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ANNUAL REPORT AND ACTIVITY REPORT 2010
OF THE FINANCIAL AND CAPITAL MARKET COMMISSION



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FRAGILE STABILITY



Chairwoman
Financial and Capital Market Commission
Irēna Krūmane

“The high public debt or sovereign risk level, interacting with the still vulnerable financial system, continued to affect global recovery of the economy and the financial system.”

Year 2010 was a turning point in Latvia after the country's economy reached the bottom line of the crisis in 2009. The financial sector stabilised, economic development was still uneven after coming out of the recession, and Latvia's gross domestic product was showing minor, yet gradual increase from quarter to quarter.

Assessing the past three years of working with the Financial and Capital Market Commission (the Commission), the conclusion was that from the outset it had been necessary to fight the consequences caused by the activity of previous years and the deregulation in the financial sector. Due to the capital adequacy threshold of 10% introduced for the Latvian banks at the end of 2008 (despite the minimum requirement of 8%) the Commission managed to maintain overall stability of the financial sector. As of the beginning of the recession Latvian banks had increased their capital by 1.3 billion lats.

At the same time, in 2009, the Latvian banking sector experienced historically higher total losses and a rapidly growing number of overdue loans due to which banks had to make provisions of an unusual volume. Despite these events 2010 was a turning point: at the end of the first quarter, the balance of deposits reported by the sector reached the pre-crisis level, i.e., the volume observed in September 2008. Throughout 2010, 14 banks increased their capital for the total of 324.4 million lats and at the end of the year the paid-up share capital of the banking sector was 1.89 billion lats. In the reporting year, 10 Latvian banks reported profit, whereas already in January 2011 (after a hiatus of two years) profit was reported in the sector in general. This trend was continuing.

However, the unbalanced recovery of the Latvian economy was accompanied by concerns about the second wave of problems caused by overdue loans and their restructuring process. If in the first months of 2010 the balance of overdue loans (up to 90 days overdue) was increasing as a result of reduced household solvency and increased expenses in business costs due to the increase in taxes and duties, then in the middle of the year credit quality stabilised and the balance of overdue loans as well as the volume of the loans that were restructured and under recovery diminished, but in the first months of 2011 credit quality started fluctuating again. Both businesses and households were still experiencing difficulties

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in settling their debts with the cost of living, inflation, tariffs and taxes growing and income remaining at a low level. It must be noted that the European Central Bank (ECB) had been retaining a record low reference rate since 2009 thus reducing the risk that the interest payments of borrowers would increase. Though the ECB decision to raise interest rate could be considered as a mark of the final stage of the global financial crisis, it also underpinned the growth of credit costs, especially for the loans in the euro — the largest share of loans in the case of Latvia.

Those banks that had been undergoing lengthy restructurisation could not be fully-fledged creditors to the economy. In 2010, the credit portfolio of Latvian banks shrunk overall by 7.1% representing 1.1 billion lats; even if a number

of banks continued lending operations on a small scale, their lending did not exceed the volume of repaid loans. The Latvian economy needed a solution to foster productivity in those conditions, improve competitiveness and create new jobs as unemployment level was brought down predominantly by the emigration level. Over the recent years, economic development had been deformed as a result of making short-term decisions and favouring the development of only few sectors. Since cheap financing was no longer available, the government's effort to reduce the share of grey economy, another reason for the deformed economic development, was also important.

The recent year-on-year global economic downturn had been the first one after the Great Depression in the 30-ties of the previous century, and in 2010 global economy returned to growth. However, the fiscal situation in Europe was complicated in 2010 with EU Member States of Greece, Ireland, Portugal and Romania seeking international financial assistance as a result of both unbalanced public expenditure and financial sector performance. Overall the national debt of the advanced economies had increased notably during the past three years and amounted to 96.6% of GDP in 2010. To reduce public debt separate countries were facing serious budget consolidation in the form of increasing taxes and cutting expenditures. The high public debt or sovereign risk level, interacting with the still vulnerable financial system, continued to affect global recovery of the economy and the financial system.

In 2010, a special bank levy was agreed at the EU level that was aimed at preventing the use of taxpayers' resources when dealing with the system-wide consequences of problems in the banking sector in the future. The financial stability duty was introduced in Latvia.

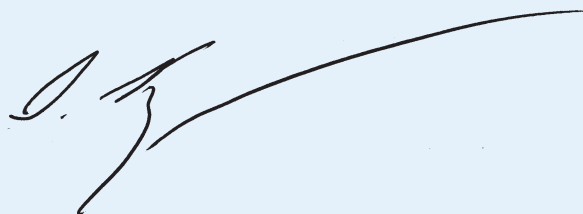
Over the past three years, we had implemented significant reforms and ensured a notably tighter supervisory framework: 23 laws, 17 Commission's regulations and three guidelines had been developed or amended. To restrict those excessive risks for the sake of short-term profit which a credit institution could not manage efficiently, the "Regulations on Core Principles of Remuneration Policies" developed by the Committee of European Banking Supervisors were introduced; according to the Regulations, the remuneration structure in a bank should be commensurate with its risk profile. In 2009 already, the volume of bonuses paid by banks to their employees was more than 14 times less than in 2007.

On 1 January 2011, the new European System of Financial Supervision started its operation; it joined three European supervisory authorities and the European Systemic Risk Board and would perform ongoing analysis of the overall situation in the financial sector, issue timely warnings about the build-up of risks and propose solutions for mitigating risks. The Commission was taking active part in these institutions. The recent issues for discussion included the necessity to introduce more radical reforms in the financial system by ensuring additional facilities to

financial market regulators to limit risky investment operations.

As a result of the reforms implemented jointly by public monitoring and the financial sector in 2010, it was possible to reduce the financial stability reserve within the international loan by 300 million euro. Therefore the funds earmarked for the banking sector stabilisation could be used by the Latvian government to reduce budget deficit. On a number of occasions international community had been appreciative of the results achieved in Latvia to stabilise the financial sector. This was a reason to believe that economic recovery, though fragile at the moment, might be strengthened under favourable conditions in the years to come to gradually return to a sustainable growth path.

Chairwoman
Financial and Capital Market Commission
Irēna Krūmane



REPORT OF THE BOARD OF THE FINANCIAL AND CAPITAL MARKET COMMISSION

The Commission is a full-fledged and autonomous public institution and it has been operating as of 1 July 2001 to ensure regulation and supervision of the financial and capital market in Latvia. The Commission's activities have been managed by its Board: Chairwoman of the Commission Irēna Krūmane, Deputy Chairman Jānis Brazovskis and Board Members Ludmila Vojevoda, Jānis Placis and Gvido Romeiko.

The Commission was supervising credit institutions, credit unions, payment institutions, electronic money institutions, insurance undertakings, insurance intermediaries and reinsurers, participants of the financial instruments market as well as private pension funds to ensure stability of the financial and capital market, promote its development and guarantee observance of interests of the customers of market participants. In the reporting year, the activities of the Commission were fully funded from the payments by the participants of the financial and capital market.

In 2010, 51 Board meeting was held during which 346 decisions were adopted (217 in 2009); as well, seven meetings of the Consultative Council of the Financial and Capital Market Commission (the Consultative Council) were held during which 24 draft regulations that were binding to the financial and capital market were discussed (48 in 2009). The Consultative Council was notified, on a regular basis, on the funds accumulated in the Deposit Guarantee Fund (DGF) and in the Fund for the Protection of the Insured (FPI) as well as the management of these funds. At the end of 2010, the Consultative Council assessed and approved draft annual budget of the Commission for 2011 and the Commission's work programme for 2011.

Overall in 2010, the Commission carried out 54 on-site inspections in all sectors of the financial and capital market (80 in 2009), of which 34 on-site inspections were carried out in banks (44 in 2009); special attention was paid to assessing capital adequacy, lending process, risk management and activities in the area of preventing money laundering. The Commission performed five full-scope on-site inspections in insurance undertakings, one inspection in a credit union, three inspections in investment management companies, and one in a manager of assets of state funded pension schemes. On-site inspections were also carried out in two private pension funds. In 2010, the Commission's experts performed six planned inspections of information system (IS) security of market participants and two extraordinary inspections in respect of security incidents, including customer data leakage.

In the reporting year, overall 30 different sanctions were applied to market participants, incl. a penalty that was applied in seven cases to various market participants and whose total amount was 100 000 lats. The licence of one bank was withdrawn and the activity of two banks restricted. A sanction in the form of a penalty of 25 000 lats was imposed on one bank for a failure to notify the Commission of customer data protection and potential information system security problems, and a penalty of 10 000 lats was imposed on one bank for a failure to comply with the regulations on large exposures. A penalty of 25 000 lats was imposed on each of the two banks for a failure to comply with the requirements of the "Law on the Prevention of Laundering

the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing". The special provisioning policy or asset recognition policy was established for nine banks. The activities of one insurance undertaking and one cooperative credit union were restricted. The Commission issued 18 warnings to different market participants and applied a penalty of 5000 lats in one case for the violations of the "Law on the Financial Instruments Market" in respect of disclosing mandatory information, notifications in respect of inside information holders, notifications about acquired or disposed qualifying holdings and other violations. A warning was issued to one bank for the violations in respect of the provided investment services, and a penalty of 5000 lats was imposed on one bank for the same violations. A penalty of 5000 lats was imposed on one participant of the financial instruments market for a non-compliant audit committee.

In order to improve restructurisation process of credit institutions, in the reporting year the Commission developed an amendment to the "Credit Institution Law" whereas three amendments to the same Law were introduced to clarify the definition of a group of related customers and to withdraw certain exemptions from restrictions on exposures in respect of several exposures. For the same purpose an amendment to the "Law

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on the Financial Instruments Market" was made. Amendments to the "Deposit Guarantee Law" were made in 2010 according to which the state guaranteed compensation to customers of Latvian banks and credit unions was increased to 100 000 euro (about 70 000 lats) as of 1 January 2011. In the reporting year, the Commission's experts developed and the Board approved new regulations governing the activities of payment service institutions and introduced five substantial amendments to other Commission's regulations. The Commission also developed "Communication Guidelines for the Participants of the Financial and Capital Market and Their Customers" to improve the communication process between market participants and their existing and potential customers and reduce the number of customer complaints about the conduct of market participants.

In 2010, the Funds Management Committee (the Committee) was established to coordinate processes related to the management of the DGF, the FPI and the investor protection scheme. The Committee also developed regulations aimed at linking the amount paid into the DGF with the risks inherent in a particular deposit taker and establishing an applicable adjustment ratio. On-site inspections were carried out in all banks to assess

their technical facilities for submitting information in accordance with the requirements of the “Regulations for Compiling and Providing Information on Guaranteed Compensations” and the investment policy and investment procedure in respect of DGF and FPI funds were changed.

In 2010, the Commission received and reviewed 464 applications about the financial and capital market participants. Of them, 283 applications were about the behaviour of banks, 102 about the activities of insurance undertakings,

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a concept was developed for a further education of the customers of market participants”

23 applications were about insurance intermediaries, 31 about the financial instruments market participants, one about a private pension fund, one about a credit union, one about an investment management company and 22 applications were about miscellaneous issues relating to the financial and capital market.

In the framework of the activities aimed at developing and improving the protection and education of the customers of market participants, the Commission presented a report to the World Bank expert meeting in which it analysed the conclusions of the study on consumer protection problems in Latvia in the area of financial services and also concluded a cooperation agreement with the Consumer Rights Protection Centre. In view of these activities, in 2010 a concept was developed for a further education of the customers of market participants and a decision was taken to establish a new educational Internet homepage “Customer School” (Klientu skola, available in Latvian at www.klientuskola.lv) that would provide information about the essence of the most popular financial products in Latvia and their risk assessment. The homepage was launched on 1 March 2011 and was available to all interested persons. To determine the confidence indicator of Latvia’s population in the financial and capital market, the annual survey in the reporting year was carried out in respect of the previous period.

With a view to keep public informed and educate people about the topical trends and developments in the financial and capital market, the Commission disseminated 59 statements to mass media in 2010 (60 in 2009). In January 2010, the Commission started publishing, on a regular basis, information about the received and reviewed customer complaints, incl. the most frequent reasons for complaints about credit institutions and insurance undertakings and the measures taken by the Commission in reviewing the complaints and dealing with problem

situations. To ensure circulation of information at the international level and availability of objective information about the situation in the Latvian financial sector in 2010, two meetings for the ambassadors accredited in Latvia were organised and information with Latvian embassies abroad was exchanged on a regular basis.

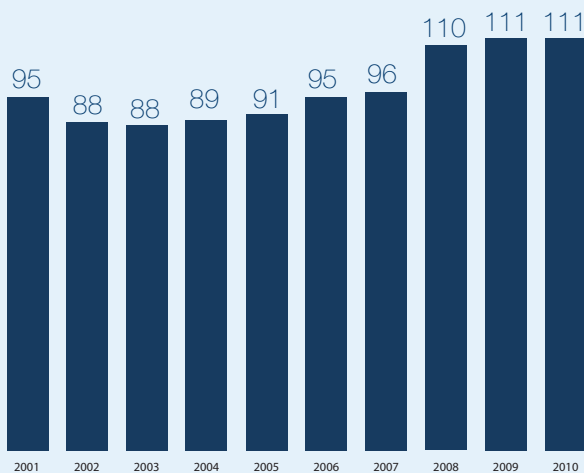
In the reporting year, the Commission continued to improve its quality management system to ensure its compliance with the requirements of EN ISO 9001:2008 standard and to foster the balance between the necessity to satisfy customer needs and the Commission’s functions to ensure that the Commission’s customers trust the unfailing quality of the services provided by the Commission. The Commission’s quality management system was audited by both internal auditors and “Bureau Veritas Certification” and the audit recognised that the Commission’s quality management system complied with EN ISO 9001:2008 standard.

Personnel was the most important resource of the Commission that ensured achieving the goals of the Commission and further development of the institution. In 2010, the Commission continued the reform of the personnel management processes initiated in 2009 by developing and implementing the Performance Management and Development System, ensuring

its electronic support in the Result-Oriented Management System, establishing the necessary competencies for all positions within the Commission and developing the Description of Job Competencies, revising the Salary Review Process and linking it with the performance assessment results.

CHANGES IN THE NUMBER OF EMPLOYEES AND PERSONNEL CHANGES

In the reporting year, the number of the persons employed by the Commission did not change and it was 111 (see Chart 1).



The average number of employees, including employees that had been absent for a long time, was 111 in 2010, of which:

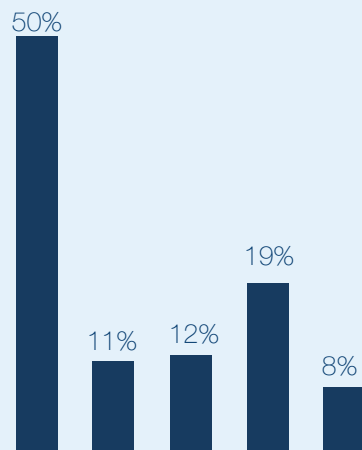
- 86 (77%) were performing core activities and 25 (23%) were performing support functions;
- 77 (69%) were public officials and 34 (31%) were employees.
- All employees were performing intellectual work.

Chart 1.

Dynamics of the Number of Employees (2001-2010)

33 employees (30%) participated, on a regular basis, in the work of the EU institutions and working groups and committees established by European financial supervisory authorities.

In 2010, 50% (55) of employees had had job relationship with the Commission for nine years, i.e., as of the establishment of the Commission in 2001, whereas 8% (9) of employees had been working with the Commission for less than a year (see Chart 2).



The staff turnover rate in 2010 was 5.4%. In the reporting year, six new employees were recruited (for an indefinite job duration). After the trial period, in accordance with the established adaptation plan all six employees received a positive assessment and stayed with the Commission. Job contracts were concluded with three employees to replace employees that had been absent for a long time (during a child care leave). In the reporting year, the Commission closed three positions of janitors and outsourced the respective service, and also terminated job relationship with three employees: two took jobs in the private sector and one employee relocated with the family to live abroad.

Chart 2.

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

STAFF QUALIFICATIONS

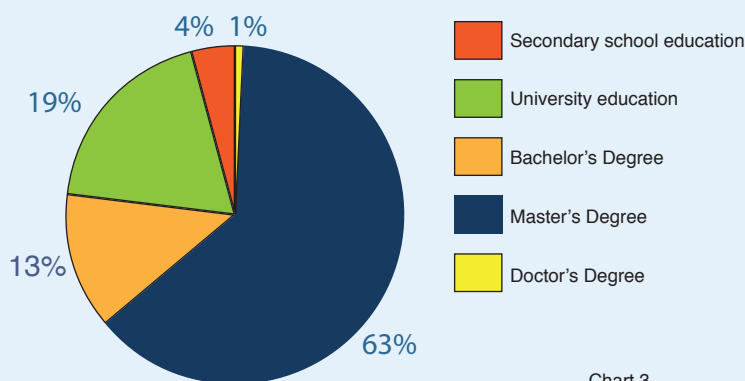


Chart 3.

Education profile of the Commission's personnel (%)

The Commission valued educated and professional employees. In the reporting year, 96% (106) of employees had university education (of which 66% had a Master's Degree), and 4% (5) of employees had general secondary school or professional secondary school education (see Chart 3).

DEMOGRAPHIC AND AGE PROFILE OF THE COMMISSION'S STAFF

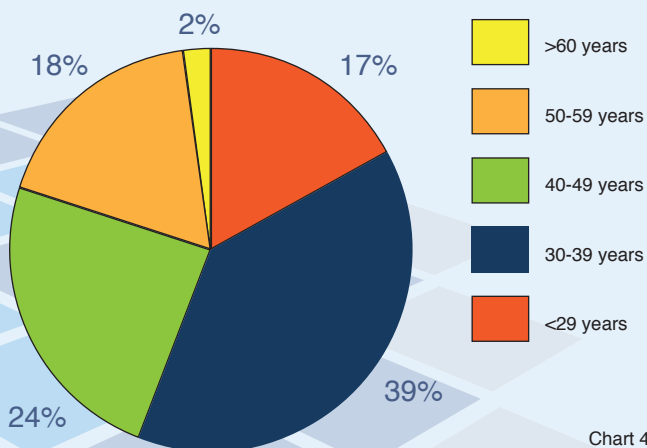


Chart 4.

Age profile of the Commission's staff (%)

In 2010, 77% (85) of all Commission's staff were women and 23% (26) were men. The average age of the Commission's staff was 40 that slightly exceeded the indicator in 2009 (39 years). The age profile of the Commission's staff in the reporting year is shown in Chart 4.

PERFORMANCE MANAGEMENT ASSESSMENT

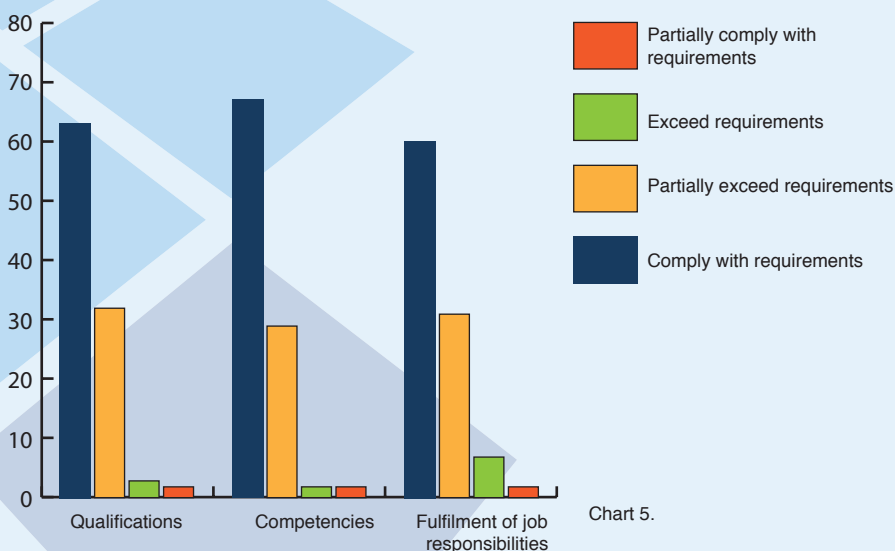


Chart 5.

Performance management assessment according to criteria (%)

In 2010, the Commission for the first time conducted performance management assessment of its employees in which 97 staff members participated: 19 were the heads of structural units (incl. four Board Members) and 78 were experts. Three performance management criteria were assessed: fulfilment of professional duties, compliance with the required qualifications (incl. the level of education, professional experience, expert knowledge and skills, language proficiency and computer skills) and the required job-related competencies. After assessing all criteria, 61% of employees were recognised as "compliant with the requirements", 35% were recognised as "partially exceeding the requirements", and 2% were recognised as "exceeding the requirements" or "partially complying with the requirements". None of the employees was recognised as "non-compliant".

In the overall assessment by criteria the assessment profile was similar (see Chart 5).

IMPROVING THE STAFF QUALIFICATIONS

In order to improve the activity processes, efficiency and productivity of the Commission pursuant to its strategy and to ensure that the supervision of the financial sector — the banking sector in particular — was carried out in line with the economic situation in the country, 72% (80) of the Commission's employees improved their qualifications by attending job-related training both in Latvia and other countries. In Latvia, they attended workshops to improve their knowledge in the area of legislation, financial analysis, record keeping, information technology (IT), job protection, presentation and management skills. To extend knowledge in the area of bank risk management, stress testing

methodology and practice, capital requirements for the insurance sector Solvency II, Basel Capital Accord II and other areas related to financial supervision, 44 Commission's employees attended seminars abroad. One employee, an expert in the area of the financial instruments market directive (MIFID), attended a training project in Turkey as a member of the European Commission TAIEX expert group.

FINANCING OF THE ACTIVITIES OF THE COMMISSION

In the reporting year, the activities of the Commission were fully financed from the payments by market participants. Within the budget for ensuring its activities, in the reporting year the Commission also managed the Deposit Guarantee Fund and the Fund for the Protection of the Insured.

COMMISSION'S BUDGET RESULT IN 2010, IN LATS

	Actual result in 2009 ¹	In 2010			
		Actual result ¹	Approved budget ¹	Budget result, %	Share of actual result, %
INCOME (+)	5 103 260	3 992 754	3 985 520	100.2	100
PAYMENTS BY THE PARTICIPANTS OF THE FINANCIAL AND CAPITAL MARKET	5 088 232	3 980 299	3 976 520	100.1	99.7
INCOME RELATED TO THE SUPERVISION OF MONETARY FINANCIAL INSTITUTIONS	3 779 598	2 833 816	2 833 770	101.5	71.0
Payments by credit institutions	3 766 848	2 821 166	2 821 120	101.5	70.7
Payments by credit unions	12 750	12 650	12 650	100.0	0.3
INCOME RELATED TO THE SUPERVISION OF INSURANCE UNDERTAKINGS	1 056 751	936 073	935 780	100.0	23.4
Payments by life insurance undertakings	120 881	131 902	131 750	100.1	3.3
Payments by other insurance undertakings	935 870	804 171	804 030	100.0	20.1
INCOME RELATED TO THE SUPERVISION OF THE FINANCIAL INSTRUMENTS MARKET AND PRIVATE PENSION FUNDS	251 404	208 694	206 970	100.8	5.2

¹ Saskaņā ar uzkrāšanas principu.

Payments by the participants of the securities market	202 922	163 694	161 970	101.1	4.1
Payments by private pension funds	48 482	45 000	45 000	100.0	1.1
OTHER PAYMENTS ¹	479	1 717	-	-	-
INCOME FROM TERM DEPOSITS	15 028	12 454	9 000	138.4	0.3
EXPENSES (-)	4 194 238	3 471 844	3 917 160	88.6	100
REMUNERATION	3 363 943	2 721 418	2 883 060	94.4	78.4
Salaries and payments equivalent to salaries ¹	2 657 221	2 163 524	2 292 570	94.4	62.3
Mandatory contributions to the State Social Insurance	641 075	521 571	553 230	94.3	15.0
Social guarantees ⁴	65 647	36 323	37 260	97.5	1.0
IMPROVING PROFESSIONAL QUALIFICATION OF THE STAFF AND BUSINESS TRIPS	146 439	166 211	269 280	61.7	4.8
SERVICES AND COMMODITIES TO ENSURE ACTIVITIES	554 522	429 737	592 980	72.5	12.4
Telecommunication, liaison and information	106 738	102 505	120 890	84.8	3.0
Information to the general public, internal and external communication	23 382	11 881	22 400	53.0	0.3
Maintenance and maintenance-related expenses	322 960	243 889	301 940	80.8	7.0
Professional services	101 442	71 462	147 750	48.4	2.1
PARTICIPATION FEES IN INTERNATIONAL ORGANISATIONS	75 416	100 504	115 910	86.7	2.9
AMORTISATION/DEPRECIATION AND EXCLUSION OF CAPITAL INVESTMENT	53 918	53 974	55 930	96.5	1.6

In comparison with 2009, in the reporting year the volume of budget expenses was decreased notably (by 17%) and so were the payments to the Commission by the participants of the financial and capital market. The payments by the participants of the financial and capital market to the Commission's budget depended, in direct proportion, on the payment rates established to the participants for financing the Commission, on changes in the performance indicators of the financial market (their increase or decrease) as well as on the amount of the expenses needed to finance the Commission's activities (see Table 1).

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

Changes in the financing for the Commission, 2007-2010, %

Table 1.

1 In accordance with the accrual principle.

2 Payments by the participants of the financial and capital market for the previous reporting year.

3 Payments equivalent to salary include one-off benefits to employees for the birth of a child (payment of benefits was stopped in November 2010), the death of a family member (the amount of the benefit was reduced notably to 180 lats in 2010), or a benefit when retiring and a compensation of up to 90 lats for correcting the eyesight with medical means (i.e., to buy glasses) as prescribed by a special doctor for vocational illnesses. In 2010, these payments included also a supplementary payment for replacing four employees who had been absent for a long time; the amount was 20% of the replacing employee's daily salary rate per replacement day.

4 Staff insurance against the risk of illness until 31 July 2011 and accident until 30 September 2010, in 2009 against both risks for a full year.

FINANCING OF THE ACTIVITIES OF THE COMMISSION

The dynamics of the financing for the Commission had also been related to the share of the costs for supervising the respective sector. Over years, market sectors had provided financing to the Commission in proportion to the share of the costs needed to supervise the respective sector. In 2009, the share of the financing by market participants changed due to the drastic changes of the market situation and financial indicators. The Commission focused more on the supervision of monetary financial institutions and it was reflected in the share of payments: in 2009, the income related to the supervision of monetary financial institutions increased by 6%, whereas in 2010 the share of financing was balanced in other sectors (see Charts 6 and 7).

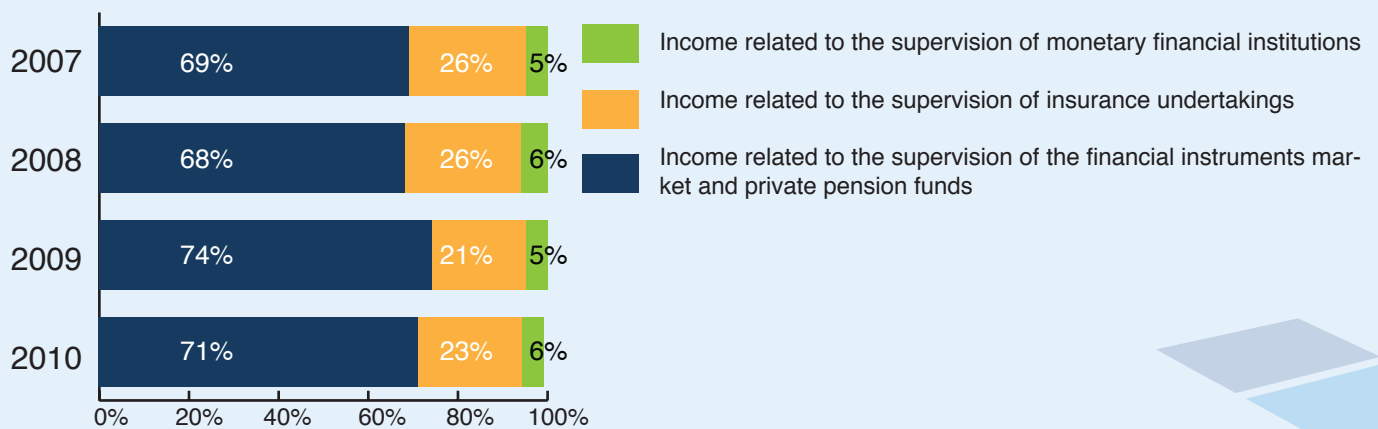


Chart 6.

Structure of the financing for the Commission, 2007-2010, share, %

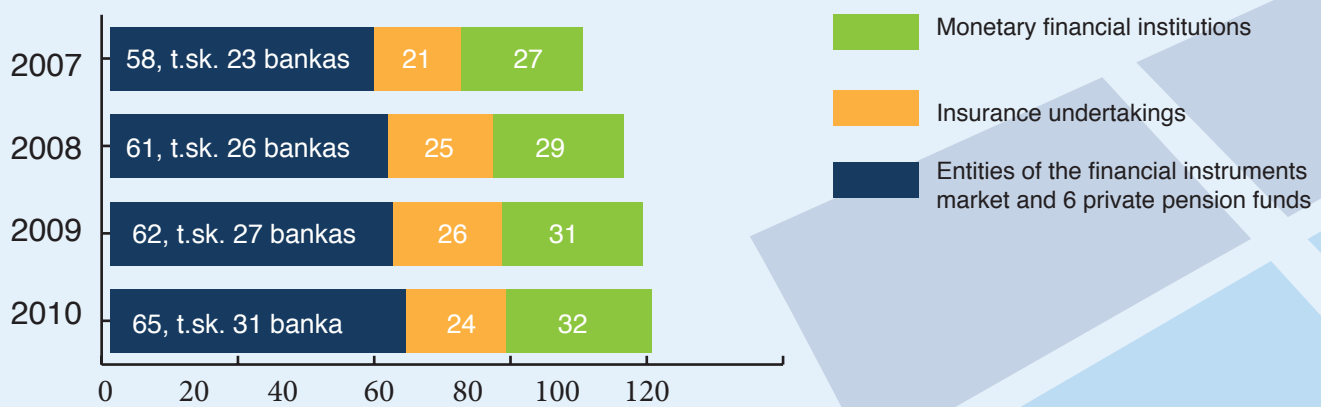


Chart 7.

The number of providers of the financing to the Commission and of the entities of the financial and capital market subject to supervision, excluding the entities that do not provide financing to the Commission, 2007-2010

In 2010, staff remuneration costs formed the largest part (78%) of the Commission's expenses, though their volume changed due to the changes in the number of employees and also salary changes in the financial sector which served as a benchmark for the remuneration of the Commission's employees; the Commission also observed the restrictions on remuneration and social guarantees in public administration bodies. In 2010, the Commission demonstrated its solidarity with other public administration bodies and took measures to reduce the salary of its employees on average by 20% to every employee, ceased insurance of its employees after the expiry of the previous insurance contracts, and reduced the amount of benefits to its employees. The remuneration system had been revised gradually as of 2008 by reducing the annual budget for remunerations and consequently the remunerations, including the salary and various personnel policy tools, both in 2009, 2010 and 2011 (see Table 2).

CHANGES IN THE AVERAGE REMUNERATION OF EMPLOYEES, 2008-2010, %

	2009/2008	2010/2009	2010/2008
Changes in the average remuneration of employees	-14	-20	-31
of which salary and payments equivalent to salary	-5	-19	-23
of which social guarantees ¹	-80	-47	-89

Table 2.

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

As of its establishment, the Commission had invested notable funds in information technologies in order to optimise supervisory and its own organisational management processes and ensure more efficient processing of the financial information submitted by the entities of the financial and capital market for supervisory purposes. In 2010, the Commission continued development of the IS Data Collection, Processing and Analysis System, launched in 2009, aimed at enabling comprehensive system-wide analysis of all participants of the financial and capital market. In the reporting year, 24 000 lats were spent for research and development of the system. At the end of 2010, IT book value was 73% of total long-term investment (see Table 3).

DYNAMICS OF THE COMMISSION'S LONG-TERM INVESTMENT, 2007-2010

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

Table 3.

¹ Insurance of employees against the risk of illness, accident and an event of death.

FINANCING OF THE ACTIVITIES OF THE COMMISSION

Investments in information technologies included regular changing of the stock of computers to ensure their optimum performance for processing and servicing supervisory IS, developing and improving information systems as well as using licensed software. In order to ensure the flow of statistical and supervisory documents and records, several information systems had been developed and adjusted for the Commission's needs with the aim to diminish the flow of paper documents and the number of manual processes and ensure swift action, quality of data and comfortable cooperation environment for market participants (see Table 4).

DYNAMICS OF CHANGES OF THE COMMISSION'S CAPITAL INVESTMENT, 2007-2010

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

Table 4.

The financial statements for 2010 of the Commission and of the Deposit Guarantee Fund and the Fund for the Protection of the Insured managed by the Commission along with the opinion of independent auditors are available on the Commission's website at www.fktk.lv.

CONTINUING THE REFORMS OF THE SUPERVISORY FRAMEWORK DURING THE RECOVERY FROM THE FINANCIAL CRISIS

After global turmoil in the financial sector at the end of 2008, the perceptions of the functioning of the financial and capital market and efficient supervision thereof had changed significantly, thus marking the start of an important reform process. Notable changes took place also in Latvia by enhancing the supervisory framework: over three years the Commission's experts had developed or amended 23 laws, 17 Commission's regulations and prepared three new guidelines that were binding on market participants. To restrict those excessive risks for the sake of short-term profit which a credit institution could not manage efficiently, the "Regulations on Core Principles of Remuneration Policies" developed by the Committee of European Banking Supervisors were introduced; according to the Regulations, the remuneration structure in a bank should be commensurate with its risk profile. As a result, in 2009 already the volume of bonuses paid by banks to their employees was more than 14 times less than, e.g., in 2007. The key task of the reform of the financial sector regulation was to eliminate the shortcomings highlighted by the crisis and

introduce new tools that would ensure financial stability in the future. The work was started in the reporting year and would continue in 2011 and 2012. The requirements of Basel III would be introduced in the banking sector and a new solvency regime

“remuneration structure in a bank should be commensurate with its risk profile.”

Solvency II would be determined for insurance undertakings and reinsurers.

¹ Gada laikā iegādātie, atskaitot izslēgtos (sākotnējās vērtības apmērā).

On 16 December 2010, the Basel Committee on Banking Supervision published a document “Basel III: a global regulatory framework for more resilient banks and banking systems” that would serve as a basis for a radical reform of the banking regulation in the EU.

The key elements of Basel III are as follows:

- Tier 1 own funds may include only those elements that absorb losses on a going concern basis;
- elements of Tier 2 own funds must provide loss absorption on a gone-concern basis;
- the requirements for own funds structure change by increasing the minimum share of the elements of Tier 1 own funds from 50% to 75%;
- the minimum capital adequacy requirement of 8% is retained;
- a capital conservation buffer requirement of 2.5% is introduced; it ensures that a bank can comply with the minimum capital adequacy requirement even if it incurs losses. During the building up of the capital conservation buffer or in case the buffer is drawn down below the threshold of 2.5% due to losses, restrictions on the staff bonus payments and payment of dividends will be established;
- macroprudential supervision will be strengthened to ensure overall stability in the banking sector. A potentially efficient tool to this effect is a countercyclical capital buffer requirement of up to 2.5%. This requirement is introduced where system-wide risks increase, e.g., as a result of excessive credit growth. National authorities decide on putting in place a countercyclical capital buffer (banks should be warned a year before), the size and the phasing out of the buffer, and this requirement is binding on all banks around the globe that transact with the residents of the respective jurisdiction (i.e., the reciprocity principle is applied). Other jurisdictions may determine a higher buffer for their banks, but the buffer may not be below the determined level (e.g., where Latvia determines the countercyclical buffer requirement of 2%, Estonia may set the buffer requirement at 2.1% for the operations of its banks with Latvian residents, but it may not set the buffer

According to Basel III, these requirements must be phased in gradually and there is a transition period until 2018. After the end of the transition period, as of 1 January 2019, Core Tier 1 own funds requirement will be 7% (minimum own funds requirement of 4.5% and capital conservation buffer requirement of 2.5%), and total capital adequacy requirement before countercyclical capital buffer requirement and capital surcharge requirement of systemically important financial institutions will be 10.5%.

INTRODUCING SOLVENCY II

On 25 November 2009, Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) was adopted and the Directive had to be introduced by 31 October 2012. It aims at strengthening the insurance sector and increase the protection of policy holders. The Directive substantially changed the effective solvency regime in the insurance and reinsurance sector and established a transition to a new procedure for calculating capital requirements on the basis of risk assessment. Solvency II also established supervisory tools and cooperation procedure for the supervisory authorities of cross-border groups of insurers. In order to implement the Directive, in 2010, the Commission started drafting a new law on insurance and reinsurance.

requirement at 1.9%). However, the reciprocity principle does not apply to a countercyclical capital buffer requirement in excess of 2.5%, and the decision to apply a countercyclical capital buffer requirement above 2.5% to the transactions of banks registered

“
macroprudential supervision will
be strengthened to ensure overall
stability in the banking sector”

in other countries with the residents of the jurisdiction that has determined the excess buffer is the discretion of each country;

- the leverage ratio that is calculated as the ratio of own funds to risk unweighted assets will be introduced to restrict building up of excessive leverage in banks;
- quantitative liquidity standards — liquidity coverage ratio and net stable funding ratio — will be introduced. In the past, quantitative liquidity indicators were not harmonised and different requirements existed in various countries;
- criteria to identify systemically important financial institutions and the regulatory framework applicable to such institutions are introduced, incl. capital surcharge requirements.

At the request by the European Commission, the Committee of European Insurance and Occupational Pensions Supervisors (now the European Insurance and Occupational Pensions Authority) developed methodology for Solvency II Quantitative Impact Study 5 (QIS 5). The Commission invited insurance undertakings to take part in QIS 5 to assess conditions of the Solvency II regime and their likely impact on the insurance market and their readiness to comply with the solvency capital requirements. The Commission prepared a report to the European Insurance and Occupational Pensions Authority whereby it compiled QIS 5 data about seven entities covering 64% of insurance undertakings within the scope of Solvency II.

EU legal provisions were increasingly based on the principle of maximum harmonisation to ensure a level playing field for all participants in the single market, and there had been a trend to use regulations for this purpose, i.e., directly applicable legal provisions. As a result, the role of the Commission's employees in drafting EU legal provisions had increased. In the reporting year, the Commission continued to improve the regulatory framework governing the activity of the market in view of the requirements of EU directives, guidelines by EU bodies, best international practice and the specific features of the Latvian financial sector. All draft regulations were coordinated with the professional associations of market participants.

AMENDMENTS TO LAWS

The Saeima (Latvian Parliament) passed laws "Amendments to the Credit Institution Law" on 28 January, 11 March, 23 September and 23 December 2010; the definition of a group of connected clients was clarified by establishing that, in addition to the previously indicated criteria for identifying such group, also the risks incurred by a significant funding source that is common to those clients had to be considered. The previously established exemption from restrictions on exposures was cancelled in respect of transactions with a credit institution or an insurance brokerage firm with a maturity of one year and a restriction was established on these large exposures — they should not exceed 25% of bank's own funds. To mitigate the effect of these changes on the functioning of small banks (their possibilities to make settlements and reduce costs deriving from maintaining additional correspondent accounts),

“state guaranteed compensation to the customers was increased to 100 000 euro”

a possibility to use an alternative quantitative restriction of 100 million euro was established for exposures to a bank or an insurance brokerage firm where the amount exceeded 25% of the bank's own funds but did not exceed the bank's own funds.

The amendments also established the rights and obligations of the supervisory authorities of cross-border groups in respect of assessing the risks of a consolidation group and of the financial institutions within that group and establishing the capital

necessary to cover those risks, also establishing supervisory measures and sanctions and information exchange, and describing the procedure whereby joint decisions about risk assessment and additional capital requirements related thereto should be taken. The amendments determined the criteria and the procedure for establishing a branch that was significant to a credit institutions.

To improve the restructurisation process of credit institutions, the amendments established the rights to the Commission to exempt a credit institution, for up to three years, from the requirement to comply with one or several regulatory requirements governing the activities of credit institutions where that credit institution, within a transitional arrangement of the business of a credit institution, transferred its assets and liabilities, in full or in part, to another credit institution. During that time the credit institution would be prohibited from accepting new deposits and other repayable funds from an unrestricted circle of customers and granting new loans or extending any existing credit limits, and after the expiration of the exemption period established by the Commission the credit institution should be liquidated where it had not been able to restore compliance of its activities with the requirements of the "Credit Institution Law".

On 16 December 2010, the Saeima approved "Amendments to the Deposit Guarantee Law". According to the amendments, the state guaranteed compensation to the customers of Latvian banks and credit unions (both natural and legal persons) was increased to 100 000 euro (about 70 000 lats). The amendments took effect on 1 January 2011. They were made to transpose the requirements of the Directive according to which by 31 December 2010 all Member States should ensure the guaranteed compensation of 100 000 euro in case of non-availability of deposits.

DRAFTING NEW REGULATIONS AND AMENDING THE EXISTING REGULATIONS

The "Regulations Governing the Operation of Payment Institutions and their Reporting Procedures", approved by the Board of the Commission on 29 March 2010, defined the assets in which a payment institution that, apart from payment services, carried out other commercial activity was entitled to invest funds received from payment service users or from another payment service provider, where these funds had not yet been credited to the payee's account or transferred to another payment service provider by the end of the next business day following their receipt. The Regulations also set out the procedure whereby a payment institution calculated its own funds.

The "Regulations on the Compliance with Restrictions on Exposures", approved by the Board of the Commission on 13 November 2010, supplemented the range of exposures to which restrictions on exposures did not apply and changed the range of exposures exempted from restrictions on

exposures. The Regulations introduced clearer requirements for adjusting the value of exposures taking into account the collateral and matching the exposure value adjustment procedure with the requirements of the "Regulations for Calculating the Minimum Capital Requirements" for mitigating credit risk. The procedure for calculating exposures with the persons connected with the institution and the requirements for managing and controlling such exposures were clarified.

Amendments to the "Regulations for Calculating the Minimum Capital Requirements", approved by the Board of the Commission on 13 November 2010, clarified the procedure for calculating capital requirements for credit risk, incl. a possibility to apply a 20% risk weighting when calculating capital requirements for credit risk in respect of exposures with local governments of Member States provided that these exposures were covered with the liabilities denominated in the currency of

the respective Member State. According to the amendments, a securitisation position might include only those investments in securitisation instruments in respect of which the institution had been explicitly notified to the effect that the originator, the sponsor or the initial lender would permanently maintain purely economic interest, and in respect of those persons (and the risks

to disclose to market participants information about the risk profile of the institution and whether additional information was needed. The amendments also established that an institution had to publish additional information where it used value-at-risk internal models to calculate capital requirement for market risks and advanced operational risk measurement approach to calculate capital requirement for operational risk. The Regulations were supplemented with the requirement to publish information about remuneration policy and its practical implementation.

“ requirement to publish information about remuneration policy and its practical implementation ”

associated with those persons) the institution had comprehensive and thorough information and understanding, adequate policies and procedures and it carried out regular and appropriate stress tests. Where the exposures included in securitisation positions failed to comply with the above mentioned requirements, the risk weighting should be increased by a definite proportion. The amendments also established that the institution should submit to the Commission an electronic copy of the borrowing agreement where the borrowed funds had been included in the calculation of Tier 2 own funds as subordinated capital.

Amendments to the “Regulations for Disclosing Information”, approved by the Board of the Commission on 13 November 2010, established the requirement that an institution had to approve policies and procedures whereby it assessed whether the published information was sufficiently comprehensive

Amendments to the “Regulations on Core Principles of Remuneration Policies”, approved by the Board of the Commission on 20 December 2010, extended the responsibility of an institution’s supervisory board for establishing or monitoring remuneration for particular positions, established the share of a material variable component of remuneration and of a particularly high variable component of remuneration in the remuneration and clarified the requirements for establishing, delaying and paying out a material variable component of remuneration and a particularly high variable component of remuneration.

The “Regulations on Information Systems Security”, approved by the Board of the Commission on 8 October 2010, aimed at limiting information systems security risks when providing services to market participants and clients as well as prescribed requirements for the management of market participant IS security risks. The revised Regulations were developed in view of the changes in the practical management of IS security by market participants and threats to IS.

LICENSING

	As at the beginning of 2010	As at the end of 2010	New market participants in 2010
Banks	21	21 (1 licence was revoked)	+1 ¹
Branches of banks of EU MS	8	10	+2 ²
Cooperative credit unions	34	34	0
Providers of banking services from European Economic Area (EEA)	240	255	+15
Electronic money institution from EEA	11	13	+2
Insurance undertakings	14	13	-1 ³
Branches of insurance undertakings of EU MS	11	11	0 ⁴

Providers of insurance services from EEA	395	437	+42
Investment management companies	16	16	0
Providers of investment management services from EEA	17	18	+1
Investment brokerage firms	7	6	-1 ⁵
Providers of investment brokerage services from EEA	1 103	1 344	+241
Agents attracted by service providers	2	1	-1
Agents from EEA attracted by service providers	3	14	+11
Private pension funds	6	7	+1 ⁶
Insurance brokerage firms	114	104 (20 entries were cancelled)	+10 ⁷
Insurance agents	736	560 (234 entries were cancelled)	+58
Providers of payment services from EEA	21	41	+20
Payment institutions	0	17 (registered)	+17 ⁸

1 In May, the Board of the Commission decided to revoke the licence of JSC "VEF banka" for the activity of a credit institution and the court initiated liquidation of the bank. At the end of March, the government took a decision about the restructurisation model of JSC "Parex banka" whereby part of its assets would be separated in a new bank; to implement that decision, in June the Commission issued a licence to JSC "Citadele banka" for the activity of a credit institution.

2 Permission to start operations was issued to the Latvian branch of "Scania Finans Aktiebolang" and the Latvian branch of "Aktisielts Eesti Krediidipank".

3 In January, Riga Municipality, the sole shareholder of the company "RSK apdrošināšanas AS", took a decision to cease the activity of the company "RSK apdrošināšanas AS" and start its liquidation; on the basis of that decision the Board of the Commission decided to cancel, as of 1 February, all licences issued to the company "RSK apdrošināšanas AS" for performing insurance activity.

4 In October, the Commission received a notification from the Norwegian insurance supervisory authority to the effect that the Latvian branch "Vital Life" of "Vital Forsikring ASA" had ceased its activities in Latvia on 15 September. Permission to start operations was issued to the Latvian branch of "AB ERGO Lietuva gyvybės draudimas".

5 The licence of the limited liability company investment brokerage firm "Maximus Capital Markets" was withdrawn.

6 A licence was issued to a new private pension fund joint-stock company "Nordea Latvijas atklātais pensiju fonds".

7 Permission to start operations was granted to the following insurance brokerage firms: LLC "ITD Reinsurance Broker", LLC "Baltic Brokeri", LLC "McKay & Poulton LTD", LLC "Amber Broker Baltic", LLC "Greenstone Insurance and Reinsurance Broker", LLC "Baltic Insurance Group", LLC "K.O. Partneri", LLC "Otkritie Apdrošināšana", LLC "Boreas Brokers", LLC "Brokeru sabiedrība Garants".

8 On 25 February, the "Law on Payment Services" was adopted and it took effect on 31 March. According to that Law, the Commission granted a licence for the operation of a payment institution and registered with the register of institutions those payment institutions that did not need to receive a licence in accordance with the requirements of Article 5 of that Law.

BANKING SECTOR

At the end of the reporting year, 21 bank and nine branches of foreign banks were operating in Latvia. In 2010, credit institutions were still operating within a financial environment with unstable outlook, even if after the events of 2008 the impact of global financial turmoil on the Latvian market was becoming less pronounced and banking performance indicators were starting to stabilise:

- losses of the banking sector amounted to 360.6 million lats that was two-fold less (by 53.4%) than in the previous year when they had been 773.4 million lats;
- expenses for the provisions for bad loans amounted to 506 million lats and they still were the main reason for the total loss in the banking sector during the year, but they were by 34.5% less than in the year before;
- profit of the banking sector before provisions and taxes reached 143.5 million lats or was by 55.4% less than in the previous years;
- 73.4% of bank loans were without overdue payments (74.5% at the end of 2009);
- performance indicators of all Latvian banks complied with the regulatory requirements and were at a high level;
- liquidity indicator of the banking sector reached 67.9% (62.8% in 2009);
- capital adequacy ratio of the banking sector was still at a high level of 14.64% (14.56% in 2009);
- 14 banks continued to increase their capital, their total contribution amounting to 324.4 million lats.

In the reporting year, the Commission continued to apply the enhanced supervisory framework, launched in 2009, that enabled to improve considerable efficiency of the preventive measures and ensured a possibility to interfere without delay into a bank's activities.

ENHANCED PERFORMANCE MONITORING

During the reporting year, the Commission continued enhanced off-site monitoring of bank performance and received, on a regular basis, additional operative overviews and reports about bank activities:

- daily reports about investment dynamics;
- reports about liabilities to related financial institutions;
- monthly statements about the structure and quality of banks' credit portfolios, quarterly reports about problem loans, i.e., restructured loans, loans whose term for repaying principal or interest had been changed and loans under recovery;
- decisions by bank credit committees and boards, reports by bank internal auditors about the performed inspections.

Also in 2010, banks were required to draw up interim financial statements for six months by the end of 30 June 2010 and carry out their audit. These statements enabled the Commission to obtain an independent third party conclusion about the financial situation in banks.

The Commission and the Bank of Latvia continued carrying out regular stress tests to broader assess the risks

The Commission applied the following sanctions to banks in accordance with the "Credit Institution Law":

- a penalty of 10 000 lats to one bank for a failure to comply with the regulatory requirements;
- a penalty of 25 000 lats to each of the two banks for violations in the area of preventing money laundering;
- a penalty of 25 000 lats to one bank for violations in the area of IS security;
- issued a warning to one bank for non-compliance with the requirements of the "Credit Institution Law" for notifying the Commission.

“banking performance indicators were starting to stabilise- losses of the banking sector”

The Commission took corrective measures by establishing additional requirements to three banks in the area of credit risk.

In the area of supervision the Commission's priority was maintaining an adequate capital basis of Latvian banks by promoting effective debt restructuring. In 2010, supervisory methods were still based on the assessment of operational risk of market participants by using related methods, such as monitoring bank performance on the basis of the analysis of financial statements and on-site inspections.

inherent in each bank in view of macroeconomic forecasts. Test results were used to establish the possible losses in credit portfolios under conservative scenarios of economic development and bank capital ability to absorb those losses. Liquidity risk stress tests were also carried out. Within those tests behaviour scenarios of several bank customers were analysed along with the bank's ability to ensure timely fulfilment of the legal claims of customers. Where necessary, the Commission carried out a dialogue with banks regarding their plans to maintain the required level of capital adequacy and ensure liquidity in contingency.

Once a quarter the Commission assessed bank performance, risk level and risk management quality and, on the basis of risk monitoring results, it planned the necessary supervisory measures, incl. on-site inspections. In 2010, credit risk, liquidity risk, strategy and business risk were identified as the key risks inherent in the activities of banks. Special attention was paid to bank strategies and profitability. Risks were analysed by using quantitative and qualitative information.

GROUP SUPERVISION

The Commission cooperated with the supervisory authorities of credit institutions of Member States that, in accordance with the requirements of regulatory provisions, carried out supervision of credit institutions on a group basis. The Commission's staff took part in the work of five colleges of

supervisory authorities of credit institutions of Member States. Topical issues included coordination of supervisory measures, assessment process of internal capital adequacy and assessment of the risk profile at the group level.

ON-SITE INSPECTIONS IN CREDIT INSTITUTIONS

In the reporting year, the Commission performed 34 inspections in banks during which particular attention was paid to assessing capital adequacy, lending process and risk management functions — managing credit risk, operational risk, liquidity risk, strategy risk and business risk and compliance control function. The aim was to identify essential risks as quickly as possible and with a maximum precision and to take immediate action to mitigate the effect of these risks and stabilise the market. In 2010, the Commission monitored bank

compliance with the Commission's "Regulations on Core Principles of Remuneration Policies", "Regulations on Assets Quality Assessment and Provisioning", "Regulations on Credit Risk Management", "Regulation on Liquidity Requirements, Compliance Procedures and Liquidity Risk Management" as well as the practical implementation of the CEBS guidelines on stress tests. The Commission provided recommendations aimed at assisting banks to improve their internal regulatory documents.

CAPITAL ADEQUACY

The Commission carried out enhanced assessment of the adequacy of bank provisions for expected losses. A positive gap between the volume of expected losses and the provisions made in accordance with the requirements of accounting standards was noted when assessing capital adequacy of banks. In 2010, corrections in capital adequacy calculation were made in nine banks. In addition to the minimum capital adequacy requirements banks assessed also their internal capital adequacy to establish the capital they actually needed in view of their risks. In 2010, an assessment was carried out in all banks as to their capital

In the reporting year, the Commission calculated the amount of capital necessary to each bank as at 31 December 2009 and 30 June 2010 by using the simplified methods established in the Commission's "Regulations on Establishing the Capital Adequacy Assessment Process"; these calculations were compared with the bank calculations and as a result internal assessment of four banks about the necessary amount of capital appeared notably lower than the amount calculated by using the simplified methods. The differences were basically due to the shortcomings in the methods the banks were using in their capital adequacy assessment process and the Commission took appropriate supervisory measures to ensure that banks eliminated the detected weaknesses. As a result of the capital adequacy assessment process most banks concluded that their capital was adequate to cover the risks inherent in their present activities and it also ensured a sufficient capital reserve in case of possible significantly adverse scenarios. During the year, only two banks increased their capital in accordance with these plans.

“most banks concluded that their capital was adequate to cover the risks inherent in their present activities

adequacy assessment process and compliance of their internal capital adequacy assessment process with the requirements of the "Credit Institution Law". Assessment results revealed areas where improvements were needed. Several banks were asked to improve their strategy, capital planning process, internal regulatory documents and processes, e.g., the procedure for establishing the amount of capital needed to cover the material risks inherent in the bank's present and planned activities, and the methods used in stress tests and the results of their analysis.

Due to the crisis many banks were forced to revise their activity strategy and seek alternative markets for their financial services. During the inspections and assessments of bank capital adequacy, the Commission paid particular attention to bank strategy and business risk as it was aware that strategy of some banks might include a significant change of the business model entailing a risk that, while looking for possibilities to compensate the significant losses of previous years and realising the existing limited opportunities to invest in the domestic economy, banks might not adequately assess risks and engage in transactions with higher profitability, but also higher risk.

CREDIT RISK

In 2010, credit portfolio of banks decreased overall by 7.2% (by 7.0% in 2009), its quality continued to deteriorate though more modestly than in 2009. Compared with 2009 when the provisions made as a result of deteriorating credit quality increased four-fold, in 2010 the volume of provisions increased by 22% and at the end of the year it amounted to 11.3% of the credit portfolio. Even if the share of overdue loans in the credit portfolio had grown insignificantly and was 26.6% at the end of the year (25.5% at the end of 2009), the share of loans overdue for more than 90 days increased within overdue loans and at the end of the year it was 19.0% of the credit portfolio (16.4% in 2009).

At the end of the year, restructured loans accounted for one fifth of the credit portfolio, their volume had grown by 370 million lats (by 15%) and amounted to 2.85 billion lats. The volume of loans under recovery had grown significantly from 1.46 billion lats at the end of 2009 to 2.19 billion lats at the end of 2010.

Of all on-site inspection in 2010, 13 were aimed at assessing in particular the quality of credit portfolio and credit risk management. Inspections covered 52.7% of overall credit portfolio of the banking sector (a portfolio of 7.5 million lats).

LIQUIDITY RISK

Turmoil in the global financial market and the subsequent ebbing of deposits from the Latvian banking sector as of September 2008 were the reason why the Commission paid particular attention to bank liquidity also in 2010. In the reporting

“banks could take swift action where it was necessary to accumulate the funds needed to repay a syndicated loan”

year, bank liquidity indicators improved notably and reached 67.9% at the end of the year (62.8% at the end of 2009). Banks that had syndicated loans had repaid their loans received before 2009. That certified to the fact that during the crisis banks could take swift action where it was necessary to accumulate the funds needed to repay a syndicated loan and to successfully surmount the liquidity crisis that was one of the most significant factors underlying the crisis. At the end of the year, only JSC “Parex banka” had an outstanding part of a syndicated loan maturing in May 2011 and the bank had secured funds for its full repayment. The role of deposits had increased in the structure of bank

Particular attention was paid to timely recognition of loan impairment losses (sufficiency of provisions) or the amount of capital correction made where the expected losses exceeded the amount of provisions. The quality of monitoring the real estate mortgaged by banks was assessed as its results directly impact timely recognition of loan impairment losses.

In view of the large share of problem loans in the credit portfolio, during inspections particular attention was paid to the bank’s activities in case of overdue and problem loans, i.e., substantiation and efficiency of credit restructuring. As a result of inspections the Commission required that banks recognise loan impairment losses by making provisions or capital correction. Additional impairment was predominantly detected in respect of the loans that depended on collateral. In view of the increased volume of new loans to non-residents and additional risks inherent in such loans, the practice of lending to non-residents was inspected, i.e., criteria for granting loans, monitoring credit quality and the quality of the granted loans.

financing. The bank deposit base had stabilised and in 2010 banks regained depositor confidence as the volume of deposits reached pre-crisis level, i.e., at the end of the year it was 11.1 billion lats.

EU banks operating in Latvia had a significant role in ensuring stability of the banking sector (their market share in loans was 70%). At the beginning of the crisis, they injected notable funds into their subsidiaries, but in 2010 the funding of parent banks decreased gradually though in large part it was set off by investments in the share capital and the subordinated capital of their Latvian subsidiaries — it evidenced the fact that the Scandinavian banks operating in Latvia were committed to keep their investments in Latvia and to ensure that their subsidiaries comply with the regulatory requirements for capital adequacy and liquidity.

To control the cash flow of banks, in 2010 the Commission continued to request that banks submit daily operative information about the dynamics of deposits and also paid greater attention to monitoring the liquidity management quality of foreign bank subsidiaries at a group level as these banks were basically relying on the resources allocated to them by their parent banks. As a result, the Commission managed liquidity risk in the banking sector in general and, where necessary, requested that banks take preventive measures to improve their liquidity risk management.

MARKET RISK

Compared with other countries Latvian banks did not have significant investments in financial instruments (overall, shares and debt securities did not exceed 6.6% of bank assets). Though in general market risk in the banking system was not significant, in view of the persisting signs of instability in international financial markets that potentially could impact

the banking system in 2010 the Commission continued to pay particular attention to assessing financial instrument portfolios of banks to make sure that banks were prudently presenting them in their financial statements and assessing liquidity of their existing securities.

COOPERATIVE CREDIT UNIONS

At the end of the reporting year, 34 cooperative credit unions were operating in Latvia; the Commission supervised them by using performance monitoring based on the analysis of their financial statements and paid particular attention to sufficiency of provisions for bad loans. In 2010, cooperative credit unions operated with a profit of 146 thousand lats that by 154.4% exceeded the profit in 2009. At the same time, they had made additional provisions for bad loans (in 2010, provisions increased by 21.2% and the ratio of provisions to the credit portfolio increased from 5.7% in 2009 to 6.8% at the end of 2010).

out to assess the financial standing, management activities, asset quality, income and expenditure structure of a cooperative credit union as well as its compliance with regulatory requirements. In view of the detected weaknesses the Commission instituted an administrative process against that cooperative credit union and in 2011 the licence of that credit union was revoked.

In the reporting year, one on-site inspection was carried

INSURANCE UNDERTAKINGS

In 2010, nine non-life insurance undertakings and four life insurance undertakings were operating in Latvia.

The Commission carried out full-scope inspections in five insurance undertakings, of which one was in a non-life insurance undertaking and four in life insurance undertakings, and reviewed applications of 97 natural and legal persons about the activities of insurance undertakings and branches of insurance undertakings of EU Member States.

The Commission followed, on a regular basis, whether insurance undertakings complied with the required solvency margin established in the "Law on Insurance Companies and Supervision Thereof" and to the extent possible warned them of a probable non-compliance to enable them to take due measures to ensure compliance.

In 2010, violations of regulatory requirements were detected and appropriate sanctions were applied: in case of one insurance undertaking the Commission determined that the required solvency margin should be by 30% higher and established a legal obligation on that entity to ensure that the level of its available solvency margin ensured compliance with the required solvency margin by ensuring that the available solvency margin equalled the required solvency margin plus 30% or exceeded that amount; it also established a legal

obligation to change the contents of the assets accepted as the cover for technical provisions, established restrictions to freely administer assets when assuming new liabilities in respect of persons related with the insurance undertaking, established a legal obligation to agree with the Commission transactions that equalled or exceeded 50 000 lats in respect of a loan, a mortgage and a planned guarantee and other similar liabilities or in respect of planned changes in already concluded agreements about such transactions, and also established a legal obligation to submit to the Commission a plan for improving the financial standing for the next two years.

In the reporting year, one insurance undertaking used the possibility established in the Commission's "Regulations on the Calculation of the Required Solvency Margin and the Available Solvency Margin for Non-life Insurers" to receive permission to include in the calculation of available solvency margin 45% of the increase in the investment property value. Another insurance undertaking used the possibility established in the Commission's "Regulations on the Calculation of the Required Solvency Margin and the Available Solvency Margin for Life Assurers" to receive permission for the repayment of a subordinated loan ahead of maturity.

GUARANTEE FUND OF THE COMPULSORY CIVIL LIABILITY INSURANCE OF OWNERS OF MOTOR VEHICLES

In 2010, the Commission performed an inspection of the guarantee fund administered by the society "Latvijas Transportlīdzekļu apdrošinātāju birojs" (Motor Insurers' Bureau of Latvia) as to compliance with the fund's establishment, accrual and administration procedure and notified the Ministry of Finance

and the society itself about inspection results; it also provided an opinion and recommendations.

GROUP SUPERVISION

In 2010, the Commission's staff participated in three college meetings of supervisory authorities of insurance undertakings and reinsurers of Member States. Topical issues on the agenda of colleges were developing an internal model of a group of insurance undertakings or reinsurance undertakings

and the expected approval process of the model by insurance undertakings and reinsurers of Member States in relation to the introduction of Solvency II requirements.

INVESTMENT MANAGEMENT COMPANIES

At the end of 2010, 16 investment management companies were operating in Latvia and they managed 37 investment funds (21 open-end and 16 closed-end funds). During the year, signs of stabilisation of the investment fund industry were evident. Total assets of investment funds increased by 36.8 million lats and their volume at the end of the year reached 205.8 million lats, whereas the increase in funds' net assets was 11.9 million lats in 2010 (17.9 million lats in 2009). Investment funds made investments predominantly in term deposits with credit institutions (34.5%), debt securities and other fixed income securities (25.6%), shares, units of investment funds and other variable income securities (17.8%) and investment property 8.8% (at the end of 2009, the indicators were 39.2%, 27.3%, 7.6% and 9.1%, respectively).

assessing the significant areas of activity of those companies and their compliance with the regulatory requirements. During each inspection, the Commission paid particular attention to the internal control system and risk management and assessed compliance and applicability of basic internal regulations. The Commission also assessed transparency of companies' activities and compliance with best practice principles, as well as whether the company respected the interests of customers.

In the reporting year, off-site supervision of investment management companies and investment funds was carried out by assessing their financial standing, asset quality, income and expenses structure and compliance with regulatory requirements. As well, on-site inspections were carried out in three investment management companies. The inspections were aimed at

The uncovered weaknesses and failures were discussed with the management of a company and an action plan was agreed for the improvements needed to ensure successful functioning of the company. Post inspection monitoring was carried out within off-site supervision to control the implementation pace of the action plan and initiate corrections, where needed. In 2010, no complaints were received about activities of investment management companies and management of investment funds.

MANAGERS OF ASSETS OF STATE FUNDED PENSION SCHEMES

By 31 December 2010, 1 124 443 participants representing 96% of the economically active Latvia's population had joined the 2nd tier state funded pension schemes (SFPS). Of all SFPS participants, 645 113 or 57.4% had joined the scheme on a mandatory basis, whereas 479 330 participants or 42.6% had joined voluntarily. In 2010, 272 280 participants (24.2% of all SFPS participants) switched investment plans.

of SFPS assets was carried out to assess the quality of their managed assets, income and expenses structure and compliance with regulatory requirements. One on-site inspection of a manager of SFPS assets was also carried out in 2010 during which particular attention was paid to assessing its internal control system, compliance of its functional division with the established structure, process of making and implementing management decisions, compliance and applicability of the internal regulatory basis and the established reporting system. The uncovered weaknesses and failures were discussed with the management of the asset manager and an action plan was agreed for the improvements needed to ensure successful functioning of the assets manager. Post inspection monitoring was carried out within off-site supervision to control the implementation pace of the action plan and initiate corrections, where needed.

At the end of 2010, the volume of net assets of investment plans had grown by 17.6% in comparison with the end of 2009 and it reached 829 million lats. In 2010, the average return of SFPS investment plans was 7.6% (12.3% in 2009) and for some investment plans return ranged between 1.1% and 12.1% (between 4.8% and 20.8% in 2009).

In the reporting year, off-site supervision of managers

In parallel with performing its supervisory function, the Commission requested that asset managers submit audited interim financial statements for six months in addition to the statements submitted on a regular basis. Comparing the data in audited interim statements for six months and those in operative statements, no differences were uncovered. The number of complaints received in 2010 about SFPS asset managers was insignificant. Complaints were mainly about information provided to general public about the offered services, incl., commercials and various offers.

The Commission requested that asset managers assess

PRIVATE PENSION FUNDS

In 2010, the investment plan value of private pension funds stabilised and the average return of pension plans was 7.9% or ranging between 2.7% and 11.5% for individual plans (10.5% or ranging between 5.5% and 21.1%, respectively, in 2009). At the end of the year, the assets of private pension plans had increased by 9.6% year-on-year and they amounted to 1.8 million lats. In four quarters of 2010, private pension funds earned overall 159 thousand lats (three out of seven private pension funds ended the reporting period with a loss).

By 31 December 2010, 191 307 participants had joined pension plans and the number was by 1% more than at the end of 2009 (the figure represented 16.5% of the economically active Latvia's population). As of the beginning of the year, 15.8 million lats were paid into pension plans that was by 8.8% less than in 2009 (17.3 million lats in 2009). The contributions by individual pension plan participants increased significantly (43.6%), whereas the contributions by employers diminished by 42.3%.

In the reporting year, off-site supervision of private pension funds was carried out to assess their financial standing, quality of pension plan assets, income and expenses structure and compliance with regulatory requirements; as well, two on-site inspections were carried out. During inspections, particular attention was paid to compliance and sustainability of the internal control system established by pension funds, identification and

INVESTMENT SERVICE PROVIDERS

In the reporting year, seven investment brokerage firms registered and operating in Latvia. In addition, 19 banks incorporated in Latvia and two branches of foreign banks were authorised to provide investment services.

In 2010, five inspections of investment service providers were carried out, incl. planned inspections and targeted inspections in response to customer complaints. During the inspections, the Commission paid particular attention to the services to customers: information provided to customers about financial instruments and related risks, suitability and appropriateness of an investment service to customer's knowledge, experience, investment objective and financial ability to assume particular risk. In respect of the detected

possibilities to provide additional training to their employees and improve information given to general public to ensure observance of the best practice principles and reduce the risk that information could be considered misleading or inappropriate. At the same time, the Commission suggested to the Investment Companies Committee of the Association of Latvian Commercial banks to consider the possibility to agree on uniform best practice principles and performance ethics in respect of SFPS asset managers to eliminate or reduce the risk of negative publicity.

management of material risks. Distribution of functions and compliance with the established structure were analysed as well as the ability of the information exchange and reporting system to ensure sufficient and traceable information to internal and external users. Attention was also paid to the procedure for outsourcing services and the range of such services to assess the established control systems for such services. The performance of both asset managers and asset holders was analysed. The uncovered weaknesses and failures were discussed with the management of pension funds and action plans were agreed for the improvements to ensure their elimination. Post inspection monitoring was carried out within off-site supervision to control the implementation pace of the action plan and initiate corrections, where needed.

During off-site supervision in 2010, stress testing of the investment portfolio of each pension plan submitted by pension funds was assessed. The indicated risk drivers, scenarios and expected activities in case of adverse scenarios were assessed. According to pension funds, important risk drivers were interest rate risk because fixed income securities dominate investment portfolios and risk of fluctuating market prices. Pension funds with significant investments in foreign currency denominated instruments had recognised currency fluctuation risk as a material risk.

violations of legal provisions in the area of providing investment services, the Commission issued two administrative rulings: in one case it issued a warning to a bank and in the other case imposed a penalty of 5000 lats on a bank. Also in future, when inspecting the provision of investment services, the Commission would purposefully assess compliance with those legal requirements that were aimed at protecting customer interests.

In August 2010, the Commission held a seminar for the providers of investment services during which, in view of the conclusions made during the supervision, it discussed issues related to the provision of information to customers, suitability of services and their appropriateness to customer interests, ensuring the best result to customers and other issues.

ISSUERS OF THE FINANCIAL INSTRUMENTS ADMITTED TO TRADING ON THE REGULATED MARKET

At the end of the reporting year, JSC "NASDAQ OMX Riga" (Stock Exchange) was operating in Latvia as a regulated market. At the end of the year, shares of 33 issuers were listed on the Stock Exchange. Listing of debt securities included nine issuers for a total of 57 various debt securities: Latvian government debt securities (43), corporate debt securities and bonds (5) and mortgage bonds (9).

The Commission followed, on a regular basis, the information disclosed by issuers and controlled its compliance with the requirements of the "Law on the Financial Instruments Market". The Commission also controlled fulfilment of other duties established to issuers in accordance with that Law. The

TRADING IN FINANCIAL INSTRUMENTS

In comparison with 2009, in 2010 the share market capitalisation of the Latvian regulated market JSC "NASDAQ OMX Riga" increased by 50.15% (the shares of JSC DnB NORD Banka were excluded from the calculation as their listing on the Stock Exchange was discontinued in 2010). During the year, trading activity on the Stock Exchange increased. Though the total number of transactions in the share market decreased by 14.8%, the number of traded shares increased by 18.0%, and total turnover in the share market in the reporting year was 16.6 million lats, by 49.2% more than in 2009.

In 2010, the Commission monitored trading continuously by following and analysing the instructions submitted to the Stock Exchange and the transactions carried out therein to identify and prevent market manipulation and using inside information in transactions with financial instruments and to promote sound activity of the financial instruments market. In two cases the

PREVENTING MONEY LAUNDERING

In 2010, the Commission continued to monitor how the financial and capital market participants and their customers reduced the risk to be engaged in money laundering and terrorist financing to mitigate the impact of those risks on the Latvian financial system and uphold the country's reputation. Attention was focused on banks as the most important market participants in terms of asset volume. The Commission notified market participants, on a regular basis, about initiatives taken by various international organisations in the area of money laundering and terrorist financing. In the reporting year, the Commission carried out 14 inspections in banks, four inspections in their foreign branches and four inspections related to the supervision of investment management

INFORMATION SYSTEM SECURITY

In the reporting year, the Commission performed six planned inspections of IS security of market participants and two extraordinary inspections related to security incidents, incl. also related to customer data leakage. In one case a penalty of 25 000 lats was imposed on a credit institution for violating the "Credit Institution Law" and the Commission's regulations. In 18 cases the Commission's staff assessed and presented an opinion about the rules and internal control procedures developed by market participants for IS management and use of outsourced services. To ensure efficient functioning of the deposit guarantee scheme and its compliance with the Commission's requirements, on-site inspections of this system were carried out in all commercial banks registered in Latvia. Overall in

Commission controlled, on an ongoing basis, whether issuers had disclosed information in a timely manner in due course of the above mentioned Law. In respect of the detected violations and after considering the essence of the violation, in nine cases the Commission required that issuers take measures to eliminate the weaknesses in disclosing mandatory information in future and instituted four administrative processes for violations in disclosing mandatory information, as well as issued administrative rulings, imposed a penalty of 5000 lats on one issuer and issued warnings to three issuers. One administrative case was instituted and a penalty of 5000 lats imposed on an issuer for non-compliance with the requirements of the "Law on the Financial Instruments Market" relating to the establishment of an audit committee.

Commission sent information about possible market manipulation to a law enforcement body for assessment, and in one of these cases that was related to transactions giving suspicion of market manipulation the Commission decided to require that the holder of the investor's financial instruments account suspend debit operations in the financial instruments account of that investor.

The Commission inspected whether the persons listed as holders of inside information had complied with the "Law on the Financial Instrument Market" to notify the Commission of their transactions and detected violations; in nine cases it issued administrative rulings by warning the respective persons. As a result of inspecting compliance with the requirement to notify the Commission of an acquired or disposed qualifying holding in due course of the above mentioned Law, the Commission issued warnings in five cases.

companies, and in five cases it assessed and prepared an opinion about the internal control procedures established by market participants to prevent money laundering. As a result of these inspections, in three cases it imposed a penalty for the violations of the "Law on the Prevention of Laundering the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing" (a penalty of 10 000 lats in one case and of 25 000 lats in two cases).

In the reporting year, the Commission reported 15 suspicious financial transactions to the Financial Intelligence Unit (Office for the Prevention of Laundering of Proceeds Derived from Criminal Activity).

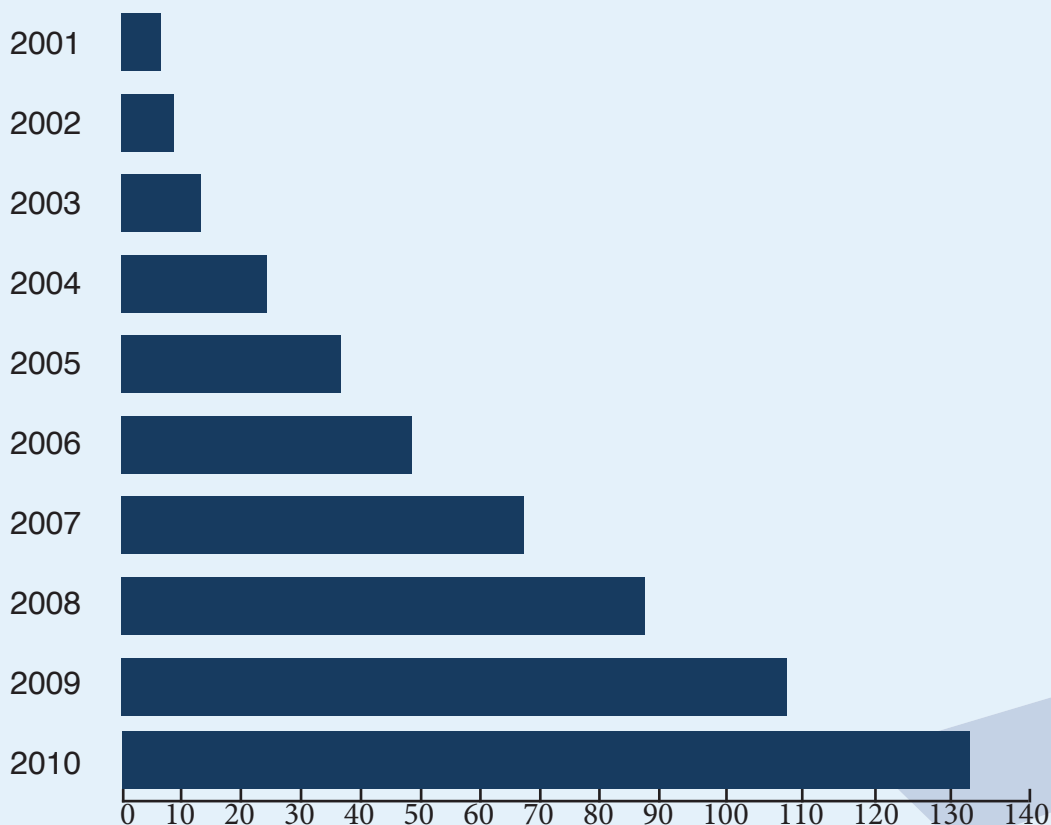
2010, particular attention was paid to the following IS security aspects during supervision: mitigation of risks related to remote services and preventing the leakage of classified information that might affect not only customer rights but also create reputation risk for a market participant and the financial sector in general. In relation to the changes in IT and their application in management processes, in 2010 the Commission approved updated "Regulations on Information Systems Security". In 2010, a Commission's representative participated in the work of the committee for preventing IS incidents of financial institutions organised by the European Network and Information Security Agency (ENISA).

ACTIVITIES OF GUARANTEE FUNDS

DEPOSIT GUARANTEE FUND (DGF)

In 2010, the guaranteed compensation to customers of Latvian banks (both natural and legal persons other than a central bank and a deposit taker, a financial institution, a transit fund or an institution financed from the general or the municipality budget) was 50 000 euro in each bank, whereas as of 2011 it

would be 100 000 euro in each bank. The funds accumulated in the DGF as of its establishment had never been used to pay compensations because there had not been any cases of deposit unavailability (see Chart 8).



Growth dynamics of DGF funds, 2001-2010 (as at the end of the year, in million lats)

Chart 8.

AT THE END OF 2010, DGF GUARANTEED COMPENSATIONS WERE AS FOLLOWS:

	Amount	Share, %
Total number of depositors	2 515 063	100.0
of which not exceeding the guaranteed compensation amount	2 481 244	98.7
of which exceeding the guaranteed compensation amount	33 819	1.3
Average amount of deposits, in thousand lats	8 180 757	100.0
of which not exceeding the guaranteed compensation amount	2 191 624	26.8
of which exceeding the guaranteed compensation amount	5 989 133	73.2
Deposits guaranteed by the DGF, in thousand lats	3 380 023	3.9

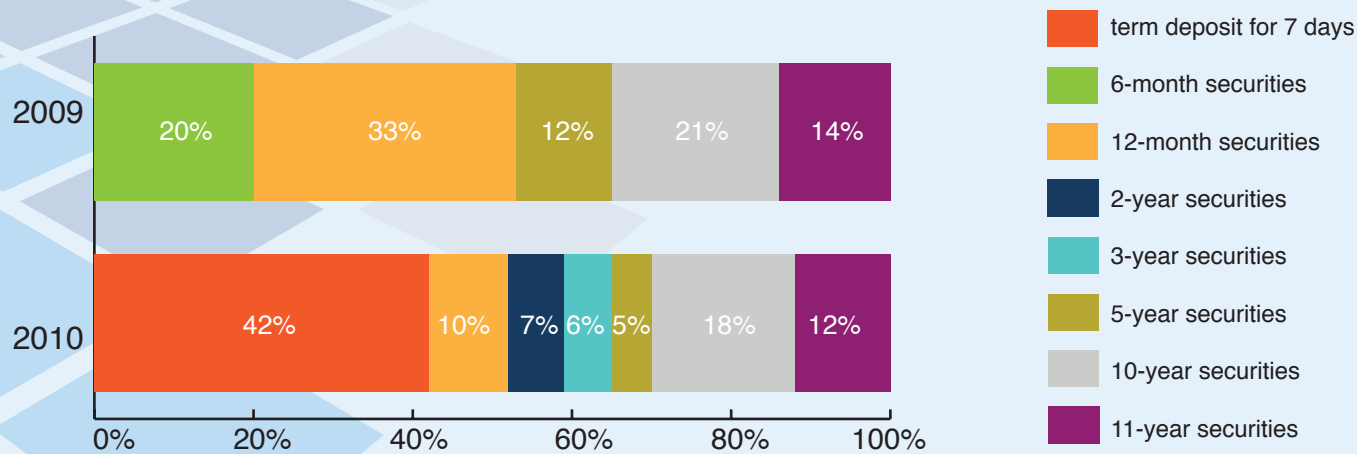
At the end of 2010, 133.1 million lats were accumulated in the DGF. In the reporting year, the funds of the DGF increased by 24.8 million lats, of which 8 million lats was investment income from investments in Latvian government securities, interest received for short-term deposits with the Bank of Latvia and cash balances in the settlement account (see Table 5). In 2010, the Commission changed the policy for investing DGF funds

so that further investments would be made in term deposits with a possibility to withdraw funds at a prior notice of at least seven days; as a result, the DGF investment structure changed significantly in 2010 (see Chart 9).

DGF INCOME SOURCES, 2008-2010 (PER YEAR)

	2008	2009	2010	Strategy
Payments by deposit takers, in million lats	17.2	14.2	16.8	0.2% of the average balance of guaranteed deposits multiplied with the risk inherent in the deposit taker %
Investment income, in million lats	3.8	6.5	8.0	Exceed the costs for maintaining deposits and making investments
Return on assets, %	4.92	6.67	6.61	Larger than or equal to the interest rate on 7-day deposit facility with the Bank of Latvia

Table 5.



DGF investment structure, 2009-2010 (as at the end of the year, %)

Chart 9.

FUND FOR THE PROTECTION OF THE INSURED (FPI)

The funds of the FPI were comprised of deductions of 1% of insurance undertakings from the total gross insurance premiums received from natural persons for the types of insurance specified in law. At the end of 2010, 7 million lats were accrued in the FPI (see Chart 10).

As of the beginning of its operation, 8 671 lats had been used to pay guaranteed compensations. In the case of an insurer's default, the compensation could

be paid only to a policyholder that is a natural person: 1) for life insurance, 100% of the insurance compensation but not more than 10 000 lats per policyholder (in effect as of 1 January 2010) excluding insurance in respect of a market-related life insurance policy; 2) for other types of insurance set out in law, 50% of the insurance compensation but not more than 2 000 lats per policyholder.

ACTIVITIES OF GUARANTEE FUNDS

GROWTH DYNAMICS OF FPI FUNDS, 2001 -2010 (AS AT THE END OF THE YEAR, IN MILLION LATS)

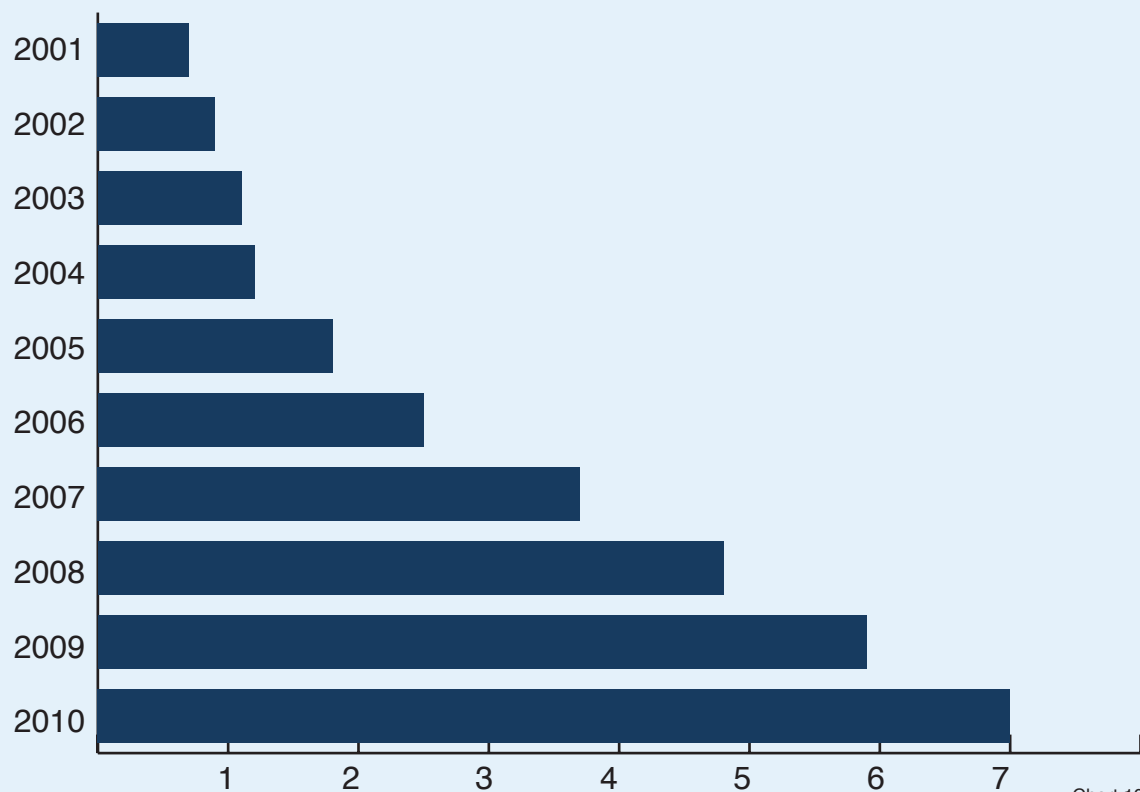


Chart 10.

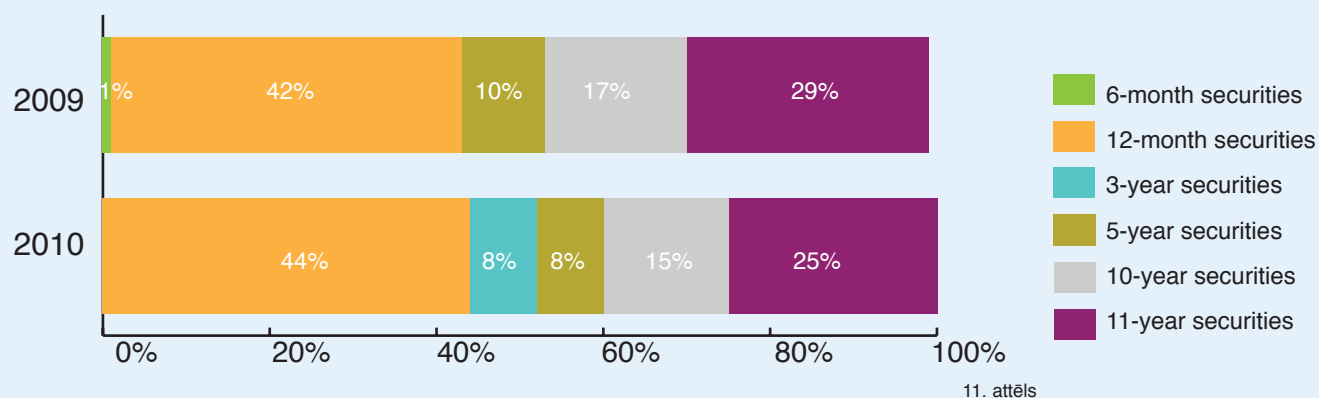
In 2010, the funds of the FPI increased by 1.1 million lats, as a result of instalments by the fund's participants, the Commission's investment of the FPI funds in Latvian government securities, interest received for short-term deposits with the Bank of Latvia and cash balances in the settlement account. The FPI investment structure and return on investments were determined by the supply of the Latvian government securities and the funds accrued in the FPI at the time of supply (see Table 6 and Chart 11).

FPI INCOME SOURCES, 2008-2010

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

Table 6.

FPI INVESTMENT STRUCTURE, 2009-2010 (AS AT THE END OF THE YEAR, %)



FUNDS MANAGEMENT COMMITTEE

In 2010, the Commission established the Funds Management Committee that would coordinate the processes related to the management of the DGF, the FPI and the investor protection scheme. The Committee was comprised of the representatives of the Office of the FCMC, Supervision Department, Legal and Licensing Department, Financial Division and IT Division. In 2010, the following measures were taken:

- the Committee developed regulations aimed at linking the amount paid into the DGF with the risks inherent in a particular deposit taker; the regulations incorporated the procedure whereby the Commission established the applicable adjustment ratio;

- to improve the procedure for arranging the payment of the guaranteed compensation, the Committee developed regulations governing compilation and submission by deposit takers of information about the guaranteed compensation;
- on-site inspections were carried out in all banks to assess their technical facilities for submitting information in accordance with the requirements of the “Regulations for Compiling and Providing Information about the Guaranteed Compensation”;
- changes were made in the investment policy and procedure regarding DGF and FPI funds.

INTERNATIONAL COOPERATION

PARTICIPATION IN THE ACTIVITIES OF THE EUROPEAN COUNCIL AND THE EUROPEAN COMMISSION IN THE AREA OF FINANCIAL SERVICES

In 2010, improvement of the financial crisis management framework remained high on the agenda of the European Council and the European Commission. In the European Council, Member States exchanged views on the following issues: preventing and solving financial crises, introducing the financial stability levy, conditions for establishing the financial stability fund, introducing other taxes in the financial sector, EU common position in the G-20 discussion on strengthening the supervision of the financial market. The Commission took part in the public consultations launched by the European Commission by providing answers to the questions on establishing the crisis management framework, introducing the financial stability levy and establishing the financial stability fund.

In the Economic and Financial Affairs Council discussions continued about draft directive on amendments to the capital requirements directive, managers of alternative investment funds,

financial instrument issue prospectuses, deposit guarantee scheme and investor protection scheme, draft regulation on establishing European supervisory authorities, financial market infrastructure and supplements to the regulation governing credit rating agencies. The committees of the European Commission focused their work on the EC regulations subject to directives in the areas of undertakings for collective investment in transferable securities and insurance and reinsurance undertakings (Solvency II). In order to present their opinion on these initiatives and draft documents, the Commission’s staff participated, on a regular basis, in the work of the European Council’s Financial Services Committee and the Financial Services Working Group and of the European Commission’s European Banking Committee, the European Securities Committee and the European Insurance and Occupational Pensions Committee and elaborated national positions and instructions for meetings.

REFORMING THE EU FINANCIAL SUPERVISION SYSTEM

In 2010, all regulatory provisions necessary for the implementation of the supervisory reform of the EU financial sector were approved and in January 2011 the European Systemic Risk Board and European supervisory authorities — European Banking Authority, European Insurance and Occupational Pensions Authority and European Securities and Markets Authority — became operational.

The activity of the European Systemic Risk Board would be aimed at a timely assessment of threats to financial stability in the EU as a result of macroeconomic and financial system development. The activity of the European supervisory authorities would be aimed at ensuring the regulation of the financial sector and supervisory convergence in the EU Member States and the authority of these bodies, compared with the authority of the Committee of European Banking Supervisors

(CEBS), Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and Committee of European Securities Regulators (CESR) that were functioning until 2011, was strengthened. The new authorities would develop draft technical standards that would be approved by the European Commission in the form of regulations or decisions that would be

directly binding on all Member States. To ensure application of uniform EU requirements, the European supervisory authorities would issue frameworks and proposals to which the principle “follow or explain” would apply. They would also be entitled to settle disputes between supervisory authorities of Member States.

PARTICIPATION IN THE WORK OF EUROPEAN SUPERVISORY COMMITTEES

During the reporting year, the Commission’s staff participated in the work of the Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and Committee of European Securities Regulators (CESR) and of the working groups established within these committees. In all committees, priority was given to the issues of supervisory reform and translation of these committees into European supervisory authorities.

Occupational Pensions Supervisors continued to develop proposals for the regulatory provisions of the European Commission in respect of equities risk, assessment of participation, correlations between risk modules in standard formula for solvency capital requirement, use of insurance-specific parameters, calculation of technical provisions a.o. issues that are subject to Solvency II directive. The Committee developed methodology for Solvency II Quantitative Impact Study QIS 5 that took place in the second half of 2010 and was aimed at assessing the likely impact of Solvency II regime on the insurance market in the EU Member States.

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priority was given to the issues of supervisory reform

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In the reporting year, recognising the importance of macroeconomic and banking sector analysis in assessing the stability of the banking sector and in order to ensure identification of early warning signals for supervisory purposes, the Committee of European Banking Supervisors carried out risk assessment in the banking sector and an EU-wide stress test of the banking sector in which major EU cross-border bank groups participated, incl. those groups whose members were present in Latvia; the aim was to assess overall stability of the EU banking sector and banks’ capacity to absorb potential credit risk and market risk shocks in future and to determine the sector’s dependence on state aid measures. The work on establishing colleges of supervisors was continuing. Guidelines in respect of the work of colleges, Pillar II supervisory process issues, disclosure by banks of information related to regulatory requirements, liquidity risk management and reporting issues were developed and improved.

In 2010, the Committee of European Securities Regulators concentrated predominantly on implementing the regulation on credit rating agencies, proposals to the European Commission on better regulation for the financial derivatives not admitted to trading on the regulated market and proposals for the expected amendments to the financial instruments market directive.

In the reporting year, EU committees were actively working on the issues related to the supervision of pension funds. The Commission’s staff participated actively in the work of the Committee of European Insurance and Occupational Pensions Supervisors in the area of pension fund supervision. One representative of the Commission took part in the work of Occupational Pensions Committee that discussed topical pension fund supervision issues in the EU, a Commission’s representative participated in the project “Management Oversight and Internal Controls Rules Applicable to IORPs” of the CEIOPS Occupational Pensions Committee as a project team member and a Commission’s representative performed project coordination functions in respect of the initiated project “DC risks related project”. Also in the reporting year, a Commission’s representative took part in the CEIOPS seminar on pension fund supervision making a presentation “DC schemes related risks” and being a lead discussant in the group “Fundamental issues about Risk Management and Internal Control”.

In 2010, the Committee of European Insurance and

COOPERATION IN THE AREA OF PREVENTING MONEY LAUNDERING

In 2010, in the area of preventing money laundering the Commission’s staff continued to participate in the work of the Committee on the Prevention of Money Laundering and Terrorist Financing of the European Commission and of the joint 3L3 Task Force on Anti Money Laundering (AML/TF) of three EU committees (Committee of European Banking Supervisors, Committee of European Securities Regulators and Committee of European Insurance and Occupational Pension Supervisors). In the reporting year, the Commission’s representatives also participated

in the activities of the Selected Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL).

To extend cooperation possibilities for the purposes of preventing money laundering, in the reporting year the agreement with the central bank of Russian Federation was supplemented to include supervision in this area.

In 2010, new agreements for cooperation and exchange of information were concluded for the supervision of bank groups “Nordea”, “DnBNor” and “Citadele banka”. The Finnish supervisory authority (Finanssivalvonta) and the Commission concluded a modified agreement for cooperation and exchange of information for the supervision of the Latvian branch of Nordea Bank Finland Plc.

In June 2010, a cooperation agreement was concluded

among the responsible ministries, central banks and financial sector supervisors of Denmark, Estonia, Iceland, Latvia, Lithuania, Norway, Finland and Sweden on cross-border financial stability and crisis management and resolution, and the first Nordic-Baltic cross-border stability group meeting was held. The Commission’s representatives participated in the working group of systemically important financial institutions established within the framework of the agreement.

PROTECTING AND EDUCATING CUSTOMERS

Improving the protection of the rights of market participant customers, especially borrowers, to strengthen public confidence in the banking sector and also measures to educate customers were significant supervision aspects in 2010.

As of 1 January 2010, the Commission had been compiling and publishing monthly information about customer complaints and informing general public about the most frequent reasons for complaints. Overall in 2010, the Commission received and reviewed 464 applications about the conduct of market participants, of which 283 complaints were submitted by bank customers and 102 complaints were submitted by customers of insurance undertakings. The number of received customer complaints and applications in respect of banks increased in 2010 in comparison with 2009 (the

the best practice, where necessary, by restructuring the existing credit liabilities upon agreement of both parties.

The complaints by customers of insurance undertakings were mainly about a refusal to pay insurance indemnity, the calculated amount of indemnity and a delayed decision-making.

The number of complaints about the activities of market participants in the 2nd and 3rd tier of the pension scheme was insignificant. In most cases pension scheme participants had failed to fully understand the long-term objective of the products offered by pension plans and pension plan conditions. Therefore the Commission requested that pension funds assess information they provided to service recipients and establish additional procedures before signing participation contract, and the Commission also requested that additional training of employees be carried out to ensure as complete and easily understandable information as possible.

In the reporting year, the Commission developed “Communication Guidelines for the Participants of the Financial and Capital Market and Their Customers” aimed at improving the communication process between market participants and their existing and potential customers to reduce the number of complaints about the conduct of market participants. To ensure smooth exchange of information and cooperation for the protection of customers of market participants, the Commission concluded a cooperation agreement with the Consumer Rights Protection Centre.

In the reporting year, the Commission continued to develop the measures to educate customers of market participants and made a decision to establish an educational Internet homepage Customer School that would provide information about the essence of the most popular financial products in Latvia and their risk assessment.

With a view to keep public fully informed about topical developments in the financial and capital market, in 2010 the Commission disseminated 59 statements to mass media (60 in 2009); in three cases when the Commission uncovered an illegal provider of investment services in Latvia, it published warnings to investors in mass media and on its Internet homepage whereby it indicated that the Commission did not perform supervision of the activities of those companies in due course of law and therefore investor interests were not protected at the state level.

To measure the confidence indicator in the financial and capital market, in the reporting year the Commission carried out the annual survey of the Latvia’s population in respect of the previous period. To ensure circulation of information at the international level and availability of objective information about the situation in the Latvian financial sector in 2010, two meetings for the ambassadors accredited in Latvia were organised and information with Latvian embassies abroad was exchanged on a regular basis.

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Commission amended the “CIL” to ensure efficient reviewing of customer applications and complaints
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Commission received 257 complaints from bank customers in 2009) whereas the number of complaints in respect of the activities of insurance undertakings did not change.

When receiving an application from a customer (a consumer), the Commission requested that the respective market participant provide an explanation that was assessed before preparing the answer or providing a consultation to the customer about the essence of the application. The Commission also checked whether the market participant had not violated laws. When the Commission uncovered that banks had failed to provide timely answers to customer complaints, it amended the “Credit Institution Law” to include an obligation for credit institutions to ensure efficient reviewing of customer applications and complaints in respect of the provided financial services and free availability of such information to customers. According to the above mentioned Law, credit institutions also had an obligation to reply to applications and complaints within 30 days of their receipt; that deadline could be extended where a credit institution could not comply with it due to objective reasons and the applicant had to be notified in writing to this effect.

Bank customer complaints were predominantly about the behaviour of banks when they changed agreements unilaterally, incl., required fulfilment of liabilities ahead of maturity or restructurisation of liabilities, and increased credit interest rates. There had been cases when banks had exercised their rights to change conditions in concluded agreements; in view of this, the Commission invited market participants to be forthcoming un seek solutions by following

1 ■ The Commission plans to develop its activity strategy for 2012–2014 to ensure planning of goals, priorities and results to be achieved for the next planning cycle.

2 ■ In the area of IT, in 2011 the Commission plans to develop two new strategies for 2012–2014. The planned IT management strategy and IS security supervision strategy will define goals for the next strategic period for both IT application and security management, and regulatory and supervisory activities to ensure that the services ensured by IS to the customers of market participants are safe and sound.

3 ■ The management and the experts of the Commission will continue their activities in the newly established European supervisory authorities and will implement the guidelines approved by the ESAs as well as standards to ensure harmonised approach to interpretation and application of legal provisions at the EU level.

4 ■ In 2011, the Commission's experts will take part in introducing Basel III requirements in the EU financial regulatory framework and will also assess the impact of the new regulatory requirements on the Latvian banking sector.

5 ■ To improve the regulatory framework governing the activities of insurers and reinsurers in view of the changes in the insurance and reinsurance market, risk management tools, cross-border nature of their activities and Solvency II requirements, the Commission will develop law on insurance and reinsurance that will replace the effective "Law on Insurance Companies and Supervision Thereof" and "Reinsurance Law".

6 ■ To ensure that the regulatory framework governing the activities of alternative investment fund managers complies with the EU requirements, the Commission will develop law on alternative investment fund managers.

7 ■ In the insurance sector eight new regulations will be developed and introduced to ensure compliance with the requirements of the "Activities of Insurance and Reinsurance In-

termediaries Law": "Regulations for Calculating Solvency Capital Requirement and Available Solvency Margin", regulations for determining capital increase of an insurance (reinsurance) undertaking and calculation methodology thereof, "Regulations for Calculating Solvency Capital Requirement and Available Solvency Margin for a Group of Insurers", regulations for core principles governing the calculation of technical provisions of an insurance (reinsurance) undertaking, "Regulations for Receiving Permissions to Use Internal Models in the Calculation of Solvency Capital Requirement", "Regulations for Disclosure Requirements to Insurers", regulations for minimum requirements on establishment and functioning of governance system of insurance (reinsurance) undertaking and regulations for the scope and structure of the minimum supervisory reporting of insurance (reinsurance) activities.

8 ■ To continue improvement of the measures for educating the customers of market participants in line with the concept developed in 2010, a new educational Internet homepage Customer School (www.klientuskola.lv) is available as of 2011 that provides information about the essence of the most popular financial products in Latvia and their risk assessment; the available information will be supplemented efficiently, where necessary.

9 ■ The Commission will continue to implement and improve performance planning and assessment system of its employees to ensure assessment of individual result-oriented performance and development of employees' competencies and to link individual remuneration with assessment results.

10 ■ To enhance efficient circulation of legally enforceable electronic documents, in 2011 the Commission will invite market participants to introduce electronic signature in document circulation and, where necessary, will ensure efficient consultation and training meetings with them. Due to the circulation of electronic documents the Commission saves on average 50% of the expected costs for postal expenses per year.

STRUCTURE OF THE COMMISSION

