governing the financial sector, worked out joint guidelines for the activity of colleges of supervisors and assessed various sector-related issues. As a participant of these committees the Commission prepared answers to 62 information requests.

As of the middle of 2008, the Commission's representative was attending the meetings of the Board of Directors of the European Investment Bank (EIB) during which the projects submitted to the Board were assessed as to their compliance with the priorities and the lending conditions of the EIB. Opinions were prepared on 65 projects that were reviewed in a written procedure and on 151 projects that were submitted for discussion at Board meetings.

Cooperation and Exchange of Information with the Financial and Capital Market Supervisory Authorities of Member States and of Other Countries and with International Financial Institutions

In view of the goal stated by the Economic and Financial Affairs Council (ECOFIN Council) in its conclusions of 14 May 2008 to enhance the role of colleges and establish such colleges for all cross-border financial groups in the EU to ensure cooperation and exchange of information among the supervisory authorities of those Member States in which a financial group carries out important activities, negotiations on six new agreements on cooperation and exchange of information in relation to the supervision of bank groups took place in the reporting year.

Negotiations were held with the Swedish Deposit Guarantee Board and with the Deposit Guarantee Fund of Portugal on memoranda for deposit guarantees and compensations to depositors. In autumn 2008, negotiations were started about signing a regional Nordic-Baltic memorandum for crisis management issues among banking supervisory authorities, central banks and ministries of finance.

Overall, the Commission had signed 24 bilateral cooperation agreements. Two agreements were reached on the exchange of information on the supervision of credit institutions without a written cooperation agreement: one with the Office of the Comptroller of the Currency, a body subject to the US Treasury, and the other with the Swiss Federal Banking Commission.

Moreover, the Commission had signed three multilateral cooperation agreements: on cooperation in financial crisis among EU banking supervisory authorities, central banks and ministries of finance, on cooperation among the institutions overseeing payment systems and banking supervisory authorities during the third stage of the Economic and Monetary Union and on cooperation in crisis management among EU banking supervisory authorities and central banks.

Priorities in 2009

In 2009, defining the principles for reforming the EU financial sector supervision system and starting the reform will be the most important issues that, according to the report of 25 February 2009 by *De Larosiere* group — a high-level group on financial supervision in the EU — will include both improving the regulation and strengthening supervisory authorities.

Tasks of the Financial and Capital Market Commission in 2009

The Commission has decided that in 2009 it will start developing the competence model and the remuneration system of its staff in order to ensure that the employees are qualified, educated and cooperation-oriented, able to perform their tasks efficiently and in a timely manner and to attain the established strategic goals.

Also in 2009, the Commission will continue organising its activities in line with the requirements of the ISO 9001:2008 standards to upgrade the certificate granted to the Commission and ensure an ongoing improvement of the activities and developing services to meet the interests of the Commission's customers.

To increase efficiency of the information exchange between the Commission and the general public, provide its customers with complete required information, facilitate information selection and obtaining, and ensure availability of timely and accurate information, the Commission's web page will be improved and updated.

In 2009, the Commission plans to start a process for developing and implementing a new system for processing and analysing new statistical information whereby processing and analysing statistical information will be improved according to customer requirements, data quality and system operation will be improved and data processing time will be reduced.

To ensure that staff of the Supervision Department applies a uniform approach to supervision and to introduce the latest regulatory requirements in the area of anti-money laundering, the Commission will further develop "Bank Risk Assessment Manual" and risk assessment system.

Moving forward with the implementation of EU directives in the Latvian financial and capital market, in 2009 the Commission plans to amend "Regulations for Calculating the Minimum Capital Requirements", "Regulations on the Compliance with Restrictions on Exposures" and "Regulations on the Compliance with Liquidity Requirements".

To improve the protection of depositor interests, reduce the feasible term for the payment of the guaranteed compensation and fine-tune the process for the payment of the compensation, the Commission will improve the mechanism for paying the guaranteed compensation by amending respectively the Deposit Guarantee Law.

In order to protect the interests of life insurance policyholders, the Commission will prepare amendments to the Insurance Contract Law specifying the information to be disclosed in life insurance contracts.

To reduce the administrative burden, establish a uniform regulation for outsourced services, revise the volume of information and of documents to be submitted to the Commission when receiving an outsourced service, the Commission will work out amendments to the Credit Institution Law, Law on Insurance Companies and Supervision Thereof, Reinsurance Law, Law on Investment Management Companies and Law on Private Pension Funds.

The Commission has also decided to develop regulations for insurers for the introduction of stress tests and compilation of a report on stress tests results. These regulations will improve the process whereby the operational risk and possible losses of insurers are assessed as they will introduce a requirement for the insurers to carry out a stress test and assess the results thereof at least once a year thereby improving the assessment of essential risks and, consequently, reduce the possible loss.

Amendments to the "Regulations for Obtaining Permits of the Financial and Capital Market Commission Regulating the Operation of the Credit Institutions and the Credit Unions and for Providing Information" will be developed, as they are necessary to improve the transparency of the regulatory requirements governing the activities of credit institutions.

Amendments to the "Regulations on the Issue of Licences for Insurance Operations and of Permits for Providing Insurance Services Abroad" will be worked out to improve transparency of the regulatory requirements governing the insurance activities and to revise the administrative burden.

The key principles for ICAAP of banks will be developed to ensure that banks use efficient ICAAP that is adequate to their risks and to establish a reporting form for the assessment of the results.

Amendments to the "Regulations for Assessing Assets and Off-balance-sheet Liabilities" will be made. They are necessary to ensure compliance with the International Accounting Standards, International Financial Reporting Standards and recommendations of the Basel Committee on Banking Supervision and also to fine-tune the requirements of the Commission in respect of provisioning. To further develop the standards for managing credit risk with a special focus on the responsibility of the senior management of a bank and to strengthen the supervision of the compliance with these standards, the "Recommendations for Credit Risk Management" will be amended accordingly.

In order to develop supervisory tools to be applied in the framework of the Second Pillar, to improve the quality of risk management and ensure adequate capitalization of banks, the Commission plans to work out a policy document on the Supervisory Review and Evaluation Process. The document will also include the criteria according to which individual banks will be required to have additional capital.

To improve and extend the Commission's entitlement to take timely corrective measures, the Commission plans to revise its rights and authorities.

In 2009, the Commission will continue to perform in the areas within its competence in accordance with the stabilisation programme of the Latvian economy as approved by the Saeima. The Commission will be responsible for the following:

- 1) ensuring the stability of the banking system, boosting depositor confidence;
- 2) protecting the interests of depositors;
- 3) protecting the interest of borrowers;
- 4) stabilising the performance of the JSC "Parex banka";
- 5) informing, on a regular basis, the International Monetary Fund and the European Commission on the performance indicators of the Latvian banking system.

FINANCIAL STATEMENTS OF THE FINANCIAL AND CAPITAL MARKET COMMISSION FOR 2008

Management Report

The Financial and Capital Market Commission (hereinafter referred to also as the Commission) commenced its activities on 1 July 2001 and is operating in accordance with the Law on the Financial and Capital Market Commission.

On 21 December 2007, based on Article 17 (9) of the Law on the Financial and Capital Market Commission, with Decision No. 180 the Commission's Board approved the Budget of the Financial and Capital Market Commission for 2008, thereby specifying the financing for activities of the Commission and the use of these funds. Decision No. 82 of 20 June 2008 of the Commission's Board On the Approval of Amendments to the Budget of the Financial and Capital Market Commission for 2008 specified the amount of additional acceptable financing (total reserve being 15% of approved expenses in 2008) in the Commission's budget for 2008. The above reserves were required both for carrying out structural changes and for appropriate maintenance of infrastructure and capacity, and remuneration of additional staff as well as maintenance of more efficient technological solutions in the Commission. The final allocation of reserve broken by the Commission's budget expense items for 2008 was approved by Decision of the Board of the Commission of 19 December 2008 No. 181 On the Approval of Amendments to the Budget of the Financial and Capital Market Commission for 2008. The financial and capital market participants made payments for financing the activities of the Commission in 2008 in accordance with the Regulations No 183 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 2008 approved by the Commission's Board on 21 December 2007. In relation to the approval of the Commission's additional expenses the amount of payments made by the financial and capital market participants was not increased in 2008 because the net asset volume of the Commission from the previous reporting periods was sufficient for maintenance of additional expenses.

The Commission conducted accounting in accordance with the Law on Accounting and, as an independent autonomous public institution possessing state property, prepared financial statements for the year 2008 in accordance with the Financial Accounting Policy of the Financial and Capital Market Commission approved by Decision of the Commission's Board No 43 of 27 March 2009.

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 perception, assets of the Funds managed by the Commission are disclosed separately in the balance sheet.

In 2008, 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 15 September 2006, which stipulate asset investments only in the primary market of securities, and in the currency, in which payments from the Deposit Guarantee Fund and the Fund for the Protection of the Insured are to be made. The said investment policies provide for keeping of at least 10% of each Fund's assets liquid either in an account held with the Bank of Latvia or invested in debt securities whose term of redemption does not exceed one year. In 2008, assets of the Funds managed by the Commission were invested in compliance with the requirements of the Agreement on Investing Assets of the Deposit Guarantee Fund and the Fund for the Protection of the Insured in Initial Placement of 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 Public Procurement, all procurements for ensuring the Commission's activities were made in compliance with the requirements of the said Law.

On 3 November 2008, the Commission entered into an agreement on the audit of the Commission's financial statements for 2008 with Ernst & Young Baltic SIA, which was represented by Sworn Auditor of the Republic of Latvia Iveta Vimba (certificate No. 153).

The State Audit Office did not perform any audits relating to activities of the Commission in the reporting year.

Funds of the Commission

At the end of 2008, assets of the Commission totalled 94 246.2 thousand lats, of which 92 466 thousand lats were managed trust assets, i.e. assets of the Deposit Guarantee Fund and the Fund for the Protection of the Insured. In 2008, activities of the Commission were financed solely from payments made by financial and capital market participants. At the end of 2008, the Commission's equity or net assets accounted for 1 478 thousand lats, or by 658 thousand lats down in comparison with

2007. The decrease in the Commission's net assets in 2008 was due to the approved amount of budget expenses and determined the amount for the financing of activities of the Commission in the year 2008.

Ensuring Activities of the Commission

In 2008, the revenues of the Commission accounted for 3 561.6 thousand lats or by 12% less than the planned revenues, as laid down in the Commission's budget for 2008 (4 067.4 thousand lats). The Commission had planned revenues from the financial and capital market participants of 4 032 thousand lats, however, revenue result constituted 3 474 thousand lats of the total. The Commission's excess of revenues over the planned revenues in 2008 was due to interest income earned from the cash balance in the Commission's current account and requirements for the payments of financial and capital market participants in 2007 recognized in 2008.

Total expenses of the Commission in 2008 were 4 219.7 thousand lats. According to the Commission's budget planning, the Commission's expenses, excluding provisions for vacation, in 2008 totalled 4 179 thousand lats, which was by 7.9% less than the planned expenses (4 537 thousand lats). The excess of expenses over revenues in 2008 was 658 thousand lats. The Commission's annual budget result in the reporting year was negative indicating that revenues of the Commission in 2008 were by the above amount lower than the expenses. The Commission was able to compensate the above excess of expenses from its net asset balance.

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 17 236 thousand lats and revenues of the Fund for the Protection of the Insured, received from insurers, constituted 943 thousand lats. Revenues from investments made by the Deposit Guarantee Fund were 3 804 thousand lats, while by the Fund for the Protection of the Insured, 221.7 thousand lats. Total assets of these Funds increased by 22 197 thousand lats, or 31.6%, i.e. assets of the Deposit Guarantee Fund rose by 21 032.9 thousand lats, or 31.6%, but assets of the Fund for the Protection of the Insured, by 1 164 thousand lats, or 31.5%. At the end of 2008 net financial assets of the Deposit Guarantee Fund were 87 608.3 thousand lats, while net financial assets of the Fund for the Protection of the Insured, 4 856.8 thousand lats.

In the reporting period, the Commission invested assets of the Funds in both short-term and long-term Latvian State Treasury securities. By the end of 2008, of the total securities portfolio of the Funds, 62.9% were placed in long-term securities while the rest in short-term securities. Of the securities portfolio of the Deposit Guarantee Fund, 62.1% were invested in long-term securities while the rest in short-term securities, whereas as regards the securities portfolio of the Fund for the Protection of the Insured, the corresponding figures were, 77.8% and 22.2%. Investment term structure of the Deposit Guarantee Fund at the end of 2008 broken by debt security maturity was as follows: up to one year, 40%; from one year to five years, 19%; from five years to ten years, 41%. Investment term structure of the Fund for the Protection of the Insured at the end of 2008 broken by debt security maturity was as follows: up to one year, 27%; from one year to five years, 22%; from five years to ten years, 51%. In 2008, the profitability of assets of the Deposit Guarantee Fund was 4.92%, but profitability of the Fund for the Protection of the Insured, 5.18%, which was calculated by dividing the sum of investment revenues of the relevant Fund during 2008 by the average asset value of the Fund during 2008.

Deputy Chairman
Financial and Capital Market Commission



Jānis Brazovskis

27 April 2009

Balance Sheet

ASSETS

	Note	31.12.2008	31.12.2007 (lats)
ASSETS OF THE FUNDS			
LONG-TERM INVESTMENTS		54 212 061	37 305 418
Investments by the Funds in securities	2	54 212 061	37 305 418
CURRENT ASSETS		38 254 020	32 962 478
Receivables		4 233 119	4 538 013
Due from market participants to the Funds	4	4 233 119	4 537 949
Settlements with the administrators related to guaranteed compensation payments	12	-	64
Investments by the Funds in securities	2	34 018 417	26 653 866
Cash		2 484	1 770 599
TOTAL ASSETS OF THE FUNDS		92 466 081	70 267 896
ASSETS OF THE COMMISSION			
LONG-TERM INVESTMENTS	3	183 134	97 169
Intangible assets		53 442	47 853
Fixed assets		129 456	41 095
Prepayments for long-term investments		236	8 221
CURRENT ASSETS		1 596 942	2 255 253
Inventories		99	80
Accounts receivable		575 965	229 231
Due from market participants to the Commission	5	570 985	225 317
Other receivables	11	1 947	3 013
Due from the staff		3 033	901
Prepaid expenses	8	16 468	6 906
Cash		1 004 410	2 019 036
TOTAL ASSETS OF THE COMMISSION		1 780 076	2 352 422
TOTAL ASSETS		94 246 157	72 620 318

The accompanying notes on pages 35 to 41 form an integral part of these financial statements.

Balance Sheet

LIABILITIES

	Note	31.12.2008	31.12.2007 (lats)
LIABILITIES OF THE FUNDS			
EQUITY	9	92 465 183	70 267 896
Net financial assets of the Funds (budget result)		92 465 183	70 267 896
PAYABLES		898	-
Overpaid prepayments		175	-
Liabilities related to securities settlement services		723	-
TOTAL LIABILITIES OF THE FUNDS		92 466 081	70 267 896
LIABILITIES OF THE COMMISSION			
EQUITY	9	1 478 310	2 136 448
Net assets of the Commission (budget result)		1 478 310	2 136 448
PAYABLES		301 766	215 974
Prepayments to the Commission by market participants	6	50 968	88 523
Accounts payable to suppliers	10	97 602	24 927
Overpaid taxes	7	1 392	428
Provision for vacation		142 695	102 096
Provision for liabilities		9 109	-
TOTAL LIABILITIES OF THE COMMISSION		1 780 076	2 352 422
TOTAL LIABILITIES		94 246 157	72 620 318

The accompanying notes on pages 35 to 41 form an integral part of these financial statements.

Deputy Chairman
Financial and Capital Market Commission

Jānis Brazovskis

Head of the Financial Division

Rita Vanaga

27 April 2009

Revenue and Expense Statement of Commission's activities

	Note	2008	(lats) 2007
REVENUES			
REVENUES RELATED TO SUPERVISION OF CREDIT INSTITUTIONS AND CREDIT UNIONS		2 392 261	2 333 147
Payments by credit institutions		2 382 348	2 324 280
Payments by credit unions		9 913	8 867
REVENUES RELATED TO INSURANCE SUPERVISION		871 723	874 070
Payments by life assurance companies		90 597	75 410
Payments by other insurance companies		781 126	798 660
REVENUES RELATED TO SUPERVISION OF THE SECURITIES MARKET AND PENSION FUNDS		210 037	155 008
Payments by securities market participants		165 279	115 358
Payments by private pension funds		44 758	39 650
OVERDUE PAYMENTS		-	202
INCOME FROM INTEREST ON THE BALANCE OF THE COMMISSION'S CURRENT ACCOUNT		57 960	43 259
OTHER PAYMENTS ¹		29 673	-
TOTAL REVENUES		3 561 654	3 405 686
EXPENSES			
Staff remuneration and other payments		(2 943 390)	(2 297 088)
Staff remuneration and other payments	13	(2 415 624)	(1 903 069)
State social insurance compulsory contributions		(527 766)	(394 019)
Provision for vacation		(40 599)	59 091
Staff insurance	14	(291 265)	(124 247)
Improvements of professional skills and business trips	15	(196 384)	(193 757)
Telecommunication and information	16	(118 996)	(39 223)
Public information and external and internal communications		(17 272)	(25 166)
Maintenance and general service expenses	17	(372 708)	(308 365)
Professional services	18	(131 167)	(82 065)
Participation in international organisations ²		(63 656)	(78 286)
Depreciation/amortisation/write-off of capital investments	3	(44 310)	(35 222)
TOTAL EXPENSES		(4 219 747)	(3 124 328)
EXCESS OF EXPENSES OVER REVENUES (BUDGET RESULT)		(658 093)	281 358

The accompanying notes on pages 35 to 41 form an integral part of these financial statements.

Deputy Chairman
Financial and Capital Market Commission



Jānis Brazovskis

Head of the Financial Division



Rita Vanaga

27 April 2009

¹ Payments of financial and capital market participants for 2007

² In 2007 expenses on co-financing for operations of the attaché in Brussels were included in the statement. In 2008, the Ministry of Finance of the Republic of Latvia maintained activities of an attaché regarding the financial and capital market area.

Revenue and Expense Statement of Activities of Deposit Guarantee Fund and Fund for the Protection of the Insured

	Note	2008	(lats) 2007
REVENUES			
DEPOSIT GUARANTEE FUND'S REVENUES		17 236 036	15 560 100
Payments by credit institutions		17 224 676	15 549 850
Payments by credit unions		11 360	10 250
REVENUES OF FUND FOR THE PROTECTION OF THE INSURED		943 030	1 053 414
Payments by life assurance companies		234 753	420 922
Payments by other insurance companies		708 277	632 492
INCOME FROM INVESTMENTS		4 025 801	2 566 745
Income of the Deposit Guarantee Fund		3 804 037	2 439 443
Income of the Fund for the Protection of the Insured		221 764	127 302
OVERDUE PAYMENTS		-	1 877
		22 204 867	19 182 136
EXPENSES			
GUARANTEED COMPENSATIONS		(64)	-
Payments from the Deposit Guarantee Fund		-	-
Payments from the Fund for the Protection of the Insured	12	(64)	-
INVESTMENT MANAGEMENT EXPENSES		(7 516)	-
Deposit Guarantee Fund		(7 129)	-
Fund for the Protection of the Insured		(387)	-
		(7 580)	-
		22 197 287	19 182 136

The accompanying notes on pages 35 to 41 form an integral part of these financial statements.

Deputy Chairman
Financial and Capital Market Commission

Jānis Brazovskis

Head of the Financial Division

Rita Vanaga

27 April 2009

Cash Flow Statement for Commission's Activities

	Note	2008	2007
(lats)			
RECEIPTS			
RECEIPTS RELATED TO SUPERVISION OF CREDIT INSTITUTIONS AND CREDIT UNIONS		2 142 675	2 373 663
Payments by credit institutions		2 133 070	2 364 853
Payments by credit unions		9 605	8 810
RECEIPTS RELATED TO SUPERVISION OF INSURANCE		798 312	999 613
Payments by life assurance companies		108 696	130 574
Payments by other insurance companies		689 616	869 039
RECEIPTS RELATED TO SUPERVISION OF THE SECURITIES MARKET AND PENSION FUNDS		179 487	190 194
Payments by securities market participants		144 222	155 618
Payments by private pension funds		35 265	34 576
OVERDUE PAYMENTS		-	202
INCOME FROM INTEREST ON THE BALANCE OF THE COMMISSION'S CURRENT ACCOUNT		57 960	43 259
TOTAL RECEIPTS		3 178 434	3 606 931
EXPENSES			
Staff remuneration and other payments		(2 946 609)	(2 293 229)
Staff remuneration and other payments		(2 419 576)	(1 898 684)
State social insurance compulsory contributions		(527 033)	(394 545)
Staff insurance		(291 323)	(124 183)
Improvements of professional skills and business trips		(197 626)	(196 455)
Telecommunication and information		(51 581)	(38 410)
Public awareness campaigns and external and internal communications expenses		(18 644)	(24 755)
Maintenance expenses		(369 138)	(308 414)
Professional services		(118 010)	(83 127)
Participation in international organisations ³		(69 761)	(77 340)
TOTAL EXPENSES		(4 062 692)	(3 145 913)
INVESTMENT ACTIVITIES			
Capital expenditure		(130 368)	(58 332)
TOTAL INVESTMENT ACTIVITIES		(130 368)	(58 332)
Net change in cash during the reporting period		(1 014 626)	402 686
Cash balance at the beginning of the reporting period		2 019 036	1 616 350
Cash balance at the end of the reporting period		1 004 410	2 019 036

The accompanying notes on pages 35 to 41 form an integral part of these financial statements.

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Head of the Financial Division

Rita Vanaga

27 April 2009

³ In 2007 expenses on co-financing for operations of the attaché in Brussels were included in the statement. In 2008, the Ministry of Finance of the Republic of Latvia maintained activities of an attaché regarding the financial and capital market area.

Cash Flow Statement for Activities of Deposit Guarantee Fund and Fund for the Protection of the Insured

	Note	2008	(lats) 2007
FINANCING			
PAYMENTS TO DEPOSIT GUARANTEE FUND		17 419 158	14 872 434
Payments by credit institutions		17 408 023	14 862 565
Payments by credit unions		11 135	9 869
PAYMENTS TO THE FUND OF THE PROTECTION OF THE INSURED		1 064 737	870 083
Payments by life assurance companies		313 639	319 719
Payments by other insurance companies		751 098	550 364
OVERDUE PAYMENTS		-	1 877
OTHER PAYMENTS ⁴		175	-
CASH FLOW FROM FINANCING ACTIVITIES		18 484 070	15 744 394
INVESTMENT ACTIVITIES			
(INCREASE) DECREASE IN DEBT SECURITIES		(24 264 628)	(16 028 087)
In the Deposit Guarantee Fund		(22 488 651)	(15 302 985)
In the Fund for the Protection of the Insured		(1 775 977)	(725 102)
INCOME FROM INVESTMENT		4 019 236	2 053 438
Deposit Guarantee Fund		3 556 781	1 949 339
Fund for the Protection of the Insured		462 455	104 099
CASH FLOW FROM INVESTMENT ACTIVITIES		(20 245 392)	(13 974 649)
EXPENSES			
PAYMENT OF COMPENSATIONS		-	-
Payments from the Deposit Guarantee Fund		-	-
Payments from the Fund for the Protection of the Insured		-	-
INVESTMENT MANAGEMENT EXPENSES		(6 793)	-
Deposit Guarantee Fund		(6 443)	-
Fund for the Protection of the Insured		(350)	-
TOTAL EXPENSES		(6 793)	-
Net change in cash during the reporting period		(1 768 115)	1 769 745
Cash balance at the beginning of the reporting period		1 770 599	854
Cash balance at the end of the reporting period		2 484	1 770 599


The accompanying notes on pages 35 to 41 form an integral part of these financial statements.

Deputy Chairman
Financial and Capital Market Commission



Jānis Brazovskis

Head of the Financial Division



Rita Vanaga

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⁴ Assets transferred into the Fund for the Protection of the Insured by mistake.

Statement of Changes in Equity

(lats)

	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
Note				
Budget result 31.12.2006	1 855 090	48 574 025	2 511 735	51 085 760
Budget result of the reporting period	281 358	18 001 389	1 180 747	19 182 136
Budget result 31.12.2007	2 136 448	66 575 414	3 692 482	70 267 896
Fixed assets write-off in 2008 charged to the budget result	1 (45)	-	-	-
Budget result of the reporting period	(658 093)	21 032 944	1 164 343	22 197 287
Budget result 31.12.2008	1 478 310	87 608 358	4 856 825	92 465 183

The accompanying notes on pages 35 to 41 form an integral part of these financial statements.

Deputy Chairman
Financial and Capital Market Commission

Jānis Brazovskis

Head of the Financial Division

Rita Vanaga

27 April 2009

Notes to the Financial Statements

The Financial and Capital Market Commission was established and has been operating under the Law on the Financial and Capital Market Commission.

The objective 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.

In accordance with the Law on the Financial and Capital Market Commission, its key functions are as follow:

- to issue binding rules and regulations and directives setting out requirements for the functioning of financial and capital market participants and calculation and reporting of their performance indicators;
- by controlling compliance with regulatory requirements and directives issued by the Commission, to regulate activities of financial and capital market participants;
- to specify the qualification and conformity requirement for financial and capital market participants and their officials;
- to establish the procedure for licensing and registration of financial and capital market participants;
- to collect and analyse information (data) relating to the financial and capital market and to publish it;
- to ensure accumulation of funds with the Deposit Guarantee Fund, and Fund for the Protection of the Insured, their management and payment of compensation from these funds in accordance with the Deposit Guarantee Law and Law on Insurance Companies and Supervision Thereof;
- to ensure payment of compensations to investors in accordance with the Investor Protection Law;
- to analyse regulatory requirements pertaining to financial and capital market and draft proposals for their improvement and harmonisation with the regulatory requirements Community;
- to engage in systemic studies, analysis and forecasting of the financial and capital market development;
- to cooperate with foreign financial and capital market supervision authorities and participate in international organizations of the financial and capital market supervision institutions.

The Commission makes independent decisions within the limits of its authority, executes functions assigned to it by law, and is responsible for their execution. No one is entitled to interfere with the activities of the Commission, except institutions and officials authorised by law. The Commission's legal ability and capacity complies with the objectives set forth in the Law on the Financial and Capital Market Commission and other laws. The Commission is assigned property owned by the state and has an independent balance sheet. The Parliament of the Republic of Latvia (Saeima) executes supervision of the Commission.

The Commission's offices are located at Kungu iela 1 in Riga.

1. Accounting Policies of the Commission

Basis for Preparation of the Financial Statements

The financial statements were prepared by using as guidelines the Financial Accounting Policies of the Financial and Capital Market Commission approved by the Commission's Board, which are in compliance with the International Public Sector Accounting Standards (IPSAS) used by public sector entities in the preparation of accounting and financial statements.

The accounting principles applied for the reporting period and previous years were used consistently. 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 as separate statements of income and expenses.

The long-term assets acquired from the budget for the Commission's establishment and commencement of activities at the launch of the Commission's activities were used to ensure activities of the Commission; consequently, these assets were included in the general balance sheet of the Commission, as well as asset depreciation/amortisation or write-off was included in the Commission's statement of income and expenses.

Principles Applied in Preparing the Financial Statements

- The financial statements, except for the cash flow statement, are prepared in compliance with the principle of accrual-based accounting. It provides for recognition of transactions and events in the financial statements at the date of their occurrence, irrespective of the related cash flows. Revenues are derived on the basis of business operations performed by financial and capital market participants, which are reported and from which payments are to be calculated. Expenses are recognised at the date of their occurrence, including accrued vacation expenses proportionate to the time actually worked.

Accrued vacation expenses shall be specified for each staff member for his or her paid vacation days accrued up to 31 December of the respective calendar year.

- 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 acquisition of assets.
- Transactions and other events are reflected by taking into account the principle of substance over form, stating that transactions and events shall 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 an on-going concern basis.

Long-term Investments

Long-term investments were recognised by taking as guidelines the Commission's Financial Accounting Policies, which prescribed that they were intangible and fixed-type investments with the period of practical use over one year and they would be used for provision of services, maintenance of other fixed assets and the needs of the Commission's administration. Depreciation and amortisation rates for the Commission's long-term investments were harmonized with depreciation rates for fixed assets set for budgetary institutions in the Republic of Latvia. Depreciation rates for long-term investments, acquired as from 2006, were applied in compliance with the Regulation No. 440, On Fixed Asset Depreciation Rates for Budgetary Institutions and Application Conditions, issued by the Cabinet of Ministers of the Republic of Latvia on 21 June 2005, which stipulates the following annual depreciation rates:

- | | |
|---------------------------|------|
| ● computers and equipment | 20%; |
| ● other fixed assets | 10%. |

Whereas depreciation rates for long-term investments, acquired before 2006, were applied in compliance with Regulation No. 96, On Fixed Asset Depreciation Rates for Budgetary Institutions, issued by the Cabinet of the Republic of Latvia on 6 March 2001, which stipulated the following annual depreciation rates:

- | | |
|---------------------------|------|
| ● computers and equipment | 35%; |
| ● other fixed assets | 20%. |

The depreciation for the Commission's fixed assets is calculated until their residual value reaches 5 lats as provided for by the Regulations No. 96 of the Cabinet of Ministers of 6 March 2001 On Fixed Asset Depreciation Rates for Budgetary Institutions. For reconstructing long-term investments acquired before 2006, their depreciation rates have been changed in compliance with provisions on fixed asset depreciation rates of the Regulation No. 440, On Fixed Asset Depreciation Rates for Budgetary Institutions and Application Conditions, issued by the Cabinet of Ministers of the Republic of Latvia on 21 June 2005.

The amount of depreciation calculated for fixed assets was included into the Commission's statement of income and expenses, except for the fixed assets taken over from budgetary institutions (the Insurance Supervision Inspectorate, the Securities Market Commission and the Deposit Guarantee Fund Administration) on 1 July 2001, the depreciation of which was directly charged against the book value of fixed assets in the Commission's balance sheet still in 2006 and the Commission's equity (net assets). Such a method is provided by the Regulations No. 96 of the Cabinet of Ministers of 6 March 2001 On Fixed Asset Depreciation Rates for Budgetary Institutions, for in the respective budgetary 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. In 2008, no depreciation for these fixed assets was developed.

1. Accounting Policies of the Commission (continued)

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.

Accounts Receivable

The Commission steadily follows that settlements are made in due time. 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. Investments in Securities

This item contains the purchased Latvian State Treasury securities. The value of securities was disclosed in the balance sheet at amortised cost.

Securities of the Funds (in lats) were placed in the following Latvian Government securities issues:

Issue No.	Issue date	Maturity date	Annual rate of return (%)	Nominal value	Book value 31.12.2008
LV0000590024	04.07.2008.	04.07.2019.	6.74	2 006 900	2 068 638
LV0000590016	10.08.2007.	10.08.2018.	5.81	15 012 100	14 728 820
LV0000580033	02.12.2005.	02.12.2015.	3.99	20 616 600	19 672 265
LV0000580017	14.02.2003.	14.02.2013.	4.86	3 785 000	3 976 034
LV0000570059	03.11.2006.	03.11.2011.	5.23	7 490 800	7 498 320
LV0000570042	04.02.2005.	04.02.2010.	3.35	6 184 400	6 267 984
Long-term investments by the Funds				55 095 800	54 212 061

Issue No.	Issue date	Maturity date	Annual rate of return (%)	Nominal value	Book value 31.12.2008
LV0000541019	05.12.2008.	04.12.2009.	11.15	838 400	751 809
LV0000540987	07.11.2008.	06.11.2009.	9.63	5 331 300	4 895 107
LV0000540979	04.09.2008.	04.09.2009.	8.23	294 900	277 499
LV0000540961	06.06.2008.	05.06.2009.	6.91	26 657 900	25 867 343
LV0000550085	30.03.2007.	30.03.2009.	5.62	1 772 600	1 850 561
LV0000540953	13.03.2008.	13.03.2009.	6.29	380 800	376 098
Short-term investments by the Funds				35 275 900	34 018 417

Issue No.	Issue date	Maturity date	Annual rate of return (%)	Nominal value	Book value 31.12.2007
LV0000580033	02.12.2005.	02.12.2015.	4.10	20 616 600	19 549 126
LV0000580017	14.02.2003.	14.02.2013.	4.85	3 785 000	3 980 855
LV0000570059	03.11.2006.	03.11.2011.	4.98	5 626 300	5 655 473
LV0000570042	04.02.2005.	04.02.2010.	3.31	6 184 400	6 268 224
LV0000550085	30.03.2007.	30.03.2009.	5.62	1 772 600	1 851 740
Long-term investments by the Funds				37 984 900	37 305 418

Issue No.	Issue date	Maturity date	Annual rate of return (%)	Nominal value	Book value 31.12.2007
LV0000540912	11.01.2007.	11.01.2008.	4.34	5 861 700	5 851 925
LV0000540920	06.06.2007.	06.06.2008.	5.50	7 869 200	7 689 253
LV0000540938	08.08.2007.	08.08.2008.	5.85	13 578 600	13 112 688
Short-term investments by the Funds				27 309 500	26 653 866

Allocation of the securities book value for the Funds was as follows:

	31.12.2008	31.12.2007
Securities of the Deposit Guarantee Fund	83 623 260	60 887 352
Securities of the Fund for the Protection of the Insured	4 607 218	3 071 932
	88 230 478	63 959 284

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

	31.12.2008	31.12.2007
Accrued income of the Deposit Guarantee Fund	961 583	839 701
Accrued income of the Fund for the Protection of the Insured	84 935	58 273
	1 046 518	897 974

3. Long-term Investments

	Book value 31.12.2007	Additions in the reporting period	Revaluated	Write-offs and disposals	Depreciation			Book value 31.12.2008
					Charge in the reporting period	Corrections, transfer	Reversal due to disposals	
Intangible assets ⁵	47 853	32 393	-	-	(26 804)	-	-	53 442
Fixed assets								
Computers and office equipment	28 979	65 985	-	(28 907)	(14 424)	139	27 986	79 758
Other fixed assets	12 116	39 927	2 995	(10 177)	(2 782)	(139)	7 758	49 698
Prepayments for long-term investments	8 221	-	-	(7 985)	-	-	-	236
	97 169	138 305	2 995	(47 069)	(44 010)	-	35 744	183 134

Changes in long-term investments in 2008 showing the amount of expenses disclosed in the statement of income and expenses:

	Charge	Write-offs or disposals, excluding the accrued depreciation	Total
Depreciation/amortisation/write-off of capital investments charged to the statement of income and expenses	44 010	300	44 310
Fixed asset depreciation/write-off directly charged to the budget result (equity)	-	45	45
	44 010	345	44 355

4. 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 2008 and the fourth quarter ended 31 December 2007; and to the Fund for the Protection of the Insured for the fourth quarter ended 31 December 2008, the third quarter 2008 in the amount of 25 176 lats and the fourth quarter ended 31 December 2007.

	31.12.2008	31.12.2007
Due from market participants to the Deposit Guarantee Fund	3 983 650	4 166 773
Due from credit institutions	3 980 657	4 164 004
Due from credit unions	2 993	2 769
Due from market participants to the Fund for the Protection of the Insured	249 469	371 176
Due from life assurance companies	81 719	160 606
Due from other insurance companies	167 750	210 570
	4 233 119	4 537 949

5. Due from Market Participants to the Commission

This item contains amounts due from financial and capital market participants to the Commission on the date set out in the statement.

Due from different segments of financial and capital market participants to the Commission:

	31.12.2008	31.12.2007
Due from credit institutions	461 962	212 684
Due from credit unions	2 514	2 206
Due from other insurance companies	65 907	-
Due from investment management companies	23 214	10 204
Due from investment firms	3 173	160
Due from the Latvian Central Depository and the Riga Stock Exchange ⁶	4 655	-
Due from private pension funds	9 560	63
	570 985	225 317

⁵ Licences, software and other intangible assets.

⁶ As from 10.01.2009 the name changed to the joint stock NASDAQ OMX Riga.

6. Prepayments of Market Participants to the Commission

This item contains amounts prepayments made by the financial and capital market participants for financing the Commission on the date set out in the statement.

Prepayments by different segments of financial and capital market participants to the Commission:

	31.12.2008	31.12.2007
Due from life assurance companies	50 968	61 940
Due from other insurance companies	-	25 603
Due from the Latvian Central Depository and the Riga Stock Exchange	-	980
	50 968	88 523

7. Taxes

Type of tax	Balance on 31.12.2007	Calculated for the reporting period	Decreased compulsory contribution result	Paid in the reporting period	Balance on 31.12.2008
Contributions to compulsory state social insurance (overcharge)	450	726 786	(1 343)	(724 437)	1 456
Personal income tax (overcharge)	(22)	526 729	-	(526 771)	(64)
	428	1 253 515	(1 343)	(1 251 208)	1 392

According to the data received from the State Revenue Service, compulsory contributions to State social insurance were decreased in 2007 by the amount that exceeded the maximum limit specified by the Cabinet, i.e. 23 800 lats per tax-payer in 2007.

8. Prepaid Expenses

	31.12.2008	31.12.2007
Data base subscription fees	3 146	2 870
Software subscription fees	1 681	2 140
Professional literature	2 072	915
Insurance services	1 160	137
Informative services	3 540	-
Other prepaid expenses	4 869	844
	16 468	6 906

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 set out in the statement.

11. Accounts Payable on Other Claims

	31.12.2008	31.12.2007
Due to the Commission for business travel expense reimbursement	1 182	2 678
Other accounts payable to the Commission	465	335
	1 947	3 013

12. Settlements with the Administrators related to Guaranteed Compensation Payments

In order to protect the interests of the insured, by the 6 December 2002 Decision No. 322, On the Procedure for Making Payments from the Fund for the Protection of the Insured in the Case of AK Alianse's Bankruptcy, the Board of the Commission established the procedure for insurance indemnity payments from the Fund for the Protection of the Insured and further procedure for use of the funding. In protecting the interests of the insured, the insurance indemnity payments from the Fund for the Protection of the Insured totalled 8 671 lats (8 607 lats from 2003 to 2004, and 64 lats in 2008).

13. Staff Remuneration and Other Payments

This item contains remuneration to the staff of the Commission, including remuneration paid for specific work done for the Commission. Expenses related to remuneration to the Board comprised 13.6% of the total remuneration expenses (in 2007 – 16.05%). At the end of 2008, the Commission had 103 staff members (in 2007 – 95), and there were 110 positions at the Commission by the end of 2008 (in 2007 – 96).

	2008	2007
Staff remuneration, incl. members of the Consultative Council of the Financial and Capital Market	2 415 624	1 903 069
incl. remuneration to members of the Commission's Board	329 174	305 515
incl. remuneration to members of the Consultative Council of the Financial and Capital Market	4 285	4 060
Average number of employees per year	102	93
incl. the number of members of the Commission's Board	5	5
The number of members of the Consultative Council of the Financial and Capital Market	6	6

14. Staff Insurance

	2008	2007
Endowment life insurance	247 157	94 880
Health insurance	40 746	26 520
Accident insurance	3 362	2 847
	291 265	124 247

In accordance with the Procedure for the Financial and Capital Market Commission's Personal Policy and Determining and Application of Its Instruments, approved by the Board of the Commission, the Commission effected insurance for its staff, including endowment life insurance for those employees who had been employed by financial and capital market supervisory authorities for at least three years, as well as endowment life insurance for all employees of the Commission who performed the functions of state officials in accordance with the above document.

15. Improvements of professional skills and business trips

	2008	2007
Training and business trips abroad*	168 876	170 592
Professional training in Latvia	27 508	23 165
	196 384	193 757

* Incl. business travel expense reimbursement related to participation in the institutions of the European Union and other international organizations, 16 509 lats in 2008, and 14 219 lats in 2007.

Business trips included regular participation in the meetings of 47 EU institutions and their working groups, as well as meetings with financial supervision institutions in the US, Sweden, Italy, Russia, Denmark, Estonia, Lithuania etc. and business trips for supervisory purposes to the subsidiaries of the Latvian financial and capital market participants in member states. In 2008, two employees of the Commission inter alia had business trips where they participated as experts in training of foreign financial institution staff: in the seminar on the AML/CFT on-site bank examinations organized by the International Monetary Fund in Kyrgyzstan and in the on-site visit in Azerbaijan planned as part of the third stage inspection within the Council of Europe *MONEYVAL* expert group. Business trip share in total number of trips abroad comprised 60% in 2008, while in 2007 - 70%.

16. Telecommunication and information

	2008	2007
Telecommunication and correspondence	24 595	18 837
Information inquiry services	9 751	9 328
Data base information	84 650	11 058
	118 996	39 223

Data base information comprises maintenance of legislative base, rent of data base of public registers, information reference, international regulatory requirement data base and maintenance of the Commission's Internet resources.

17. Maintenance and General Service Expenses

	2008	2007
Rent of premises	229 474	216 495
Maintenance and public utility fees	21 429	35 823
Other maintenance and general service expenses	121 805	56 047
	372 708	308 365

A contract between the Commission and *SIA Drave* was concluded for the rent of premises at 1 Kungu Street, Riga, for 10 years, until 31 August 2011. An agreement was entered into on 18 October 2007 prescribing that as from 20 October 2007, the rent of the Commission's premises would be EUR 80 669 per quarter (EUR 322 676 per year or EUR 18.76 per square metre per month). On 19 September 2008, an agreement was entered into prescribing that as of 20 October 2008, the rent would be EUR 87 662 per quarter (EUR 350 648 per year or EUR 20.39 per square metre per month). The contract prescribes that the rent is revised and raised once a year in accordance with the consumer price index⁷ for the Republic of Latvia, but in case of increase in the rent it may be raised not more than 6% or corresponding to equivalent premises in Old Town of Riga. Upon agreement in writing between the Commission and the lessor, the contract may be terminated before its expiry date. The Commission has not intended to terminate the contract.

18. Professional Services

	2008	2007
Compensation payments to administrators for financial and capital market participants in liquidation	3 304	37 796
Services in development of regulatory norms	149	27 140
The Commission's financial statements and quality management system audit	7 180	5 511
Lawyers services	-	2 360
Other professional services	120 534	9 258
	131 167	82 065

Other professional services covered expenses for translation, assessment of regulatory norms and provision of other specific professional services.

19. 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.

On 29 December 2006, an application was submitted to the District Administrative Court calling for revoking the 21 December 2006 Decision No. 215 of the Board of the Financial and Capital Market Commission on Withdrawal of the Credit Institution Licence Granted to the JSC OGRES KOMERCBANKA regarding the paragraphs on the withdrawal of the credit institution operating licence No. 06.01.02.01/104 granted to the JSC OGRES KOMERCBANKA and the Commission's application to the Riga Regional Court asking to put the JSC OGRES KOMERCBANKA into liquidation. In the said application to the court, the JSC OGRES KOMERCBANKA had neither claimed any damages from the Commission nor indicated the due amount of damages. Theoretically, in case of any administrative action there is an option to claim damages from an institution both by appealing the institution's administrative act to the court and by initiating separate proceedings. Up to now, the JSC OGRES KOMERCBANKA (in liquidation) has not made a claim for recovery of damages. The Board of the Commission holds the view that the JSC OGRES KOMERCBANKA cannot provide any material and legal basis to justify claiming recovery of any damages from the Commission.

Justified and legal operations of the Commission have been also verified by the 2 February 2007 ruling of the Regional Administrative Court, according to which the claim from the JSC OGRES KOMERCBANKA against the Commission's decision was rejected. The ruling of the District Administrative Court of 27 March 2009 was also ruled in favour of the Commission according to which the claim from the JSC OGRES KOMERCBANKA against the Commission's decision was rejected. The above ruling was appealed by submitting appeal of the JSC OGRES KOMERCBANKA (in liquidation) to the Regional Administrative Court on 15 April 2009.

⁷ Consumer price index set by the Central Statistical Bureau of the Republic of Latvia.



INDEPENDENT AUDITORS' REPORT

To the Parliament of the Republic of Latvia

Report on the Financial Statements

We have audited the accompanying financial statements of Financial and Capital Market Commission (hereinafter – the Commission) for the year ended 31 December 2008, set out on pages 5 through 20 which comprise the balance sheet as at 31 December 2008, the statements of income and expense, changes in equity and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

The Commission's management is responsible for the preparation and fair presentation of these financial statements in accordance with Cabinet Regulations No. 749 Procedure for Preparation of Annual Reports of State Institutions and Municipalities and the Commission's accounting policy disclosed in the Notes to these financial statements. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

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. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above give a true and fair view of the financial position of the Commission as at 31 December 2008, and of the results of their operations and their cash flows for the year then ended in accordance with Cabinet Regulations No. 749 Procedure for Preparation of Annual Reports of State Institutions and Municipalities and the Commission's accounting policy disclosed in the Notes to these financial statements.

Report on Compliance of the Management Report

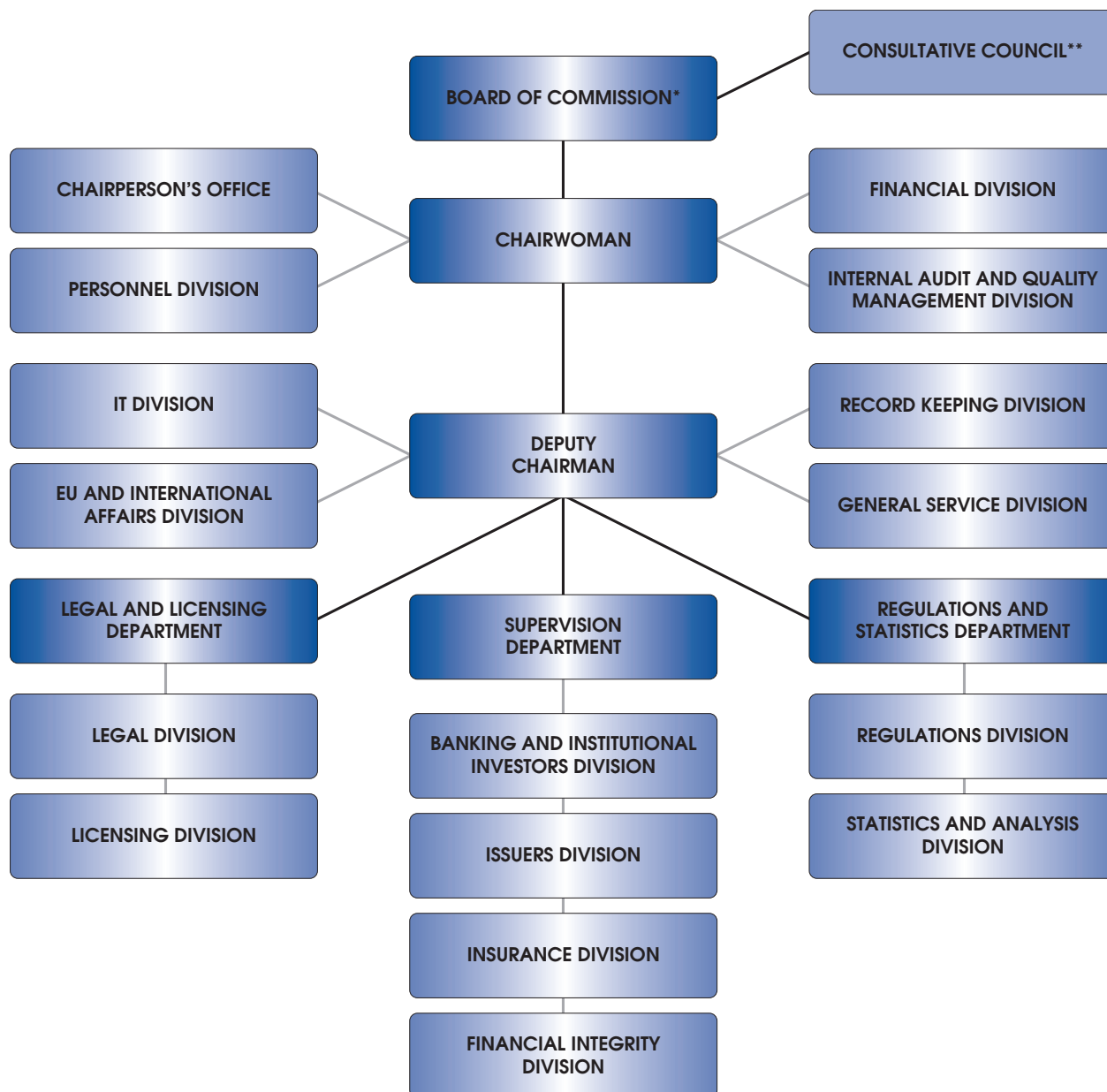
Furthermore, we have read the Management Report for the year ended 31 December 2008 (included on pages 3 through 4 of the accompanying 2008 annual report) and have not noted any material inconsistencies between the financial information included in it and the financial statements for the year ended 31 December 2008.

SIA Ernst & Young Baltic
Licence No. 17

Iveta Vimba
Member of the Board
Certified Auditor
Certificate No. 153

Riga, 27 April 2009

STRUCTURE OF THE FINANCIAL AND CAPITAL MARKET COMMISSION



* The Board of the Commission ensures that the functions of the Commission as established by law are performed by taking decisions on issues that are within the competence of the Commission in accordance with the Law on the Financial and Capital Market Commission. The Board comprises five members: Chairwoman of the Commission, Deputy Chairman of the Commission and three Board members who are also Heads of Departments.

** The Consultative Council is formed on a parity basis and is an advisory body comprising representatives of the Commission and the heads of public organisations (professional associations) of the participants of the financial and capital market.

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