

ANNUAL REPORT AND ACTIVITY REPORT **2012** OF THE FINANCIAL AND CAPITAL MARKET C O M M I S S I O N

MISSION

Ensure effective regulation and supervision of the activity of the financial and capital market and participants thereof, promote stability, competitiveness and development of the financial and capital market and safeguard interests of investors, depositors and the insured persons

VISION

Customer-oriented and proactive supervisory authority of the financial and capital market, one of the most efficient, flexible and dynamic in Northern Europe and Baltic region that ensures compliance with high standards of financial services and promotes the development of the Latvian financial and capital market

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INTRODUCTION

CHAIRMAN'S STATEMENT: GLIMPSE INTO THE YEAR 2013



YEAR 2013: FROM STABILISATION TO PRUDENT DEVELOPMENT

Year 2012 was characterised by a stabilisation trend, with a number of positive developments in the financial sector and stabilisation of several key performance indicators. This gives cause to be prudently optimistic about the development of the sector in 2013 despite the continuous presence of risks in the financial sector mainly due to external economic factors.

For the Financial and Capital Market Commission (FCMC) 2013 will be another year of challenge as we will experience finalisation of projects that had been started long before as well as launching new processes. FCMC will follow the strategic path that was started the year before. We have identified three key strategic priorities aimed at a more efficient implementation of the functions of a supervisory authority: streamlining the regulatory framework of the financial sector, strengthening supervision and improving the level of financial education and awareness.

STREAMLINING THE REGULATORY FRAMEWORK

In 2013, regulatory reforms of the financial sector will continue; this will include new capital requirement regulations for banks (CRDIV/CRR), crisis resolution mechanism, introducing the deposit guarantee system in the banking sector, introducing Solvency II in the insurance sector and other initiatives to contribute to the joint effort to strengthen the international financial system.

STRENGTHENING SUPERVISION

In 2012, the authority of FCMC was expanded to enable a more efficient implementation of the supervisory function. As of 1 December 2012, FCMC has been authorised to carry out on-site searching and inspecting upon receipt of permission by a judge and in the presence of the State Police. FCMC also started applying new and innovative supervisory techniques thereby enhancing the protection of customer interests. We also started using Mystery Shopping in the supervision of market participants and the first outcomes are expected this year. In 2013, the foundation will be laid for a uniform banking supervision system in Europe. The new supervisory mechanism will be implemented by the European Central Bank (ECB) and national supervisory authorities. With Latvia's accession to the euro area in 2014, three major banks could be subject to direct supervision by the ECB in cooperation with the national supervisory authority.

SUPERVISION OF NON-RESIDENT DEPOSITS

Management of the risks inherent to non-resident deposits is still high on FCMC agenda. Reference to Latvia as the main destination of the monies from Cyprus is undeserved and unjustified.

At the end of 2012, deposits with Latvian banks totalled LVL 2.7 billion having increased by LVL 1.4 billion or 12.7% during the year. Throughout the year, resident deposits increased by LVL 530 million and non-resident deposits increased by LVL 876 million. This increase corresponded to the historical trend that had been unchanged as of the second half of 2009 when a gradual increase in non-

resident deposits resumed. The current trend is expected to continue in 2013 with a gradual increase in non-resident deposits.

Banks that focus on serving non-resident business and specialise in serving cash flows of foreign nationals perform as a regional financial centre. Latvian banks engage in financial logistics, i.e. they provide services in respect of cash inflowing for a shorter term. This may be considered as an export of financial services that improves profitability of the banking sector, creates and maintains highly qualified jobs and helps to enlarge the tax base.

However, non-resident business not only benefits but brings also certain risks. For this reason, FCMC has designed a set of specific measures for monitoring nonresident deposits. This reduces to the minimum the possibility that the volume of cash inflows to Latvia could be disproportionate to the current size of the country's financial sector. Banks that focus on non-resident business are subject to higher capital adequacy requirements and an individual minimum liquidity requirement in view of the share of services to non-residents in bank's total services. Banks are also required to comply with strict requirements in the area of preventing money laundering and terrorist financing.

IMPROVING THE LEVEL OF FINANCIAL EDUCATION AND AWARENESS

Promoting financial knowledge is one of our priorities to ensure that people are increasingly aware of the products and services available in the financial sector and the potential risks related thereto and to prevent them from doing business with non-licensed market participants and surrendering to rumours and unverified information about the financial sector.

In 2012, FCMC became the coordinating authority for financial awareness issues between the financial sector institutions and public institutions in continuing education programmes. FCMC signed a cooperation agreement with the National Centre for Education whereby information will be exchanged to improve the content of education. Work is ongoing to improve FCMC's education site KLIENTU SKOLA (Customer School, available in <u>Latvian at www.klientuskola.lv</u>) that provides objective information about the most frequently used financial services.

When I assumed office, I promised to look for solutions in respect of the bank security index. Since banks cannot be grouped according to single criteria, we have suggested a solution by establishing an informative tool BANK COMPASS: it provides the key performance indicators of banks on the basis of their publicly available quarterly reports. More detailed information is available on FCMC's website at <u>www.fktk.lv</u>.

CONCLUSION

In my opinion, 2013 will be the year of intensive work for the financial sector. Even if performance indicators of the sector for 2012 have complied with norms, there is a question about their sustainability. Not all indicators suggest a complete recovery of the economy; for example, credit risk is still particularly high in the household segment. The quality of household loans has not changed notably and banks may have to make further loan loss provisions throughout the year. As well, concerns about the effect of external factors on the development of the financial sector trigger prudent opinion about the developments in the short run. Those market participants that will take a prudent stance in assessing future developments and take into account risks will be able to ensure balanced and sustainable development.

Kristaps Zakulis

FCMC Chairman

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CONCERNS ABOUT THE EFFECT OF EXTERNAL FACTORS ON THE DEVELOPMENT OF THE FINANCIAL SECTOR IN 2013 TRIGGER PRUDENT OPINION ABOUT THE DEVELOPMENTS IN THE SHORT RUN

REPORT OF THE BOARD

FCMC BOARD MEMBERS





Kristaps Zakulis

Pēters Putniņš





Gvido Romeiko



Ludmila Vojevoda

Jelena Ļebedeva

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FCMC is an autonomous public institution and has been performing in this capacity for nearly 12 years as of its establishment on 1 July 2001; it ensures regulatory framework for and supervision of the Latvian financial and capital market as well safeguards the interests of customers of market participants and promotes soundness, competitiveness and development of the sector in general.

The activities of FCMC are managed by the Board. During the reporting year, notable changes took place in the composition of the Board. On 12 January 2012, Kristaps Zakulis was appointed Chairman of FCMC (he succeeded in the position Irēna Krūmane, the former Chairwoman of the Commission). At the end of the year, the term of office of Janis Brazovskis expired and the Saeima of the Republic of Latvia (RoL) appointed Pēters Putninš Deputy Chairman of FCMC. On 1 March 2012, Jelena Lebedeva, Director of the Supervision Department, was appointed Member of the Board of FCMC. Gvido Romeiko, Director of the Legal and Licensing Department, and Ludmila Vojevoda, Director of the Regulations and Statistics Department, continued to perform as Board members in 2012.

In 2012, 46 meeting of the FCMC Board took place during which 281 decisions were made (in 2011, 60 meetings were held and 325 decisions taken); as well, eight meetings of the Consultative Council of FCMC were held during which 32 draft regulations that were binding on the financial and capital market were approved (43 drafts in 2011).

In the reporting year, the FCMC Board approved amendments to the strategy of the Commission's activities for 2012-2014 by defining three strategic priorities aimed at a more efficient implementation of the functions of the supervisory authority: to streamline the regulatory framework and supervise the performance of the financial and capital market and participants thereof, to promote soundness, competitiveness and development of the financial and capital market and to safeguard interests of investors, depositors and the insured persons.

New strategic priorities along with the goal to develop FCMC and improve efficiency and transparency of its activities triggered organisational changes in FCMC. At the beginning of 2012, the Communications Division was established. After the suspension of the activities of JSC "Latvijas Krājbanka", the Guarantee Funds Division was established and the increasing volume of supervisory methodology triggered the establishment of the Methodology Division.

The core function of FCMC is to ensure ongoing supervision of market participants and this includes traditional supervisory measures: monitoring the performance of market participants on the basis of their financial statement analysis and on-site inspections. Overall in 2012, FCMC carried out 54 on-site inspections of market participants, of which 35 inspections were in banks, 3 in insurance companies, 4 in credit unions, 6 in payment institutions and electronic money institutions, 4 in investment management companies and 4 inspections in general in state and private pension funds. Within FCMC inspections, 15 on-site audits of the security of information systems were carried out.

However, in view of the lessons learnt from the global financial crisis, supervisors had to carry out more profound and substantial analysis of the performance of both individual market participants and the financial system in general and make conclusions. Risk-focused supervision is one of the key supervisory principles. It means that supervisory measures are mainly directed towards timely identification of trends and potential problems as well as the dialogue with market participants rather than towards applying corrective measures and sanctions. However, during the year, fines were imposed in six cases for the total amount of LVL 82 700 and also other sanctions were applied. The largest fine of LVL 75 000 was imposed on a credit institution for the detected weaknesses in the area of preventing money laundering, restrictions on the provision of financial services were imposed on four banks for the failure to comply with regulatory requirements and a warning was issued to one bank for the lack of prudence in increasing the growth rate of its credit portfolio. FCMC also applied corrective measures by imposing additional requirements on two banks in the area of credit risk. Significant violations of regulatory requirements were detected in the insurance sector resulting in legal sanction: the licence of one insurance company was suspended and for two insurance companies their licences for the provision of insurance were cancelled.

Also in 2012 FCMC continued its consultations to the participants of the financial and capital market and also to other institutions in the area of document management related to the introduction of electronic documents, secure electronic signature and electronic record-management system.

FCMC, in cooperation with the Latvian National Archives, continued its work on the pilot project that was dedicated to identifying problems and suggesting solutions in respect of document description in line with the Latvian and international standards.

As a result of the internal audits performed during the reporting year, it was found that in the audited areas the internal control system had been established and was functioning efficiently in all material aspects, yet separate improvements were still needed; overall, the assessed control procedures were adequate, sufficient and efficient and provided appropriate evidence that FCMC risks were managed and the institution had reached its objectives.

STRATEGY OF FCMC ACTIVITIES

In 2012, the FCMC Board approved amendments to the strategy of the Commission's activities for 2012–2014 by defining three strategic priorities aimed at a more efficient implementation of the functions of the supervisory authority: to streamline the regulatory framework and supervise the performance of the financial and capital market and participants thereof, to promote soundness, competitiveness and development of the financial and capital market and to safeguard interests of investors, depositors and the insured persons.

THREE STRATEGIC PRIORITIES TO ENSURE SOUNDNESS OF THE FINANCIAL SECTOR

FCMC STRATEGIC PRIORITIES FOR 2012-2014

STREAMLINING REGULATORY FRAMEWORK FOR THE FINANCIAL SECTOR

The priority of streamlining the regulatory framework for the financial sector includes the participation of the FCMC in the European financial supervisory authorities and in implementing the European Union (EU) regulatory requirements in the bank and insurance sectors. Where EU directives provide for an option, the FCMC will assess the application of the more appropriate solution for the sector. The FCMC will participate in the process of establishing a single EU framework for crisis management to ensure the representation of the national position in the process of elaborating recovery and resolution framework for credit institutions and investment brokerage firms. The priority also includes promoting free and fair competition and diversification of the financial market as well as participation in the introduction of the euro to ensure readiness of the Latvian financial market for the transition to the new currency.

STRENGTHENING SUPERVISORY FRAMEWORK

One of the key tasks in the process of strengthening the supervisory framework is to notably enhance macrosupervision in cooperation with the Bank of Latvia for timely identification of systemic risks and taking preventive or mitigating measures in respect of these risks. Enhanced supervision also includes stronger monitoring of the performance of market participants and supervision of the internal control system, improving cross-border supervision of the security of information systems of market participants and enhancing cooperation with domestic and foreign supervisory authorities of the financial and capital market.

IMPROVING THE LEVEL OF FINANCIAL EDUCATION AND AWARENESS

Since FCMC is convinced that financial knowledge is a necessity in the modern world, the third priority is improving the level of financial education and awareness. The priority includes raising customer awareness of both the financial services and the risks thereof and the nature of the activities of the financial sector to encourage customers to make well-informed choices about each financial service. It also includes ensuring availability of extensive information about the activities of FCMC and the financial and capital market by encouraging the market participants to publish, in time and without delay, information about their financial standing, performance and associated risks.



FCMC ACTIVITIES IN 2012

SUPERVISION

SUPERVISORY PRINCIPLES

In the aftermath of the global financial crisis, also in 2012, FCMC cooperated with the supervisory authorities of other EU Member States (EU MS) to continue revising and improving supervisory principles and techniques in order to eliminate the deficiencies in the supervisory process highlighted by the crisis.

The increasing volume of the supervisory methodology triggered changes in the structure of FCMC's Supervision Department. At the end of 2012, Methodology Division was formed and it is responsible for ensuring that the methods used to supervise banks, credit unions, payment institutions and electronic money institutions are improved on an ongoing basis and comply with EU requirements.

Irrespective of the activities of supervisory authorities, market participants themselves have to revise their business plans and strategies in order to enhance the risk control functions.

As in previous years, also in 2012, FCMC approach was to ensure ongoing supervision that included traditional supervisory measures: monitoring bank performance on the basis of their financial statement analysis and on-site inspections.

However, in view of the lessons learnt from the global financial crisis, supervisors had to carry out more profound and substantial analysis of the performance of both individual market participants and the financial system in general. Supervisory measures were directed towards timely identification of trends and potential problems to ensure, in cooperation with market participants, mitigation of likely risks. The main focus was on the sufficiency of risk control and capital adequacy for inherent and potential risks related with the strategies of financial market participants. Corrective measures and sanctions were imposed in cases when market participants had failed to comply with regulatory requirements.

Irrespective of the performed supervisory activities, owners and the management bear relevant responsibility for ensuring sound operation of financial market participants. For this reason, FCMC considers that maintaining a constructive dialogue with owners and the management of market participants and assessing their professional capacity and competence were among the priorities of supervisory activities.

BANKING SECTOR

In view of the notable share of the banking sector in the Latvian financial market, in 2012, the largest part of supervisory measures were directed towards supervising the banking sector.

Even if the quality of the credit portfolio continued to improve and the share of loans that were overdue for more than 90 days was on a decrease, credit risk continued to be one of the main risks also in 2012 due to the notable part of restructured loans and loans under recovery.

As well, in view of the structure of the Latvian banking system and the share of

SUPERVISORY MEASURES ARE DIRECTED TOWARDS IDENTIFYING POTENTIAL PROBLEMS AND TIMELY MITIGATION OF LIKELY RISKS non-resident deposits in total deposits, liquidity risk was another notable risk in the banking sector; FCMC paid particular attention to monitor that risk by means of daily liquidity reports and by assessing liquidity stress tests carried out by banks. In line with their business model banks shall ensure that their liquidity ratio would sustain particularly pessimistic stress tests with a significant ebbing of customer deposits.

In 2012, particular attention was paid to assessing bank capital and capital adequacy. Within the capital adequacy assessment, FCMC assessed activity risks, their management quality and strategies and the capacity of the available capital to absorb any potential loss.

Banking supervision is increasingly geared towards bank business models. Depending on the activity trend of each bank, FCMC established tailor-made requirements. Individual capital adequacy and liquidity requirements were applied to banks doing business predominantly with non-residents.

FCMC held regular meetings with the management and other senior staff members of individual banks to maintain on going contacts and obtain a more accurate view directly from the source about each bank's development profile, current operating priorities, existing risks and policy concerning bank's readiness to assume and manage risks.

Risk-oriented supervision is one of the main principles of supervision. In line with this principle and on the basis of the information received, FCMC assessed, on a regular basis, the performance of market participants, risk levels and risk management quality. In view of the risk monitoring outcomes, FCMC planned the necessary supervision, including on-site inspections.

In 2012, significant uncertainties persisted in international financial markets. In that situation, FCMC paid particular attention to the quality of services to customers and regaining customer confidence.

As well, FCMC made regular assessments of the quality of public disclosure made by market participants to ensure broad and truthful information about their activities and services to enable taking of prudent decisions for choosing a particular service or provider thereof.

In 2012, banking risk assessment tools were revised and risk assessment reports and risk information surveys submitted to the FCMC Board were improved; as well, new supervisory methods were introduced, *inter alia* regular presentations by bank managements to FCMC about the strategy, operating plans and actual performance of their banks, the risks taken, their volumes and management, capital and liquidity management, stress test results and other aspects.

At the beginning of 2013, the work that was started last year to improve the supervisory methodology was finalised: a manual of on-site inspections of banks was prepared and stress test monitoring procedures were revised to bring them in line with the European banking guidelines. As well, methodology for assessing operational risk was revised in line with the types of operational risk events set by the Basel Committee on Banking Supervision, the procedure for checking whether bank business continuity is ensured was improved and inspection procedures for implementing the recommendation on lending in foreign currencies by the European Systemic Risk Board were introduced.

BANKING SUPERVISION IS INCREASINGLY ORIENTED TOWARDS TIMELY RISK ASSESSMENT OF BANK BUSINESS MODELS The contradictory development trends of the financial system suggested that FCMC should continue strengthening the enhanced supervisory framework introduced in 2009 to enable risk-focused and result-oriented supervisory measures and ensure the possibility for timely FCMC intervention in a bank's activity by taking the necessary measures to solve problems or reduce losses.

In 2012, the priorities for supervising banks in Latvia were as follows:

- assess the adequacy of the capital base;
- assess liquidity maintenance and management quality;
- assess activities of banks with problem loans and the recognition of loan impairment losses in bank statements;
- assess the potential impact of bank operating strategy on the structure and volume of risks.

In 2012, supervision of banks was carried out by applying the following related techniques: bank performance monitoring on the basis of the analysis of their financial statements and on-site inspections.

BANK PERFORMANCE MONITORING

In 2012, FCMC continued its enhanced off-site monitoring of bank performance on the basis of the analysis of regular reports submitted by banks; as well, FCMC continued to receive from banks the following additional operative overviews and activity reports:

- daily reports about deposit dynamics;
- reports about liabilities to related financial institutions;
- minutes of the meetings of bank credit committees, management boards and supervisory boards as well as internal audit reports about inspections,

results of credit risk, liquidity risk and market risk stress tests.

During the year, FCMC paid particular attention to the balance of banks' correspondent accounts and their availability through on-site and off-site inspections in banks.

In cooperation with the Bank of Latvia, FCMC continued regular stress tests of credit risk and liquidity risk. Stress tests for credit risk were carried out by taking into account macroeconomic forecasts. Outcomes of those tests were used to determine likely losses in the credit portfolio under conservative assumptions about economic development and the capacity of bank's capital to absorb those losses. As well, stress tests in respect of liquidity risk were carried out. Within these tests, several customer behaviour patterns were analysed along with the banks' ability to ensure timely fulfilment of legal claims by customers. Where necessary, FCMC maintained a dialogue with banks about their plans to ensure appropriate capital adequacy and liquidity in emergency.

Risk-oriented supervision is one of the main principles of supervision. In line with this principle and on the basis of reports and other information, FCMC assessed, on a quarterly basis, bank performance, level of risks and their management quality. Risk monitoring results were used to plan the necessary supervision, including on-site inspections.

For several years already FCMC had been assessing risks of banks by assigning a rating to each bank according to its risk size and risk management quality. The

FOR SUPERVISION PURPOSES, EACH BANK IS ASSIGNED A RATING rating system is a tool used by FCMC to identify, analyse and assess risks inherent to the activities of the institutions subject to supervision and to assess the quality, adequacy and appropriateness of risk management techniques in view of the volume and complexity of bank's operations.

THE MAIN OBJECTIVES OF THE RATING SYSTEM ARE AS FOLLOWS:

- assess the risks inherent to the activities of the institutions subject to supervision and risk management systems;
- introduce a standard supervisory approach to identify, analyse and assess these risks;
- make a brief and comparable summary of assessment results (i.e., by assigning a rating to each institution subject to supervision);
- ensure efficient and targeted planning of supervision;
- ensure continuity and transparency of supervision;
- promote introduction of a more advanced approach to risk management in the institutions subject to supervision;
- promote communication and dialogue with the institutions subject to supervision.

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

In 2012, on the basis of FCMC's inspection results, the ratings of five banks were revised. Overall, at the end of the reporting year, banks were assigned the following ratings:

Rating scale	1-2	2.1-3	3.1-4
Number of banks	7	9	3

In 2012, the main risks associated with the activities of banks were still credit, liquidity, strategy and business risks. In particular, attention was paid to strategies of banks and their profitability.

Within its supervisory activities, FCMC applied the following sanctions to banks in 2012 in line with the Credit Institution Law:

- in case of four banks, restrictions for the provision of financial services were imposed for the failure to comply with regulatory requirements;
- a penalty of LVL 75 000 was imposed on one bank for violations in the area of money laundering;
- a warning was issued to one bank for a lack of prudence in increasing the growth of credit portfolio.

FCMC also applied corrective measures to two banks by establishing additional requirements in the are of credit risk.

GROUP SUPERVISION

In 2012, FCMC's staff participated in the work of six colleges of supervisory authorities of credit institutions of EU MS and chaired one college as the responsible supervisory authority. Topical issues on the agenda of colleges were coordination of supervisory measures, internal capital adequacy assessment and risk profile assessment at a group level.

ON-SITE INSPECTIONS IN CREDIT INSTITUTIONS

In the reporting year, FCMC carried out 35 inspections in banks and paid particular attention to assessing capital adequacy, lending process and also risk management functions: management of credit risk, operational risk, liquidity risk, strategy risk and business risk and the compliance control function. The strategic task of supervision was to accurately identify, as quickly as possible, the material risks and take immediate action to mitigate the effect of those risks and stabilise the market.

Weaknesses and inconsistencies detected during the inspections were discussed with the managements of banks and action plans were agreed to correct them. Follow-up monitoring was carried out within off-site supervision by controlling the implementation pace of the action plan and, where necessary, suggesting the necessary corrections

CAPITAL ADEQUACY

FCMC carried out enhanced assessment of the adequacy of bank provisions for expected losses. A positive difference between the volume of expected losses and the provisions made in line with the requirements of accounting standards was taken into account when assessing capital adequacy of banks. In 2012, corrections were made in the capital adequacy calculation of 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. As a result of capital adequacy assessment, all banks concluded that their capital was sufficient to cover the risks inherent to their current operations and also ensured a sufficient capital buffer in case of significantly adverse scenarios affecting their operations.

FCMC inspection results uncovered areas where banks needed improvements; they were the procedure whereby banks established the amount of capital needed to cover the material risks inherent to their current and planned operations, stress test techniques and the analysis of stress test results.

FCMC continued dialogue with several banks about their strategies and capital planning process. During the assessment of bank capital adequacy, FCMC paid particular attention to whether capital adequacy was consistent with further activity strategy of each bank and with the size of risks inherent to bank's planned operations as well as to the methods for managing these risks. When FCMC uncovered that banks had assumed unduly high risk, it, in line with the rights vested to it in accordance with the Credit Institution Law, imposed an obligation on 10 banks to maintain own funds above the minimum capital requirement.

IN 2012, FCMC PERFORMED 35 ON-SITE INSPECTIONS IN BANKS

IN 2012, FCMC REQUIRED THAT 10 BANKS MAINTAIN OWN FUNDS ABOVE THE MINIMUM REQUIREMENT (8%)

CREDIT RISK

In its supervision work, FCMC's priority was to ensure that Latvian banks maintained a sufficient capital base and to promote efficient debt restructuring.

In view of the large proportion of problem loans in the credit portfolio, during inspections additional attention was paid to the work by banks with overdue and problem loans, i.e. justification for and efficiency of loan restructuring. As a result of inspections, FCMC required that banks additionally recognise loan impairment losses by making provisions or capital correction. Additional impairment was mainly uncovered in respect of the loans that depended on collateral. In view of the increase in the volume of new loans to non-residents and additional risks associated with loans to non-residents, during inspections, lending practice to non-residents was assessed, i.e. the criteria for issuing a loan, credit quality monitoring and the quality of issued loans.

Of the 35 on-site inspections in banks, eight inspections were carried out to assess the quality of credit portfolios and credit risk management. These inspections covered 28.6% of the total credit portfolio of the banking sector (a portfolio of LVL 3.4 billion). Particular attention was paid to timely recognition of loan impairment losses (adequacy of provisions) or volume of the capital correction made where the expected losses exceeded the volume of the provisions made. The quality of monitoring the real estate pledged for the benefit of banks was assessed because the results of that monitoring affected timely recognition of loan impairment losses.

RISK MANAGEMENT FUNCTION

When providing financial services, banks have to ensure efficiency of every business unit or activity type and also establish and efficiently implement the overall risk management function that is important for the bank's activities. During bank inspections in 2012, FCMC continued to pay more attention to the quality of managing each material risk. When assessing each risk management function, the size of each risk was assessed along with the effect of its changes on the bank's overall activity, as well as the efficiency of the bank's internal control system and of the management's work when identifying, measuring and managing each relevant risk. Particular attention was paid to establishing whether banks were using the results of various stress tests and stress scenarios when managing their material risks; as well, quality of those stress tests and suitability to the nature of each bank were assessed.

LIQUIDITY RISK

Protracted uncertainty in global financial markets was the reason for FCMC to continue to pay more attention to bank liquidity also in 2012.

In order to control bank cash flows, in 2012, FCMC continued to require that banks submit daily operative information about deposit dynamics and applied enhanced supervision to liquidity management quality of foreign bank subsidiaries at a group level as these banks mainly relied on the resources allocated to them by their parent banks. Thereby FCMC managed liquidity risk in the banking system in general and, where necessary, required that banks took preventive measures to improve their liquidity risk management.

MARKET RISK

In contrast to banks of other countries, Latvian banks did not have significant investments in financial instruments also in 2012 (overall, shares and debt securities did not exceed 9.9% of bank assets). Even though market risk was insignificant in the banking system in general, in view of the persisting sovereign debt risk that could affect the banking system, in 2012, FCMC continued to perform enhanced assessment of banks' portfolios of financial instruments to ensure that banks were disclosing them prudently in their financial statements and assessing the liquidity of their existing securities.

INSURANCE COMPANIES

FCMC followed, on a regular basis, whether insurance companies complied with the requirements for the required solvency margin and the cover for technical provisions as established in the Law on Insurance Companies and Supervision Thereof.

In 2012, significant violations of regulatory provisions were detected and consequently the sanctions set out in the Law on Insurance Companies and Supervision Thereof were applied during the year: the licence of one insurance company was suspended and in case of two insurance companies licences for the provision of insurance were cancelled.

In 2012, FCMC cooperated with the supervisory authorities of insurance and reinsurance companies of the countries of European Economic Area (EEA) that carried out supervision of those insurance groups and reinsurance groups whose members were insurance companies authorised in Latvia. During the year, FCMC's employees participated in three meetings of colleges of supervisory authorities of insurance and reinsurance companies of EEA countries. The most topical issue in the work of these colleges was the development of an internal model for an insurance group or a reinsurance group and the expected approval of the model by the supervisory authorities of insurance and reinsurance of EU MS in relation to the implementation of the requirements of the Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) as well as information exchange process among supervisors.

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

In accordance with Section 51 of the Compulsory Civil Liability Insurance of Owners of Motor Vehicles Law and Paragraph 19 of Regulations No. 195 of the Cabinet of Ministers "On the Procedure for Establishing the Guarantee Fund of the Compulsory Civil Liability Insurance of Owners of Motor Vehicles, for Accruing Assets in the Fund and Managing the Fund" of 22 March 2005, FCMC inspected the guarantee fund administered by the society "Latvijas Transportlīdzekļu apdrošinātāju birojs" (Motor Insurers' Bureau of Latvia) as to its compliance with the fund's establishment, accrual and administration procedures and notified the Ministry of Finance and the society itself about inspection results.

THREE FULL-SCOPE INSPECTIONS OF THE ACTIVITIES OF NON-LIFE INSURANCE COMPANIES WERE CARRIED OUT

INSURANCE AND REINSURANCE INTERMEDIARIES

In 2012, FCMC staff performed two off-site inspections of insurance and reinsurance brokers (legal persons) to assess compliance with the requirement of the Activities of Insurance and Reinsurance Intermediaries Law about keeping the funds acquired from insurance and reinsurance mediation distinct from the funds of the insurance and reinsurance intermediary itself, and assessed whether the requirement for free availability of customer complaint handling procedures was fulfilled. As well, FCMC carried out six thematic inspections to assess compliance of insurance and reinsurance intermediaries (legal persons) with the requirements of the above mentioned Law.

During the inspections, material violations of regulatory requirements were uncovered and the following legal sanctions were applied to insurance and reinsurance brokers (legal persons): in one case FCMC suggested removing the responsible staff member from office, in two cases a warning was issued to responsible staff members for violations of the requirements of the Activities of Insurance and Reinsurance Intermediaries Law, legal obligations were imposed on two brokers with a deadline for ensuring compliance with those obligations, a fine of LVL 100 was imposed on two brokers, in respect of one broker the entry was cancelled in the FCMC register of insurance and reinsurance intermediaries and a warning was issued to three brokers for the violations of legal requirements.

COOPERATIVE CREDIT UNIONS

In the reporting year, four on-site inspections were carried out to assess the financial standing of cooperative credit unions, their management work, asset quality, income and expenses structure and compliance with regulatory requirements.

FCMC applied the following sanctions to cooperative credit unions in 2012: in case of two credit unions restrictions on taking deposits were imposed and in case of one credit union a restriction on issuing loans was imposed.

PAYMENT INSTITUTIONS AND ELECTRONIC MONEY INSTITUTIONS

During the reporting year, six on-site inspections in payment institutions and electronic money institutions were carried out to assess their operating model, management work and compliance with regulatory requirements. In 2012, no sanctions were imposed on payment institutions and electronic money institutions.

INVESTMENT MANAGEMENT COMPANIES AND INVESTMENT FUNDS

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

At the end of 2011, new regulatory requirements were introduced as a result of transposition of the requirements of Directive 2009/65/EC (UCITS IV) into the national regulatory framework. The new provisions introduced additional requirements for the managers of investment funds in respect of risk management and disclosure of information. Consequently, additional off-site analysis measures ADDITIONAL REQUIREMENTS WERE INTRODUCED FOR INVESTMENT MANAGEMENT COMPANIES IN THE AREAS OF RISK MANAGEMENT AND DISCLOSURE OF INFORMATION were taken to ensure that investment management companies implement the new regulatory requirements. An assessment was made whether synthetic indicators of investment funds as indicated by investment management companies complied with profitability fluctuations of funds and whether money market funds ensured compliance with FCMC's "Regulations Governing the Use of the Name of a Money Market Fund". In particular, attention was paid to assess whether key investor information complied with regulatory requirements.

As well, more attention was paid to off-site analysis of the internal control system and internal audit of investment management companies.

During the reporting year, four on-site inspections in investment management companies were carried out. Inspections were aimed at assessing material operating areas of those companies, their compliance with RoL laws, FCMC regulations and guidelines and other regulatory requirements. During inspections, particular attention was paid to the established internal control system and risk management by assessing appropriateness and applicability of the internal regulatory basis. As well, transparency of operations and compliance with the best practice principles as well as respecting of customer interests were assessed.

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

Follow-up monitoring was carried out within off-site supervision by controlling the implementation pace of the action plan and, where necessary, suggesting the necessary corrections.

MANAGERS OF ASSETS OF THE STATE-FUNDED PENSION SCHEME

In the reporting year, off-site supervision of State-funded pension scheme (SFPS) asset managers was performed to assess the asset quality of the investment plans they managed, the structure of income and expenses and their compliance with RoL laws, FCMC regulations and guidelines and other regulatory requirements.

In 2012, three on-site inspections of SFPS asset managers were carried out. Particular attention was paid to assessing the internal control system, compliance of distribution of functions with the established organisational structure, the decision-making and implementation of management decisions, appropriateness and applicability of the internal regulatory basis and the established reporting system. Attention was also paid to selecting providers of outsourced services and the use of those services by assessing the control systems established by asset managers to assess outsourced services. The performance of custodians was also assessed.

The weaknesses and inconsistencies uncovered during inspections were discussed with the management of the SFPS asset managers and action plans were agreed for the improvements needed to ensure successful functioning of asset managers. Follow-up monitoring was carried out within off-site supervision by controlling the implementation pace of the action plan and, where necessary, suggesting the necessary corrections.

During off-site inspections in 2012, the stress scenario analysis submitted by SFPS asset managers for the investment portfolio of each investment plan was assessed. The identified risk drivers, scenarios and expected activities in case of adverse scenarios were assessed.

While carrying out off-site supervision, the internal audit function of asset managers was assessed by requesting, for assessment purposes, their internal audit plans and opinions. As well, meetings were held with the management of asset managers to follow any significant events in the activities of asset managers and fulfilment of business strategies between on-site inspections.

Representatives of FCMC also participated in a working group that was assessing potential changes in the procedure whereby the commission fee of asset managers was calculated and changes in restrictions on investments.

PRIVATE PENSION FUNDS

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

As well, one on-site inspection was carried out in a pension fund aimed at assessing its activities when carrying out the functions set out in the Law on Private Pension Funds. During the inspection, particular attention was paid to appropriateness and sustainability of the internal control system established by the pension fund and identification and management of material risks. Distribution of functions and compliance with the established organisational structure were analysed as well as the capacity of the information exchange and reporting system to ensure sufficient and traceable information to internal and external users. In particular, attention was paid to choosing providers of outsourced services and using such services by assessing the control systems for such services established by the pension fund. The performance of both asset managers and asset holders was analysed. During inspections, FCMC also assessed risk trends of the products offered by the pension fund.

The uncovered weaknesses and inconsistencies were discussed with the management of the pension fund and action plans were agreed for the needed improvements to ensure successful functioning of the pension fund. Follow-up monitoring was carried out within off-site supervision by controlling the implementation pace of the action plan and, where necessary, suggesting the necessary corrections.

When carrying out off-site supervision, the stress scenario analysis submitted by pension funds for the investment portfolio of each pension plan was also assessed. The identified risk drivers, scenarios and intended actions in case of adverse scenarios were assessed.

According to pension funds, interest rate risk was a material risk driver as this risk derived from the fact that fixed yield instruments dominated investment portfolios; they also noted the risk of volatile market prices. Pension funds with significant investments in instruments denominated in foreign currency recognised currency fluctuation risk as a material risk.

During off-site supervision in 2012, the internal audit function of private pension funds was assessed on the basis of submitted internal audit plans and opinions.

In 2012, active work was carried out in the area of pension fund supervision in committees at the European level. FCMC representatives participated actively in the work of the European Insurance and Occupational Pensions Authority

PENSION FUNDS ADMITTED THAT THE RISK OF VOLATILE INTEREST RATES AND MARKET PRICES WAS A MATERIAL RISK DRIVER (EIOPA) in the area of pension fund supervision and of the Occupational Pensions Committee that dealt with topical supervision issues in Europe in respect of pension funds. One FCMC staff member participated in the project "Survey on default investment option" by the Occupational Pensions Committee and in "Peer Review on IORPS" by EIOPA.

INVESTMENT SERVICE PROVIDERS

In 2012, three (two planned and one targeted) inspections were carried out in banks and three targeted inspections were performed in investment brokerage firms. Targeted inspections were mainly carried out in response to customer complaints and also to ensure that the obligations set by FCMC were fulfilled. During inspections, FCMC assessed compliance of the provided investment services with regulatory requirements, e.g., disclosing information 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. As well, FCMC assessed the topicality of internal processes and documents of investment service providers and their compliance with regulatory requirements.

In 2012, no violations in the area of investment services were detected and no sanctions were imposed on the respective participants of the financial and capital market; moreover, FCMC cancelled the restrictions it imposed in 2011 on one provider of investment services to provide investment services and ancillary investment services.

FCMC continued the tradition of holding question and answer sessions to the providers of investment services on topical issues in view of the observations made during supervision.

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

At the end of the reporting year, JSC "NASDAQ OMX Riga" (Stock Exchange) was operating in Latvia as the only regulated market. At the end of the year, shares of 31 issuers were listed on the Stock Exchange. Listing of debt securities included six issuers for a total of 39 various debt security issues: Latvian government debt securities (24), corporate debt securities and bonds (15).

FCMC followed, on a regular basis, whether issuers disclosed information in a timely manner and in compliance with the requirements of the Law on the Financial Instruments Market. When detecting violations and after considering the essence of the violation, in five cases FCMC required that issuers took measures to eliminate the weaknesses in disclosing mandatory information in future or publish corrected information. FCMC instituted three administrative processes for violations in disclosing mandatory information and, as a result, issued respective administrative rulings by issuing a warning to an issuer and imposing a penalty of LVL 5000 on one issuer.

AT THE END OF 2012, SHARES OF 31 ISSUER WERE LISTED ON THE STOCK EXCHANGE A SIGNIFICANT DECREASE IN SHARE TRADING ACTIVITY WAS EVIDENT IN THE STOCK EXCHANGE IN 2012

TRADING IN FINANCIAL INSTRUMENTS

On the Stock Exchange, the regulated market in Latvia, a significant decrease in share trading activity was evident in 2012. In comparison with 2011, the total number of transactions in the share market decreased by 21.1% and the number of traded shares decreased by 67.7%, whereas total turnover in the share market in 2012 was LVL 11.6 million, by 55.6% less than in 2011. At the end of 2012, the share market capitalisation of the Latvian Stock Exchange had increased by 2% year-on-year.

To promote sound operation of the financial instruments market, FCMC monitored, on an ongoing basis, the trading in financial instruments by following and analysing the instructions submitted to the Stock Exchange and the transactions carried out therein to identify and prevent market manipulation and using of inside information in transactions with financial instruments.

FCMC inspected whether the persons listed as holders of inside information had complied with the Law on the Financial Instruments Market and notified FCMC of their transactions and whether it had been notified, in due course of that Law, about acquiring or disposing of a qualifying holding; it instituted an administrative case in three cases as a result of which a warning was issued to two persons and a penalty of LVL 1500 was imposed on one person. In other cases when minor weaknesses or inaccuracies were detected, instead of instituting an administrative case, FCMC issued a warning to the persons to prevent re-occurrence of the weaknesses in future.

SECURITY OF FINANCIAL SERVICES AND INFORMATION SYSTEMS

In 2012, FCMC continued to improve the process for monitoring the security of information systems. Over the reporting year, 15 on-site audits of the security of information systems were carried out.

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

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

In 2012, FCMC started processing in detail the security incidents of the information systems of market participants. This innovation was introduced to assess the real risks and improve internal incident management processes of market participants.

Since market participants centralise IT management in order to optimise processes, during the reporting year, FCMC was more actively cooperating with supervisory authorities of the financial and capital market of the Baltic States for IS security supervision.

As well, cooperation became more pronounced and closer with CERT.LV, a body that prevents IT security incidents. FCMC experts participated in training for incident prevention "Cyber Europe 2012".

IN 2012, 15 ON-SITE AUDITS OF THE SECURITY OF INFORMATION SYSTEMS WERE CARRIED OUT IN 2012, A FINE OF LVL 75 000 WAS IMPOSED ON ONE BANK FOR THE WEAKNESSES DETECTED IN THE AREA OF MONEY LAUNDERING

PREVENTING MONEY LAUNDERING

To assess compliance of participants of the financial and capital market with requirements of the Law on the Prevention of Laundering the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing, in 2012, FCMC carried out 13 on-site inspections in banks, of which one was in a foreign branch of a bank, four inspections related to the supervision of electronic money institutions and two inspections related to the supervision of payment institutions. As well, FCMC carried out seven off-site inspections (including an assessment of procedures) in banks and 19 inspections (an assessment of procedures) in financial institutions, of which eight were related to the supervision of electronic money institutions, eight with payment institutions, one with the supervision of investment management companies and two with the supervision of insurance intermediaries that provide life insurance services.

As a result of the weaknesses detected during an inspection, FCMC imposed a penalty of LVL 75 000 on one bank and also issued a warning for removing from position the responsible member of the management board and established an obligation to take measures for improving the functioning of the internal control system. As well, FCMC imposed a fine of LVL 1000 on one payment institution for non-compliance with legal requirements and in parallel established a restriction on its activities until inconsistencies in the internal control system were corrected.

During 2012, for information exchange purposes in respect of money laundering issues, FCMC received 16 requests for information from foreign supervisory authorities of the financial and capital market: five from the US, five from Russia, three from the UK, two from Lithuania and one from Australia. FCMC sent nine information requests to supervisory authorities of other countries: three to Lithuania, three to Russia, two to Australia and one to the US.

In the framework of ongoing cooperation with the Central Bank of the Russian Federation, in 2012, several meetings were held both in Moscow and in Riga during which opinions were exchanged and issues discussed relating to further cooperation in the area of preventing money laundering.

In the area of preventing money laundering, in 2012, FCMC's representatives continued their participation in the activities of the European Commission's (EC) Committee for the Prevention of Money Laundering and Terrorist Financing, and in the work of Anti Money Laundering Committee of the three EU supervisory authorities (European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA)). In the reporting year, FCMC's representatives also participated in the work of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL).

In accordance with FCMC's register of unusual and suspicious financial transactions, eight reports were sent to the Financial Intelligence Unit (Office for the Prevention of Laundering of Proceeds Derived from Criminal Activity) in 2012.

SUPERVISION OF THE ADMINISTRATOR AND THE INSOLVENCY PROCESS OF JSC "LATVIJAS KRĀJBANKA" IN 2012

In accordance with Paragraph 4, Section 154 of the Credit Institution Law FCMC is entitled to control the activities of an administrator. For this purpose, the authorised representative of FCMC has the right to become acquainted with all the documentation of a credit institution and of the administrator, which is related to the bank, as well as to receive explanations and any other necessary information, which is associated with the insolvency proceedings of the credit institution from the administrator.

To exercise the rights vested to it by the said Law, FCMC established a group of proxies comprised of three employees that in 2012 carried out off-site supervision of the administrator of JSC "Latvijas Krājbanka" (LKB) by analysing activity reports of LKB's administrator and submitting monthly statements about them to FCMC management and by solving topical issues relating to the activities of LKB's administrator. In order to ensure that FCMC had the broadest possible information about the liquidation process of LKB, the administrator submitted to it monthly information about the most important aspects of the liquidation process: asset recovery and realisation, creditor claims, litigations, cooperation with major customers of LKB, staff-related and other issues.

In addition to the above mentioned off-site supervision, FCMC also carried out on-site supervision of LKB as one of the Latvian banks. An on-site inspection was carried out during 6 June – 13 July 2012 and the next inspection is due in autumn 2013.

As well, FCMC invited representatives of LKB administrator for a discussion to clarify liquidation-related issues and receive explanations about separate aspects of interest for FCMC. All discussions were held upon necessity to ensure the performance of FCMC's supervisory functions.

LICENSING

At the end of 2012, 20 banks were operating in Latvia and the number of licensed credit institutions had diminished by two because the licences issued to JSC "Parex banka" and JSC "Latvijas Krājbanka" were cancelled. Even if the number of branches of banks of EU MS remained unchanged during the year, some changes took place also in that sector. In 2012, Latvian branch of Allied Irish Bank p.l.c. discontinued in operations and DNB Bank ASA established a branch in Latvia. As a result, in 2012, nine branches of banks were still operating in the market. The number of cooperative credit unions increased and was 34 as the licence was issued to Lauksaimniecības kameras Kooperatīvā krājaizdevu sabiedrība (Cooperative Credit Union of the Chamber of Agriculture).

During the reporting year, changes took place also in the insurance market: the number of insurance companies decreased from 12 to nine because FCMC revoked licences for the performance of insurance issued to IJSC "Seesam Latvia", IJSC "LKB Life" and MICU (Mutual Insurance Cooperative Union) "Lauto klubs". At the same time, the number of branches of insurance companies of EU MS grew by three as FCMC issued a permit to operate in Latvia to the Polish insurance company "Compensa Towarzystwo Ubezpieczeń S.A. Vienna Insurance Group", Lithuanian "Uždaroji akcine bendrove draudimo kompanija "PZU Lietuva"" and Estonian "ERGO Kindlustuse Aktsiaselts".

changes in the name of incensed market participants in 2012					
	AS AT THE BEGINNING OF 2012	AS AT THE END OF 2012	CHANGES IN THE NUMBER OF MARKET PARTICIPANTS		
Banks	22	20	- 2 ¹		
Branches of banks of EU MS	9	9	0		
Cooperative credit unions	33	34	+12		
Providers of banking services from EEA	269	285 (-3 companies)	+19		
Insurance companies	12	9	-33		
Branches of insurance companies of EU MS	10	13	+34		
Providers of insurance services from EEA	462	485 (-11 companies)	+34		
Investment management companies	14	14	0		
Providers of investment management services from EEA	20	22	+2		
Investment brokerage firms	6	5	-1 ⁵		
Branches of investment brokerage firms of EU MS	0	1	+16		

Table 1

Changes in the number of licensed market participants in 2012

Providers of investment	1512	1693	+230
brokerage services from EEA		(-49 companies)	
Agents attracted by investment service providers	0	9	+9
Agents from EEA attracted	19	16	+4
by investment service providers		(-7 attracted agents)	
Private pension funds	7	7	0
Insurance brokerage firms	86	86	+47
		(4 cancelled entries in the register)	
Insurance agents	621	591	+28
		(58 cancelled entries in the register)	
Providers of payment	97	134	+38
services from EEA		(-1 companies)	
Payment institutions	32	34	+58
(registered)		(3 cancelled entries in the register)	
Electronic money institutions (registered)	12	14	+6 ⁹
Electronic money	16	26	+13
institutions from EEA		(-3 companies)	

<u>1 Banks:</u>

On 15.03.2012, the licence issued to JSC "Parex banka" for the operation of a credit institution was cancelled.

On 10.05.2012, the licence issued to JSC "Latvijas Krājbanka" for the operation of a credit institution was cancelled.

² Cooperative Credit Unions:

On 01.11.2012, the licence for the operation of a credit union was issued to Lauksaimniecības kameras Kooperatīvā krājaizdevu sabiedrība "Krājkase".

³ Insurance companies:

On 27.01.2012, all licences issued to IJSC "Seesam Latvia" for the provision of insurance were cancelled.

On 19.04.2012, all licences issued to IJSC "LKB Life" for the provision of insurance were cancelled.

On 10.05.2012, the licence issued to MICU "Lauto klubs" for the provision of guarantee insurance was cancelled.

⁴ Branches of insurance companies of EU MS:

On 11.06.2012, FCMC received information from Polish insurance supervisory authority to the effect that "Compensa Towarzystwo Ubezpieczeń S.A. Vienna Insurance Group" wanted to establish a branch in Latvia and on 01.08.2012, FCMC did not object to opening the branch. Latvian branch of "Compensa Towarzystwo Ubezpieczeń S.A Vienna Insurance Group" was registered with the Commercial Register on 19.09.2012.

On 03.09.2012, FCMC received information from Lithuanian insurance supervisory authority to the effect that "Uždaroji akcine bendrove draudimo kompanija "PZU Lietuva"" wanted to establish a branch in Latvia and on 06.09.2012, FCMC did not object to opening the branch. Latvian branch of "Uždaroji akcine bendrove draudimo kompanija "PZU Lietuva"" was registered with the Commercial Register on 10.10.2012.

On 06.09.2012, FCMC received information from Estonian insurance supervisory authority to the effect that "ERGO Kindlustuse Aktsiaselts" wanted to establi sh a branch in Latvia and on 07.09.2012, FCMC did not object to opening the branch. Latvian branch of "ERGO Kindlustuse Aktsiaselts" was registered with the Commercial Register on 24.10.2012.

⁵ Insurance brokerage firms:

On 07.12.2012, the FCMC Board took the decision to cancel the licence issued to LLC IBF (Investment Brokerage Firm) "SEB Enskilda" for the provision of investment services and ancillary investment services.

⁶ Branches of investment brokerage firms of EU MS:

Latvian branch of "Admiral Market AS". On 08.02.2012, an announcement was received and on 01.03.2012, FCMC did not object to opening the branch. The branch was registered with the Commercial Register in July 2012.

^z Insurance brokerage firms:

In 2012, the following insurance brokers were registered with the register of insurance and reinsurance intermediaries:

- RECIPO Baltic SIA was registered on 18.01.2012;
- LLC "AgroBroker" was registered on 01.03.2012; .
- .
- LLC "Risk Management" was registered on 14.03.2012; LLC "STR Insurance Brokers" was registered on 22.11.2012.

<u>ayment institutions:</u>

In 2012, the following payment institutions were registered:

- LLC "LV Service" (currently "VENIPAK LATVIJA") was registered on 06.01.2012;
- LLC "Hermes Financial Services" was registered on 19.04.2012;
- •
- LLC "Maiden" was registered on 19.04.2012; LLC "Express-Europe" was registered on 18.06.2012;
- LLC "BalticPay Corporation" was registered on 20.09.2012.

In 2012, the following entries were cancelled in the register:

- on 27.01.2012, LLC "Transact Pro" was granted the status of an electronic money institution:
- on 28.04.2012, LLC "Latvijas Mobilais Telefons" was granted the status of an electronic money institution;
- on 02.08.2012, the entry about LLC "Baltic Pay" was cancelled in the register of payment institutions.

⁹ Electronic money institutions:

In 2012, the following electronic money institutions were registered:

- LLC "MyPay" was registered on 13.01.2012;
- LLC "E-karte" was registered on 20.01.2012; LLC "Qiwi Baltic" was registered on 20.01.2012;
- LLC "Transact Pro" was registered on 27.01.2012;
- LLC "E Pay Service" was registered on 12.04.2012; LLC "Latvijas Mobilais Telefons" was registered on 28.04.2012.

DEVELOPING REGULATORY PROVISIONS

NATIONAL REGULATIONS

In 2012, active preparative work was carried out for the financial sector regulatory reform Basel III and Solvency II: positions in respect of draft EU legislation were formulated, new RoL regulations drafted and effects of the new regulatory framework assessed.

Amendments to regulatory requirements were directed towards strengthening internal governance, improving risk management and providing better information to customers about the risks associated with investments in financial instruments.

AMENDMENTS TO LAWS

On 1 December 2012, amendments to the Law **on the Financial and Capital Market Commission** took effect whereby FCMC was entrusted with the authority to carry out on-site searching and inspecting upon receipt of permission by a judge and in the presence of the State Police. FCMC functions were extended to enable obtaining evidence from those persons that engage in the activities covered by the regulatory provisions governing the activities of the financial and capital market with or without any authorisation or licence and also to encourage any person to disclose information at its disposal about possible violations of law. All procedural activities will be carried out in due course of the Administrative Procedure Law and in exceptional cases only rather than within routine supervisory activities.

Amendments to the **Law on Insurance Companies and Supervision Thereof** took effect on 21 December 2012 and were developed to implement the EU principle of equal treatment of men and women in relation to access to goods and services, delivery of goods and provision of services; according to the amendments, it is prohibited to establish a different insurance premium and insurance indemnity depending on the gender.

MOST IMPORTANT NEW REGULATORY PROVISIONS AND AMENDMENTS TO REGULATIONS

The **"Regulations for Selecting Candidates for the Position of Administrator of Insolvency Proceedings and Liquidator of a Credit Institution"** were developed to enhance transparency of the process whereby FCMC's suggested candidates for the position of administrator and liquidator of a credit institution were assessed.

The **"Regulations for Establishing the Internal Control System"** establish more stringent requirements for the level of knowledge, skills and experience needed for the members of supervisory boards and management boards of credit institutions and investment brokerage firms both collectively and individually. A requirement was introduced to appoint Risk Director. The new requirements were aimed at improving understanding of risks and risk management quality. The Regulations introduced principles for establishing an efficient internal

ACTIVE PREPARATIVE WORK WAS CONTINUING FOR THE FINANCIAL SECTOR REGULATORY REFORM BASEL III AND SOLVENCY II control system according to the "Principles for enhancing corporate governance" by the Basel Committee on Banking Supervision and "Guidelines on Internal Governance" by the European Banking Authority.

Amendments to the "Regulations on the Compliance with Restrictions on **Exposures**" were developed to specify the establishment of internal limits for claims on institutions depending on whether claims arise as a result of ensuring settlement or an institution invests funds in another institution for profit and also taking into account risks that a bank is likely to incur in transactions with other banks.

Amendments to the "Regulations on the Information Disclosure" were prepared to promote the introduction of the best practice for disclosing information on remuneration and ensure disclosing of information in accordance with the guidelines of the European Banking Authority. Information referred to in draft amendments must be disclosed for the first time about the year 2012.

Amendment to the "Regulations on Currency Matching for Assets and Technical **Provisions**" was developed to extend admissible deviations for matching the coverage of technical provisions and matching of technical provisions by currency. According to the amendment, provisions not only in Latvian lats, as in the current wording of the Regulations, but also in Danish krone, Lithuanian litas and Bulgarian lev may be covered by investments in euro.

Amendments to the "Regulations on the Procedure for Submitting Information to the Official System for Central Storage of the Regulated Information" improve the procedure whereby market participants that are issuers submit information set out in the Law on the Financial Instruments Market to the Official System for Central Storage of the Regulated Information.

The **"Regulations on the Procedure for Reporting Short Positions or Uncovered Positions in Financial Instruments"** establish the procedure whereby an investor shall register to be able to report short positions or uncovered positions and the procedure for using the reporting system. To enable investors to report the positions they hold, the development of a dedicated portal is in the pipeline.

According to the **"Recommendations for Offering Packaged Investment Products to Retail Investors"**, before executing a transaction (signing a contract), life insurance companies and banks provide to their customers or potential customers who do not have the relevant experience, knowledge and competence in the area of finances information about the nature of a packaged investment product, its objectives and related investment policy, risks, previous performance and likely future results as well as all costs of the product.

According to the "Regulations on the Information to be Included in the Offer Document and on the Preparation of the Offer Document" an offer document shall be prepared when making a public offer of transferable securities included in the offer where the total payment for the offer that is calculated for 12 months ranges between EUR 100 000 and EUR 5 000 000 and it shall contain information about the issuer, offered securities and issuer's financial standing. The Regulations were developed to ensure protection of investors' interests also in cases when the offer of securities is of a small volume.

Amendments to the "Regulations on the Preparation of Annual Reports of State-funded Pension Scheme Investment Plans" were made to reduce administrative burden related with the requirement to publish annual report and report by a sworn auditor in at least one daily newspaper that is available in the whole territory of Latvia. Public availability of the annual report and the report by a sworn auditor is ensured by placing both documents on the homepage of the asset manager of the fund and issuing copies of those documents to interested parties upon request.

Amendments to the **"Regulations for Enhanced Customer Due Diligence"** establish an obligation for payment institutions and electronic money institutions to carry out enhanced customer due diligence in cases stipulated in the Regulations, a list of indicators of products (services) of a payment institution and an electronic money institution when the institution is under the obligation to carry out enhanced customer due diligence and threshold volumes for customer transactions above which the transaction is assigned high risk of money laundering or terrorist financing and the institution is under the obligation to carry out enhanced customer due diligence during the business relationship. The Regulations are also supplemented with a list of commercial activities of customers that have a high risk of money laundering or terrorist financing.

Amendments to the **"Regulations on Issuing Licences for the Operation of a Payment Institution and an Electronic Money Institution, Registering a Payment Institution and an Electronic Money Institution, Submitting Documents and Disclosing Information"** specify the documents to be submitted by institutions that do not need to receive a licence in accordance with the requirements of Articles 5 and 51 of the Law on Payment Services and Electronic Money. A requirement is added in Paragraph 7 of the Regulations whereby a licensed payment or electronic money institution must submit an updated commercial activity plan if it wishes to start provision of another payment service type or significantly change the service it is providing.

The **"Recommendations for Equal Treatment of Genders in Respect of Establishing the Volume of Insurance Premiums and Insurance Indemnities"** determine those insurance contracts to which requirements to ensure equal treatment of genders apply in respect of establishing the volume of insurance premiums and insurance indemnities and those insurance contracts to which the above requirements do not apply and also lists cases when gender-related information may be used.

EU REGULATORY PROVISIONS ADOPTED IN 2012

Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps. The Regulation introduces requirements for making a notification and disclosing to the public information about short selling of shares and significant net short positions in sovereign debt of EU issuers or equivalent uncovered positions in credit default swaps. In emergency situations supervisory authorities are granted temporary powers to establish restrictions for short selling and credit default swaps. In such cases ESMA has powers to coordinate the activities of supervisory authorities to ensure that measures are proportionate. ESMA has powers to intervene in cases when there are threats to the activity and security of the EU financial system.

The Regulation took effect on 1 November 2012. Moreover, in 2012, EC approved two delegated regulations establishing technical standards for applying separate provisions.

Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories. The Regulation establishes that information about OTC derivatives should be notified to trade repositories and financial supervisory authorities should have access to such information. This would also promote additional information available to the market. Standardised OTC derivative contracts should be cleared through a central counterparty. This will mitigate counterparty credit risk, i.e., risk of default by a party to the transaction.

The Regulation took effect on 16 August 2012. Moreover, in 2012, EC approved nine delegated and implementing regulations establishing technical standards for applying separate provisions.

Directive 2012/23/EU of the European Parliament and of the Council of 12 September 2012 amending Directive 2009/138/EC (Solvency II) as regards the date for its transposition and the date of its application, and the date of repeal of certain Directives. According to the Directive, the deadline for the transposition of Directive 2009/138/EC (Solvency II) has been extended from 31 October 2012 to 30 June 2013 and application date has been moved from 1 November 2012 to 1 January 2014; however, during the revision of the proposal for Omnibus II directive a possible further extension of deadlines is considered.

DRAFT EU REGULATORY PROVISIONS DISCUSSED IN 2012

CREDIT INSTITUTION SECTOR

Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/ EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010

The proposal is aimed at minimising the use of taxpayers' money to resolve credit institutions in difficulty and safeguarding financial stability and confidence in credit institutions. Introduction of a specific minimum set of resolution tools is planned in all member states and would include, e.g., selling of business, separating of assets, establishing of a bridge bank that would notably improve possibilities to achieve successful and efficient resolution, e.g., by ensuring managed and timely bankruptcy of credit institutions, allowing to maintain continuity of financial services un overall stability of the financial system. An additional mechanism would allow writing down bank's debt or partially convert it into own funds (debt write-down tool).

Proposal for Council Regulation **conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions**

Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (**European Banking Authority**) as regards its interaction with Council Regulation, (EU) conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions

The proposal is aimed at establishing a single supervisory mechanism in Europe that would comprise the European Central Bank (ECB) and national

supervisory authorities. ECB will be responsible for the overall functioning of the single supervisory mechanism and will have key role in the supervision of credit institutions in the euro area MS, whereas supervision will be implemented in a differentiated manner. On the basis of specific criteria, e.g., the size of a credit institution and its relative importance in the economy, the mechanism will single out those credit institutions that will subject to direct supervision by ECB while national supervisory authorities will have a more significant role in their supervision; at the same time, retaining the possibility that any credit institution may be subject to direct supervision by ECB. In any case, at least three major most important credit institutions of the country involved in the mechanism must be supervised by ECB. While the mechanism respects the specific circumstances of each MS, the structure of the sector and other characteristics, it also ensures a sound basis enabling ECB to implement its tasks and be actually and efficiently responsible for the overall operation of the single supervisory mechanism as a system. According to the approved criteria, of all 6000 banks operating in the euro area about 200 banks will be subject to direct supervision by ECB.

PROPOSALS UNDER DISCUSSION SINCE 2011

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

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

These proposals establish higher requirements for the quality and volume of own funds and a gradual introduction, from 2014 till 2021, of several new capital adequacy ratios; as well, higher requirements for capital adequacy ratios will be introduced in parallel providing an opportunity for MS to establish higher requirements for capital adequacy ratios without a transition period, i.e. as of 1 January 2014 (provided that they publish relevant regulatory provisions by 30 June 2013). Along with other requirements, two new minimum quantitative standards for liquidity management will be introduced: liquidity coverage ratio for short-term liquidity management and net stable funding ratio for short-term liquidity management.

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

The proposal is aimed at establishing basic requirements for separate aspects relating to credit agreements signed with consumers for residential property. It sets out the volume of information to be provided by the creditor and the credit intermediary to the borrower before signing the agreement and during the agreement, establishes an obligation for the creditor to assess borrower's creditworthiness and for the borrower to provide information to the creditor as well as the procedure for issuing authorisations to credit intermediaries and for their supervision and other issues.

FINANCIAL INSTRUMENTS MARKET SECTOR

PROPOSALS PUBLISHED BY EC IN 2012

Proposal for a Regulation of the European Parliament and of the Council on improving securities settlement in the European Union and **on central securities** *depositories (CSDs)* and amending Directive 98/26/EC

The proposal is aimed at enhancing security and efficiency of security settlement, removing obstacles to the functioning of internal market resulting from divergent national rules governing securities settlement and governing the activities of central securities depositories which operate securities settlement systems. This objective will be reached by introducing common rules for settlements in financial instruments in the EU and rules governing the organisational structure and activities of CSDs.

Proposal for a Regulation of the European Parliament and of the Council on key information documents for investment products

The proposal is aimed at ensuring the provision of information to consumers and consumer protection when offering more complicated investment products and improving transparency of the investment product market for private investors. Draft Regulation specifies the essential elements of an investment product that should be described in the KID: the identity of the product and its manufacturer, the nature and the main features of the product, including if an investor may lose capital, risk and reward profile, costs and past performance. As well, the proposal sets out a common format to promote comparability of products and liability of the manufacturer in respect of KID.

Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to **undertakings for collective investment in transferable securities (UCITS)** as regards **depositary functions, remuneration policies and sanctions**

The proposal is aimed at establishing tasks and responsibilities of depositories (custodian banks), specifying their liability and conditions for delegating the functions of a depository, establishing requirements for developing and recording remuneration policy of UCITS and for disclosing remuneration-related information and harmonising the sanction regime in the area of UCITS.

PROPOSALS UNDER DISCUSSION SINCE 2011

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

The proposal is intended to reduce administrative burden on issuers by abolishing the requirement to publish interim management reports and restricting the rights of MS to impose additional requirements to those set out in the directive, e.g., the requirement to publish quarterly reports. At the same time, the proposal specifies the range of financial instruments that are subject to reporting requirements, establishes more harmonised requirements for notifying a significant holding and is intended to improve the network of officially appointed storage mechanisms.

Proposal for a Directive of the European Parliament and of the Council **on markets** *in financial instruments*

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

Both proposals are intended to extend the notion of a financial instrument, determine that all organised trading in financial instruments shall be provided on regulated trading venues: regulated markets, multilateral trading facilities and organised trading facilities and provide appropriate definitions. These proposals introduce changes in the requirements for disclosing both pre-trading and post-trading information by including therein debt securities, structured finance products, emission allowances trading and financial derivatives. The scope of transaction reporting will be extended. Providers of investment services will have to report to financial supervisory authorities all transactions in financial instruments except those financial instruments that are traded on regulated trading venues. At the same time, regulated markets, multilateral trading facilities and organised trading facilities will be required to report transaction details where the provider of investment services is not under an obligation to report transactions to supervisory authorities. Transaction reporting will be carried out through an approved reporting mechanism.

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

In view of the rapid development of the financial market, the current Directive 2003/6/EC fails to provide complete regulation to ensure monitoring of abuse of inside information and market manipulation. The new draft Regulation is intended to modify the provisions of the Directive, ensure that new market instruments and new markets are covered, supplement the notions of inside information and of market manipulation and also establish broader and more accurate powers of supervisory authorities and cooperation in the area of supervision in view of market developments.

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

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

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

The proposal establishes the requirement for certain financial institutions to carry out credit risk assessment themselves to prevent overreliance on the ratings assigned by credit rating agencies, improves provisions for disclosing to the public credit rating methodology and introduces stricter provisions for assigning sovereign credit rating.

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

The proposal is intended to introduce the requirement that an investment management company, when it assesses UCITS assets, and an alternative

investment fund manager, when it assesses assets of alternative investment funds, should not rely solely on external credit ratings but rather use them as one of the factors in the process.

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

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

The Regulations set out which alternative investment funds (AIF) may qualify as European Venture Capital Funds and European Social Entrepreneurship Funds and will be entitled to use that name. They are addressed to the managers of European Venture Capital Funds and of European Social Entrepreneurship Funds that are registered with the competent authority in accordance with the requirements of Directive 2011/61/EC on alternative investment fund managers and whose asset management does not exceed the threshold of EUR 500 million. The said registration will entitle them to trade units of European Venture Capital Funds and of European Social Entrepreneurship Funds in all MS.

INSURANCE AND PENSION FUND SECTOR

PROPOSALS PUBLISHED BY EC IN 2012

Proposal for a Directive of the European Parliament and of the Council on insurance mediation (recast)

The proposal is intended to extend the scope of insurance mediation directive so that it covers all distribution channels (direct writers, car rental companies a.o.), identify, manage and mitigate conflicts of interest, ensure greater harmonisation for administrative sanctions and measures for breach of key provisions of the current directive, strengthen adequacy and objectiveness of advice, ensure that professional qualifications of sellers match the complexity of products sold, simplify and approximate the procedure for cross-border entry to insurance markets in the EU.

PROPOSALS UNDER DISCUSSION SINCE 2011

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

The proposal sets out amendments to Solvency II Directive in respect of the responsibilities and powers of insurance supervisory authorities, in particular when performing group supervision, in respect of establishing European Insurance and Occupational Pensions Authority, additional transitional provisions for implementing separate sections of Solvency II Directive, additional provisions for establishing the amount of technical provisions under stress conditions in the financial market and for insurance products with long-term guarantees. The deadline for Solvency II Directive taking effect depends on the adoption of Omnibus II Directive.
PLANNED EU INITIATIVES IN 2013

In the first quarter of 2013, proposals for a Directive and for a Regulation **in the area of money laundering and terrorist financing** will be developed to ensure better safeguarding of public interests against crime and terrorism along with a proposal **in respect of bank accounts** aimed at achieving transparent and comparable bank account fees and facilitate the process whereby consumers switch bank accounts.

In the sector of banks and financial instruments, a proposal will be developed to establish **a single resolution authority and a single resolution fund** along with a proposal to develop a **European framework of money market funds** aimed at ensuring better security of investments made in such funds.

As well, a proposal for **shadow banking** regulation will be developed because at present there is no such regulation at the EU level. This will improve transparency and possibilities to obtain data about separate financial transactions to promote financial stability.

At the end of 2013, EC will revise regulations that underlie the supervisory framework for the European financial sector and at the end of the year it will publish the proposal for the required amendments to Regulations along with the proposal for a **crisis resolution and management framework for non-bank financial institutions** aimed at a successful restructurisation of those institutions without stirring a systemic impact.

EC will also have to approve delegated and implementation measures for prospectuses, alternative investment funds, Solvency II, financial market infrastructure, new capital framework CRDIV/CRR, credit rating agencies and other areas.

GUARANTEE SYSTEMS

In Latvia, the structure of the financial stability system was comprised by the following elements:

1. the Deposit Guarantee Fund;

2. the Fund for the Protection of the Insured;

3. protection of customers of the financial instruments market (investors);

4. financial stability fee.

Table 2

DEPOSIT GUARANTEE FUND

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

The State guaranteed that every customer of a deposit taker was compensated an amount of up to EUR 100 000 irrespective of the fact whether there were sufficient funds in the Deposit Guarantee Fund (DGF) at that time. According to the Deposit Guarantee Law, if the funds were insufficient, FCMC should provide them by borrowing funds from the Treasury.

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

	AMOUNT	SHARE, %
Total number of depositors	2 327 250	100.0
incl. up to the amount of GC	2 311 052	99.3
incl. above the amount of GC	16 198	0.7
Amount of deposits, in thousand lats	10 242 353	100.0
incl. up to the amount of GC	3 077 914	30.1
incl. above the amount of GC	7 164 439	69.9
Deposits guaranteed by DGF, in thousand lats	4 216 309	41.2

At the end of 2012, DGF guaranteed 41.2% of total deposits with Latvian banks: for 99.3% of all depositors, the full amount of their deposit was guaranteed whereas for 0.7% of all depositors the guaranteed amount was EUR 100 000 but it did not cover the deposit in full.

PAYMENT OF THE GUARANTEED COMPENSATION AFTER UNAVAILABILITY OF DEPOSITS OF JSC "LATVIJAS KRĀJBANKA"

When FCMC determined unavailability of deposits at JSC "Latvijas Krājbanka" (LKB), 220 thousand depositors were entitled to receive the guaranteed compensation for the total amount LVL 335.6 million. For 99.8% of all LKB depositors, the deposit guarantee system covered 100% of their deposits. Payment of the guaranteed compensation was arranged as quickly as possible without waiting for the maximum number of days to lapse (30 business days according to law). DGF determined a centralised venue for paying the guaranteed compensation on the fifth business day after the occurrence of unavailability of deposits, but partial payment of the guaranteed compensation (up to LVL 50) was ensured already on the next day after unavailability of deposits. Centralised payment of the guaranteed compensation to LKB customers was arranged by FCMC via JSC "Citadele banka" (paying bank) as FCMC considered it the most appropriate bank at the time for performing this task: it could ensure comfortable services to customers and maintain sound financial performance. According to the agreement between FCMC and the paying bank about the payment of the guaranteed compensation to LKB customers, the paying bank was not charging any commission fee for the payment of the guaranteed compensation where it was made as a lump sum. The most intensive payment of the guaranteed compensation took place in the first three months after the start of payments. Chart 1 shows the payment dynamics of the guaranteed compensation to LKB customers.

Chart 1

Payment dynamics of the guaranteed compensation by month, 11.2011-12.2012



Paid guaranteed compensation by month, 11.2011-12.2012: LVL 329 489 127, number of clients: 117 042

From the start of payments until the end of 2012, the paid guaranteed compensations amounted to LVL 329.3 million (98%) and payments were made to 117 thousand depositors (53%). In 2012, the amount of the paid guaranteed compensations was

LVL 33.4 million. The profile of the paid guaranteed compensations is shown in Chart 2. LKB depositors account for the largest part of recipients of guaranteed compensations (34.2%) and the guaranteed compensation paid to them ranged from LVL 10000 to LVL 10 000 and the share of payments to them accounted for 41.4% of total paid guaranteed compensations.



Chart 3 shows the profile of outstanding guaranteed compensations. At the end of 2012, outstanding guaranteed compensations amounted to LVL 392 thousand and the number of depositors who had not received the guaranteed compensation was 94.3 thousand (representing 91.1%); they were entitled to the guaranteed compensation of up to LVL 50 whereas nine depositors had not received the guaranteed the guaranteed compensation of EUR 100 000.







Total outstanding guaranteed compensation as at 31.12.2012: LVL 6 694 432

Outstanding guaranteed compensations excluded those LKB depositors to which payments had been suspended until they met their liabilities in full amount to the State Revenue Service, sworn bailiffs and other parties that had the rights to recovery from debtor's funds; their deposits amounted to LVL 2.5 million and the number of such customers was 1.85 thousand.

PAYMENT OF THE GUARANTEED COMPENSATION AFTER UNAVAILABILITY OF DEPOSITS OF RAUNA COOPERATIVE CREDIT UNION

In 2012, payment of the guaranteed compensation was additionally recognised to one depositor of Rauna Cooperative Credit Union (Rauna CCU) amounting to LVL 10 000. In 2011, when unavailability of deposits occurred, 24 depositors were entitled to receive LVL 10.3 thousand in guaranteed compensations.

FCMC ensured that, after receipt of the relevant information, payment of the guaranteed compensation was made to settlement accounts of Rauna CCU depositors.

Payment of the guaranteed compensation to depositors of Rauna CCU:

Table 3

Summary about the payment of the guaranteed compensation to depositors of Rauna CCU as at 31.12.2012:

GC TO BE PROVIDED FROM DGF	INDICATORS	GC paid by 31.12.2012.	OUTSTANDING GC BY 31.12.2012	SHARE OF OUTSTANDING GC,%
25	Number of depositors	12	13*	52
20 281	Amount of GC, in lats	10 009	10 272	50.6

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

When unavailability of deposits occurred at LKB, total assets of DGF were LVL 149.9 million. Since DGF had to ensure LVL 335.6 million to pay the guaranteed compensation to LKB depositors, the shortfall of LVL 185.6 million was lent to DGF (FCMC) by the Republic of Latvia. The borrowing from the Republic of Latvia will be repaid from DGF assets that are supplemented quarterly with payments that deposit takers make in due course of the Deposit Guarantee Law and from the funds recovered from LKB for the paid guaranteed compensations. DGF's rights of claim rank first in the amount of the guaranteed compensations. In 2012, LKB repaid to DGF LVL 90 million, and DGF repaid to the RoL LVL 115.9 million plus a borrowing fee of LVL 2.3 million.

In accordance with the Deposit Guarantee Law deposit takers (banks and credit unions) make a quarterly payment to DGF amounting to 0.05% of the average balance of deposits with the deposit taker in the previous quarter. The above mentioned Law also stipulates that after the payment of the guaranteed compensation to depositors FCMC may increase the amount of payment into DGF for up to one year to accelerate the accumulation of assets in DGF. In 2012, FCMC increased payments to DGF 1.5 times. FCMC also establishes the correction ratio that is applicable to the payment by each deposit taker. In 2012, the mean correction ratio applied to the quarterly payments to DGF was 103.14% for banks and 101.50% for cooperative credit unions. When establishing the ratio, FCMC takes into account each deposit taker's capital adequacy, liquidity and large exposure indicator as well as the quality of the credit portfolio in the previous calendar year. In 2012, deposit takers paid LVL 30.8 million into DGF.

FUND FOR THE PROTECTION OF THE INSURED

The assets of the Fund for the Protection of the Insured (FPI) were comprised of deductions of 1% of insurance companies from the total gross insurance premiums received from natural persons for the types of insurance specified in law. At the end of 2012, LVL 9.1 million were accrued in FPI (see Charts 4 and 5).



Chart 5



As of the beginning of its operation, LVL 8671 lats had been used to pay guaranteed compensations. In 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 LVL 10 000 per policyholder, excluding insurance in respect of a market-related life insurance policy;

2) for other types of insurance set out in law, 50% of the insurance compensation, but not more than LVL 2 000 per policyholder.



In 2012, FPI assets increased by LVL 1.08 million lats due to the contributions by fund participants and as a result of FCMC's investment of FPI assets in Latvian government securities, received interest income for short-term deposits with the Bank of Latvia and for the cash balance in the settlement account. 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 4 and Chart 6)

Table 4

FPI income indicators, 2008-2012

	2008	2009	2010	2011	2012	STRATEGY
Payments by FPI participants, in million lats	0.9	0.7	0.6	0.7	0.7	1% of total guaranteed insur- ance premiums
Investment income, in million lats	0.2	0.3	0.4	0.3	0.3	Exceed the costs for main- taining deposits and making investments
Return on assets, %	5.18	6.29	6.84	4.41	4.07	In accordance with the fixed income rate fluctuations of the Latvian government securities

Chart 6

FPI investment structure by initial maturity, 2010-2012 (at the end of the year, %)



PROTECTION OF THE CUSTOMERS OF THE FINANCIAL INSTRUMENTS MAR-KET (INVESTORS)

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

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

ADMINISTRATION OF THE FINANCIAL STABILITY FEE

The objective of the financial stability fee (FSF) is to strengthen the financial system in general to finance, if necessary, the measures that would mitigate the negative impact of those credit institutions that have encountered financial difficulties on other participants of the financial market, as well as to partially compensate the State budget funds that have been channelled to stabilise the situation in the financial sector from which the banking sector in general benefitted directly or indirectly. FSF is paid by banks registered in Latvia and their branches in MS and other foreign countries and by Latvian branches of banks registered in MS and other foreign countries (FSF payers).

FCMC controls the payment of FSF into the budget account, the calculation of FSF and completeness and accuracy of information underlying the calculation. Since the largest component of FSF are deposits that are subject to the deposit guarantee scheme operating in Latvia or other EU MS, in 2012, FCMC carried out inspection of the compliance of classification of those deposits in three banks.

In 2012, an FCMC representative participated in a working group established by the Ministry of Finance for the development of proposals to improve administration of state fees and accounting revenues from fees; as a result of that work, amendments to the Law on Taxes and Fees will be introduced.

Table 5FSF and indicators of FSF payers, 2011-2012:

	2012	2011
FSF payers	3110	33 ¹¹
FSF object, in million lats	6 065.1	6 572.1
FSF rate, %	0.072	0.036
FSF, in lats	4 121 441	2 363 211
FSF payment received in the State budget, in lats	3 329 782	2 389 931

¹⁰ Incl. JSC "Parex banka" that was FSF payer for three months in 2012 and Allied Irish Bank that was FSF payer for nine months in 2012.

¹¹ Incl. JSC "Latvijas Krājbanka" and Latvian branch of AB "Bankas Snoras" that were FSN payers for 11 months in 2011 and Latvian branch of Pohjola Bank plc that did not perform any activities and whose FSF object and state fee was 0 lats.

COOPERATION

INTRA-INSTITUTIONAL COOPERATION AT THE NATIONAL LEVEL

In 2012, FCMC strengthened national cooperation with other public institutions to ensure efficient compliance with the Law on the Financial and Capital Market Commission, other laws and regulatory requirements governing the activities of participants of the financial and capital market and the activities and functioning of FCMC.

In the reporting year, FCMC representatives participated, on a regular basis, in the meetings of the Budget and Finance (Taxation) Committee of the Saeima that reviewed draft laws governing the Latvian financial sector and supervision thereof. FCMC management also participated in the meetings of the National Security Committee and Public Expenditure and Audit Committee of the Saeima, during which issues related to the financial sector supervision were discussed. FCMC continued regular exchange of information with the Bank of Latvia and the Ministry of Finance. At least quarterly FCMC submitted to the Bank of Latvia and the Ministry of Finance summary information about the situation in the financial and capital market and cooperated with the Bank of Latvia to develop enhanced macroprudential supervision framework for timely identification of systemic risks and measures to eliminate or mitigate these risks. To explain the development trends in the Latvian financial sector and trends in its supervision, FCMC took part in the meetings with rating agencies organised by the Treasury. During the reporting year, FCMC cooperated with the Consumer Rights Protection Centre to ensure more operative protection of consumer rights in respect of financial services and, in cooperation with the Consumer Rights Protection Centre, Register of Enterprises and State Police, addressed the problem of unauthorised business in Latvia, namely, took part in combating financial pyramids in Latvia.

FCMC representatives participated in the working groups established by the Cabinet of Ministers and ministries (Working Group for Improving Cooperation with International Rating Agencies at the Cabinet of Ministers, Steering Committee established by the Prime Minister for the introduction of the EU single currency in Latvia, Financial Sector Working Group and Public Information and Communication Working Group within the Euro Project by the Ministry of Finance, Financial Sector Development Strategy Working Group, Working Group established by the Ministry of Welfare for developing draft Law on Amendments to the Law on State Funded Pensions, FCMC and Bank of Latvia Working Group for joining FCMC database for credit portfolio structure (KREDIS) and the Bank of Latvia's credit register database (KREGS)) and councils (Financial Sector Development Council, Audit Consultative Council).

IN THE AREA OF INTERNATIONAL COOPERATION, FCMC's PRIORITY IS COOPERATION WITH COUNTERPARTIES IN EUROPE

INTERNATIONAL COOPERATION

In the area of international cooperation, FCMC's priority is to take part in developments in Europe. FCMC takes part in the discussions of draft regulatory provisions at the Council of the European Union and EC Committees and also in the work of European financial supervisory authorities. It is important to continue bilateral cooperation with supervisory authorities of those countries that engage in cross-border cooperation with Latvia.

FCMC COOPERATED, ON A REGULAR BASIS, WITH THE REPRESENTATIVES OF THE RELEVANT COMMITTEES OF THE LATVIAN PARLIAMENT (SAEIMA) AND OF THE BANK OF LATVIA, MINISTRY OF FINANCE, TREASURY, CONSUMER RIGHTS PROTECTION CENTRE AND STATE POLICE

PARTICIPATION IN THE WORK OF THE COUNCIL OF THE EUROPEAN UNION AND EC IN THE AREA OF FINANCIAL SERVICES

In 2012, the Council of the European Union continued discussing the proposals relating to the financial sector that were published in 2011: the new capital requirement framework for credit institutions (CRDIV/CRR), amendments to directives about the financial instruments market, market abuse, Solvency II and other directives. New proposals were introduced for the directives on recovery and resolution of credit institutions, on packaged investment products (PRIPS) and on a single supervisory mechanism of credit institutions as well as amendments to the directives on undertakings of collective investment in transferable securities and on insurance mediation. FCMC experts were involved in developing national positions and discussing proposals at the Financial Services Working Group of the Council of the EU and Ad hoc Working Group on the single supervisory framework of credit institutions.

On several occasions, as a result of cooperation with peers from other MS, the initial wording of regulations was changed as suggested. For example, in view of the fact that major Latvian credit institutions are subsidiary undertakings of credit institutions of other EU MS, during the discussions about the proposed directive on the recovery and resolution of credit institutions, FCMC experts made a suggestion supporting a significantly more favourable balance to subsidiary undertakings in respect of rights between parent and subsidiary undertakings and rights and duties between home and host supervisory/resolution authorities (in respect of recovery plans, resolution plans, and also group resolution, including financing) and this suggestion has been included in the current draft of the directive. During the adoption of CRDIV/CRR, the scope of powers of host supervisory authorities was maintained in relation to the supervision of liquidity of subsidiary undertakings of credit institutions and it was agreed that a prudential approach would be pursued for including unrealised profit in Tier I core capital. As well, the definition of a group of connected customers was specified by establishing that the group is comprised of the central government and each of the capital companies it controls rather than all capital companies together. The principle of reciprocity was enhanced successfully in relation to capital buffers that are essential for efficient application of macrosupervisory tools, especially in small countries. FCMC did not support relaxing the definition of non-performing loans and supported maintaining the minimum capital adequacy threshold for banks that use internal models to calculate capital requirements until the introduction of the financing structure ratio. In discussions about the establishment of the single supervisory mechanism it was agreed that the application of macrosupervisory tools would remain the competence of the supervisory authorities of MS while the ECB Supervisory Board would take decisions with a simple majority of votes according to the principle "one country - one vote".

At the level of the EC Committees whose membership included FCMC's experts, work was carried out for EU regulatory provisions subject to directives in the areas of alternative investment funds, financial market infrastructure (EMIR) and reinsurance companies (Solvency II) and discussions were held for the EC initiatives planned for the financial sector. The Table below presents an overview of the regulatory provisions that were discussed in the EU bodies in 2012 and the actions planned in 2013.

Table 6

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

EU LEGISLATION	ACTIVITIES IN 2012	PLANNED ACTIVITIES IN 2013			
Credit Institutions Sector					
Capital requirements Directive and Regulation (CRD IV/CRR)	Discussion about amendments to the Directive and a proposal for a new Regulation was continuing in the Working Group at the Council of the EU, the Council of the EU and the European Parliament.	Draft amendments to the Directive and the proposal for a Regulations could be approved by July 2013 (December 2013 the latest). EBA will continue its work on developing technical standards. Work on national legal acts to implement CRDIV requirements.			
Directive on deposit guarantee scheme	Discussion of the proposed amendments to the Directive were suspended in 2011 when the European Parliament and the Council of the EU failed to reach an agreement on the proposal for the Directive in the first reading.	As soon as the Directive on recovery and resolution of credit institutions is approved, the work on the Directive on the deposit guarantee scheme will continue.			
Directive on credit agreements relating to residential property	Discussion about the proposal for a new Directive continued in the Working Group at the Council of EU, the Council of EU and the European Parliament.	Discussion about the Directive could finalised during 2013.			
Directive on establishing a framework for the recovery and resolution of credit institutions and investment companies (crisis management framework)	Discussion in the Working Group at the Council of EU of the proposal for the Directive published by EC on 6 June 2012.	Discussion of the proposal for the Directive could be finalised in 2013.			
Regulation for a single supervisory mechanism of credit institutions	Discussion about the proposed amendments to the Regulation on EBA powers and the proposal for a new Regulation on ECB powers in the area of prudential supervision published by EC on 12 September 2012 in the Working Group at the Council of EU, the Council of EU and the European Parliament.	Amendments to the Regulation and draft new Regulation will be approved in the first half of 2013.			
Initiative on bank accounts	In March 2012, EC published a consultation document about access to bank accounts and interested parties were invited to submit their comments.	On the basis of the received comments, EC could present a legislative proposal in the first half of 2013.			

Initiative on shadow banking	In March 2012, EC published Green Paper on shadow banking and interested parties were invited to submit their comments.	On the basis of the received comments, EC could present a legislative proposal in the 3rd quarter of 2013 and after the publication of the proposal work will commence in the Working Group at the Council of EU.	
Directive/Regulation for reforming the structure of the EU banking	-	In the 4th quarter of 2013, Ed could present a proposal for a Directive or a Regulation aimed at separating in the banking sector trading in financial instruments in own name and on own account from the activities that are services to customers.	
Regulation on a single resolution authority and single resolution fund (single resolution mechanism)	-	In the 4th quarter of 2013, EC could present a Regulation aimed at establishing a single resolution mechanism at the EU level.	
Financial Instruments Sec	ctor		
Directive on Alternative Investment Fund Managers	Discussion and adoption of the delegated Regulation of the Directive in EC. Developing draft Law on Alternative Investment Fund Managers.	In 2013, EC could present four more second level regulatory provisions. ESMA will continue its work on developing technical standards and framework. Draft Law on Alternative Investment Fund Managers (incl. amendments to 10 other laws) will be reviewed by the Cabinet of Ministers and prepared for submissior to the Saeima.	
Transparency requirements Directive	Discussion about the proposed amendments to the Directive continued in the Working Group at the Council of EU.	Discussion about the Directive could be finalised during 2013. After adoption of the Directive amendment to the Law on the Financial Instruments Market will be developed. ESMA will work on developing technical standards.	
Directive and Regulation on the market in financial instruments	Discussion about amendments to the Directive and the proposal for a new Regulation continued in the Working Group at the Council of EU, the Council of EU and the European Parliament.	Discussion about amendments to the Directiv and the proposal for a Regulation could be finalised during 2013. ESMA will work on developing technical standards and framework.	
Market abuse Directive	Discussion about the proposal for a Regulation and a Directive continued in the Working Group at the Council of EU.	Discussion about the Directive and the Regulation could be finalised during 2013.	
Regulation on credit rating agencies	Discussion about the proposal for amendments to the Regulation continued in the Working Group at the Council of EU, the Council of EU and the European Parliament.	Discussion about amendments to the Regulation could be finalised and draft Regulation could be approved in the first half of 2013.	

Directive on investor compensation schemes	Discussion about the proposed amendments to the Directive were suspended in 2011 when the European Parliament and the Council of the EU failed to reach an agreement on the proposal for the Directive on deposit guarantee scheme in the first reading.	No information is available when the revision of the lega act could continue.		
Regulation on European market infrastructure	The Regulation was adopted in July 2012. At the end of 2012, nine EC delegated and implementation Regulations were adopted that established technical standards for the implementation of the Regulation. ESMA worked on other technical standards.	ESMA will continue its work on other technical standards and framework.		
Regulation on short selling and certain aspects of credit default swaps	The Regulation was adopted on 14 March 2012. ESMA worked on technical standards that took effect at the end of 2012.	In 2013, work on ESMA framework is planned.		
Regulation on European Venture Capital Funds and Regulation on European Social Entrepreneurship Funds	The proposals for new Regulations were discussed in the Working Group at the Council of EU, the Council of EU and the European Parliament.	The proposals for Regulations could be approved in the first half of 2013. At the beginning of 2013, ESMA will develop technical advice for delegated and implementation measures.		
Regulation on central securities depositories	Discussion about a proposal for a new Regulation in the Working Group at the Council of EU.	Discussion about the Regulation could be finalised during 2013. ESMA will work on technical standards and framework.		
Directive on undertakings of collective investments in transferable securities (UCITS)	The proposed amendments to the Directive published by EC in July 2012 were discussed in the Working Group at the Council of the EU. In 2012, EC launched new public consultation on liquidity management, rules for investment products, money market funds a.o. during which interested parties could submit their comments.	Discussion of the proposal for a Directive could be finalised during 2013. ESMA will work on technical standards and framework. In parallel, on the basis of the comments received during the consultation, EC plans to develop new amendments to the Directive (UCITS VI).		
Directive on securities rights	Development of a proposal for a new Regulation by EC.	EC could publish the proposal for the Regulation in the 2nd quarter of 2013.		
Prospectuses Directive Prospectuses Directive Approval by EC of the delegated acts. ESMA worked on technical standards.		ESMA will continue its work on technical standards and framework.		

Proposal for the framework of European money market funds	Development of draft proposal by EC.	EC could present the proposal for the regulation governing money market funds in the 2nd quarter of 2013 and it will be aimed at improving security of investments made in those funds.
Proposal for improving activities of European long-term investment fund market	Development of draft proposal by EC.	In the 2nd quarter of 2013, EC could present a proposal for an easier identification of long-term investment funds and improved cost-efficiency (proposal will be part of the Single Market Act II).
Insurance and Pension Fu	und Sector	
Solvency II Directive	Discussion and approval of the Directive that extends the deadline for adopting and applying Solvency II directive in the Council of EU and the European Parliament. Development of draft Law on Insurance and Reinsurance and agreeing with market participants. Approval of delegated and implementation acts by EC.	EIOPA will work on technical standards and framework. Improving draft Law on Insurance and Reinsurance ir line with Omnibus II Directive
Omnibus II Directive (amendment to Solvency II)	Discussion about the proposed amendments to the Directive in the Council of EU and the European Parliament.	Discussion about the Directive will continue in the Council of EU and the European Parliament with a view to adopt the Directive during 2013. EIOPA will develop technical standards.
Directive on insurance intermediaries	The proposed amendments to the Directive published by EC in July 2012 were discussed in the Working Group at the Council of EU.	Discussion about the Directive could be finalised during 2013.
Regulation on packaged investment products (PRIPS)	The proposal for the Regulation published by EC in July 2012 was discussed in the Working Group at the Council of EU.	Discussion about the Regulation could be finalised during 2013.
Directive on the activities and supervision of institutions for occupational (supplementary) retirement provision	Development of the proposed amendments to the Directive by EC.	Proposal for amendments to the EC Directive could be published in the 2nd quarter of 2013.
Payment Services Sector		
Payment services Directive	EC assessed the necessity for amendments and worked on the report for the implementation of the Directive and its impact.	EC could present legislative proposals in the 2nd quarter of 2013.

Preventing Money Laund	ering and Terrorist Finan	cing	
Directive and Regulation for the prevention of money laundering and terrorist financing	Development of a new draft proposal for a Directive and a Regulation by EC.	In February 2013, EC published a new proposal for the Directive and the Regulation. Discussion of the proposal for a new Directive in the Working Group at the Council of EU.	
Financial Sector		Council of EO.	
Proposal for a review of regulations of European financial sector supervisory authorities	-	During 2013, EC could revi the Regulations underlying the European supervisory framework for the financia sector and at the end of th year it will publish proposa for necessary amendment to Regulations.	
Proposal for crisis resolution framework and resolution of non-bank financial institutions	-	At the end of 2013, a proposal could be publishe for the crisis management framework and resolution of non-bank financial institutions aimed at a successful resolution of problems of those institutions without creatin a systemic effect.	

PARTICIPATION IN THE WORK OF EUROPEAN SUPERVISORY AUTHORITIES

As an EU Member State, Latvia is part of the single financial services sector and its financial stability is often related to the cooperation with other Member States. FCMC, in its turn, can impact the formulation of the European supervisory policy and practice by taking part in the work of European financial supervisory authorities.

European financial supervisory system is comprised of microsupervision and macrosupervision. Representatives of national supervisory authorities participate in the work and decision making of the Supervisory Board of European supervisory authorities (European Banking Authority, European Insurance and Occupational Pensions Authority and European Securities and Markets Authority) that is supervision at micro level. The main task of European supervisory authorities is to develop draft technical standards, issue guidelines and recommendations, ensure application of equivalent EU legal acts to investigate violations, carry our peer reviews, resolve disputes between supervisory authorities, coordinate uniform action in emergency, promote safeguarding of consumer rights and product control.

The Chairman of FCMC participates, in the capacity of an observer, in the meetings of the European Systemic Risk Board (ESRB) that has been vested with the supervisory powers at macro level; its task is to assess potential threats to financial stability and ensure timely warning about the likely emergence of systemic risks.

In 2012, FCMC experts were nominated to participate in 64 committees and working groups of the European financial supervisory system and participated in 39 of them (122 meetings overall). Participation in a working group is decided

AS AN EU MEMBER STATE, LATVIA IS PART OF THE SINGLE FINANCIAL SERVICES SECTOR by taking into account the principle of usefulness, i.e., to what extent the issues to be discussed are relevant for the Latvian financial market and to what extent the issue is important in the EU context.

In the reporting year, EBA carried out a number of public consultations about draft regulatory and implementation standards developed by the committees in which FCMC also participated (15 regulatory standards relating to own funds, one about credit risk, one about market risk, five implementation standards for the purposes of supervising credit institutions (COREP, FINREP, large exposures, leverage a.o.), one implementation standard about disclosing information about own funds). Six frameworks were published about the advanced measurement approach, failure to comply with additional liabilities for own funds and migration risk, about value-at-risk under pressure, data collection about persons receiving high remuneration, comparative assessment of remuneration and also about assessing the suitability of the members of management structures and persons who perform core functions. In the area of crisis management, in 2012, work was started to develop the necessary technical standards for recovery and resolution of credit institutions. Public consultations were held about the possible structure of bank recovery plans. Additional information about EBA activities is available on its homepage at www.eba.europa.eu.

In 2012, EIOPA main priorities were the development of technical standards for the introduction of Solvency II Directive about solvency capital requirements, assessment of assets, liabilities and technical provisions, own funds, group supervision and other issues. FCMC participated in the working groups established to develop these projects to ensure that the specifics of the Latvian insurance sector were taken into account when developing regulatory requirements for the EU insurance sector as a whole. For example, experts took active part in the development of the technical standard regarding currencies pegged to the euro: due to their explanation about the stable peg of the lats to the euro, a lower stress ratio for the lats was achieved and consequently lower capital requirement was established for Latvian insurers. Public consultations about technical standards will be started as soon as an agreement is reached about Omnibus II Directive. EIOPA proposals for amendments to the directive on pensions were finalised and sent to EC. In order to enhance protection of consumers, the first EIOPA framework was approved establishing efficient supervisory practice and uniform understanding for the application of EU standards in handling customer complaints. In 2012, EIOPA work in the area of financial stability was still focused on early identification of negative trends and potential risks caused in the insurance sector by economic developments. To ensure convergence of supervisory practices, EIOPA started peer reviews about the supervisory practice in the pension sector, practice for supervising branches of EEA insurance companies and for implementing internal models before application process in supervisory authorities. Additional information about EIOPA activities is available at www.eiopa.europa.eu.

In 2012, ESMA implemented those regulatory provisions governing the financial sector that were developed in the aftermath of crisis and implemented G20 commitments (EMIR, issues of supervising credit rating agencies and regulation on short selling). It was more important that Latvia took part in developing technical standards for prospectuses, alternative investment funds and UCITS. It was also important to follow the formulation of ESMA position in issues related to the regulation of the securities sector in the area of MIFID/MIFIR, preventing

of market abuse and central depositories, i.e., those regulatory provisions for which agreement would soon be reached between the Council of the EU and the European Parliament. To ensure convergence of supervisory practices ESMA carried out peer reviews about supervisory powers in supervising market manipulation and abuse of inside information and practice for implementing regulations governing prospectuses. As well, framework for competent authorities was approved in respect of systems and control in an automated trading environment, framework for risk assessment and calculation of overall risk for certain structured UCITS, for repo and reverse repo contracts, funds admitted to trading on the regulated market a.o. Additional information about ESMA activities is available at <u>www.esma.europa.eu.</u>

At the end of 2012, ESRB approved provisions for bank financing and also money market funds. In the reporting year, FCMC sent to ESRB relevant statements about the proposal of 2011 for lending in foreign currencies, powers of national supervisory authorities in the area of macrosupervision mandates and proposal for the planned introduction of financial resources of credit institutions in US dollars.

COOPERATION WITH SUPERVISORY AUTHORITIES OF OTHER COUNTRIES

In the supervision of the financial sector, FCMC's priority is cooperation with the supervisory authorities of the Baltic States and Nordic countries

In the supervision of the financial sector, cooperation with the supervisory authorities of other countries is key. Priority is cooperation with the supervisory authorities of Baltic States and Nordic countries. Recently FCMC has engaged in closer cooperation with peers from Central and Eastern Europe. Bilateral cooperation continued with the supervisory authorities of Russia and the USA.

In accordance with the cooperation agreement among relevant ministries, central banks an financial sector supervisory authorities of Nordic and Baltic States on cross-border financial stability, crisis management and resolution, work was carried out in the four working groups that were consequently established. Inter alia, barriers to exchanging confidential information among institutions were identified, proposals were prepared regarding cost sharing among countries in crisis resolution cases, models for assessing the impact of systemic risks were developed. In 2012, the fifth working group on crises management for Nordea banking group was established and it was vested with the responsibility to develop cooperation agreement among institutions for cross-border crisis management and resolution within Nordea group. Two meetings of cross-border stability working group took place in which the accomplished tasks were reviewed and future tasks were approved. FCMC was involved in the Macroprudential Forum of Nordic and Baltic States in the framework of which heads of supervisory authorities and of central banks discussed topical issues of macproprudential policy.

In 2012, FCMC also started to participate in the group of Central and Eastern European counties that had been established to formulate a common position of supervisory authorities in the area of EU regulations for which the countries of this block have similar opinions and interests. In the supervisors' group, during the implementation stage of CRDIV/CRR Directive, opinions were exchanged about

IN THE SUPERVISION OF THE FINANCIAL SECTOR, FCMC'S PRIORITY IS COOPERATION WITH THE SUPERVISORY AUTHORITIES OF THE BALTIC STATES AND NORDIC COUNTRIES ensuring powers of host country supervisory authorities in the new regulation and, during the discussion about single banking supervision regulation, the supervisory authorities of these countries cooperated to present a common opinion about ensuring equality between euro area countries and those noneuro area countries that join the single supervisory mechanism. Topical issues in the pace of implementing Solvency II Directive in the area of insurance were discussed.

Bilateral cooperation among supervisory authorities relies on concluded agreements for information exchange and cooperation. Overall FCMC has signed 33 bilateral and multilateral cooperation agreements (for more information please http://www.fktk.lv/lv/komisija/sadarbiba/informacijas_apmainas_ligumi/ligumi_ar_arvalstu_iestadem/page1).

As well, in 2012, FCMC members participated in the work of seven banking supervisory colleges and chaired one of them as the responsible supervisory authority, and in the work of three insurance supervisory colleges.

Cooperation with the Central Bank of Russian Federation continued and in 2012, several meetings were held both in Moscow and in Riga during which opinions were exchanged and issues discussed relating to enhancing cooperation in the area of preventing money laundering. To exchange information about the development trends and topical issues regarding the financial sector, FCMC management continued the practice started in previous years to hold meetings with USA public authorities and financial supervisory authorities during IMF Annual Meetings.

Moreover, in 2012, FCMC concluded cooperation agreement with Deposit Guarantee Fund of Portugal for cooperation and information exchange in respect of the payment of the guaranteed compensation to the customers of the Portuguese branch of a Latvian JSC "PrivatBank". Negotiations started with the *Commission de Surveillance du Secteur Financier* (CSSF), Luxembourg, about signing and agreement for cooperation and information exchange in respect of the subsidiary undertaking of JSC "ABLV Bank" in Luxembourg.

In 2012, FCMC continued negotiations about joining International Organization of Securities Commissions (IOSCO) and made the relevant amendments to regulatory provisions in line with the requirements of IOSCO information exchange agreement. At the end of the year, IOSCO responsible committee confirmed that Latvian legal acts complied with the requirements for IOSCO membership, therefore in 2013, FCMC is expected to be accepted as a member. This will enhance cooperation opportunities in the area of securities with the supervisory authorities of non-EU MS.

CUSTOMER PROTECTION

ONLY 3% OF TOTAL CUSTOMER COMPLAINTS SUBMITTED TO BANKS WERE TRANSMITTED TO FCMC THAT WAS A POSITIVE SIGN OF BANK COOPERATION WITH CUSTOMERS Safeguarding the rights of customers of market participants was a significant supervisory aspect in 2012.

In 2012, FCMC received and reviewed 307 applications about the behaviour of the participants of the financial and capital market, of which 195 were complaints of bank customers, 68 were from customers of insurance companies, one complaint was about an insurance intermediary, 29 complaints were about the participants of the financial instruments market, one application was about a credit union, two applications were about private pension funds, three complaints were about electronic money institutions and eight were about miscellaneous issues relating to the financial market.

In all cases FCMC sought an explanation from market participants and assessed them before preparing the answer or providing a consultation to the customer about the essence of the application within FCMC competence. FCMC also checked whether the respective market participant had not violated regulatory provisions.

Of 195 complaints by customers of banks, in ten cases FCMC uncovered weaknesses in the activities of market participants. After FCMC was involved in the solution, those weaknesses were eliminated. Bank customers complaints were mostly about bank behaviour when providing lending services, failure to start cooperation or terminating cooperation and providing payment services. FCMC considered that the fact that banks had received and reviewed 6 054 customer complaints in 2012 and only 3% of those customers turned to FCMC to lodge a complaint about a bank was a positive sign of bank cooperation with customers.

In respect of payment of the guaranteed compensation to the depositors of JSC "Latvijas Krājbanka" in 2012 and with a view to ensure effective solution of customer-related matters, the FCMC dealt separately with the applications that were about the payment of the guaranteed compensation up to EUR 100 000 from DGF. Overall, 185 applications to this effect were received and processed in 2012.



Chart 7

FCMC invited people to refrain from doing business with unauthorised providers of financial services by placing warnings on its homepage and in mass media about particular companies. In 2012, two warnings were issued to customers. As well, FCMC prepared information "What is a financial pyramid" (available in Latvian) explaining the essence of financial pyramids, why it was advisable not to engage in them, how it was possible to stop their operation a.o. issues.

COMMUNICATION WITH GENERAL PUBLIC. EDUCATING CUSTOMERS AND MARKET PARTICIPANTS

DURING THE YEAR, PEOPLE IN LATVIA WERE INCREASINGLY TRUSTING FINANCIAL INSTITUTIONS AND FCMC Communication with general public under a revised approach was one of the most significant activities of FCMC in 2012. FCMC's Communications Division was reestablished in 2012 by recruiting additional experts and revising the distribution of responsibilities. In the reporting year, FCMC developed its communication strategy for 2012–2015 specifying open and proactive approach to providing information to general public about FCMC's activities, functions and role by using both traditional and social media. Significant task was to explain financial education issues in order to increase public awareness about financial services.

According to SKDS (marketing and public opinion research centre) survey about trusting financial institutions in Latvia, in 2012, an increase in confidence was recorded in contrast to 2011. Confidence in FCMC, commercial banks, insurance companies and the state-funded pension system had improved more notably.

In order to provide complete information to general public about topical trends in the financial and capital market, in 2012, FCMC disseminated 116 statements (96 in 2011) to mass media and held three media events about topical issues. As of January 2012, FCMC had been communicating in the social network <u>Twitter.com</u> account @FKTK_LV. It was a new opportunity to address directly social network public and maintain a dialogue with interested persons.

In 2012, improvements of the crisis communication process were started by developing a crisis communication plan for uniform communication involving the relevant public authorities of the financial sector. Prime Minister approved the plan on 2 February 2012. The plan suggested active cooperation in crisis among FCMC, the Bank of Latvia, the Ministry of Finance and the Office of Prime Minister by involving market participants and their professional associations upon necessity. In 2013, approval of crisis communication guidelines for market participants is expected.

FINANCIAL EDUCATION ACTIVITIES

In line with the activity strategy revised in 2012, one of strategic priorities of FCMC for 2012–2014 is to increase financial education and awareness of general public about financial services and risks thereof and the nature of the sector and supervision thereof in Latvia.

Necessity to improve education about financial issues derives from the conclusion that appropriate understanding about basic financial issues at the level of service recipients is becoming more important each year for the financial sector in general because every stable household that manages its risks is the basis for the stability of the sector and predictable development in the long run. Educated users of services expose themselves to a less risk and do not react spontaneously when learning unverified information (including rumours) about the events in the sector or about activities and financial stability of market participants, banks in most cases. Therefore in 2012, FCMC experts developed a permanent information flow on financial education issues by making available existing and new reference materials to general public and also carrying out direct education activities in various target groups.

APPROPRIATE UNDERSTANDING ABOUT BASIC FINANCIAL ISSUES IS IMPORTANT FOR THE OVERALL STABILITY OF THE SECTOR AND ITS PREDICTABLE DEVELOPMENT IN THE LONG RUN In response to the call by the public that, in order to take informed decisions about doing business with a particular bank, it is important to learn about performance indicators of individual Latvian banks rather than the data about the sector in general provided by FCMC on a regular basis, in 2012, FCMC developed an interactive tool *BANK COMPASS*; it is available at FCMC homepage and provides key bank performance indicators along with their explanations. Apart from publicly available quarterly indicators, *BANK COMPASS* provides definitions and explanations of key indicators.

To ensure follow-up of the successful cooperation that had been established in the area of financial education with the Bank of Latvia, BA School of Business and Finance, Consumer Rights Protection Centre and Association of Commercial Banks of Latvia, in 2012, FCMC started active cooperation with the Ministry of Education and Science and the National Centre for Education. During meetings it was concluded that after re-establishment of market economy the basic issues about the economy and finances had been partially integrated in various subjects taught in Latvian schools, but this was insufficient to ensure that school leavers understood financial issues. Moreover, there were schools that placed financial education high on the curriculum thanks to knowledgeable and qualified teachers, but in most cases school graduates and even university students (especially those who study arts) failed to receive proper knowledge and develop understanding to become fully-fledged participants in the rapidly evolving and multi-dimensional modern financial world. Disparities in education do not contribute to a smooth development of the Latvian society, integrity in the area of finances and stability of the sector.

In order to jointly assess the global topicality of financial education and develop ideas for future, in 2012, FCMC held a discussion involving cooperation partners about the trends in educating general public in the area of finances; the discussion was aimed at agreeing on activity directions and responsibilities of each institution and promote diversified, topical and modern financial education. During the discussion, parties agreed that in future the content of financial education would be developed by the financial sector jointly with the Ministry of Education and Science by taking the following actions:

- supplement significantly the existing curriculum by integrating into it study materials and interactive tools developed by the financial sector and assessed by FCMC experts;
- the Ministry of Education and Science would assume responsibility for developing national strategy in financial education issues;
- FCMC will coordinate and promote introduction of the suggested materials and tools into further education programmes for various groups of people in Latvia.

On 16 November 2012, FCMC and the National Centre for Education signed an agreement on cooperation in economic education issues that provided for exchanging of information and improving the content of education. In the agreement, FCMC endorsed its readiness to take part in developing study materials, ensure the necessary consultation and submit proposals for improving curriculum. In 2012, FCMC prepared an overview of the study materials and interactive tools developed by the financial sector, assessed their suitability for the study process and provided the analysis to the National Centre for Education for improving curriculum; materials were also sent to all parties involved. In order to promote further the cooperation in ensuring financial education, in 2012, an agreement was reached for establishing an educational stand provided by FCMC in the Bank of Latvia's visitors' centre Money World. In the reporting year, the conceptual and textual material of the stand was developed and public procurement was organised. The stand was opened to the public in March 2013.

To ensure that every user of financial services understands the financial and capital market, its services and relevant risks, topical information must be broadly available to all members of the public. For this reason, as of 2011, FCMC has maintained and supplemented upon necessity the education site Customer School at its homepage (www.klientuskola.lv). Thereby FCMC offers further education to those people who are too old to go to schools and learn basic knowledge about financial services. In 2012, via the Customer School site, 79 consultations were provided by e-mail.

In the reporting year, FCMC assessed topical information about the offers in the financial sector and supplemented the Customer School site with descriptions of three new services: structured investments, electronic money and FOREX transactions. To provide equivalent information about financial services, customer protection and guarantee system in Latvia to the Russian-speaking part of the population, in October 2012, FCMC launched the site also in Russian. Thereby FCMC will ensure that even those users of services who are still mastering the official language have a better understanding of financial terms and their use.

After assessing the questions received on the Customer School site, the current statistics about changes over the past years in the financial situation of people in Latvia, the most popular behaviour models and likely changes of habits, FCMC experts concluded that in future, significant improvements were needed to change the habit of long-term financial planning, ranging from payment discipline to private savings and investments. This position and solutions were included in FCMC's communication strategy developed in 2012. In line with the strategy, the Customer School site will be gradually transformed into a broad reference and education site and incorporated into an international network of financial education activities. In the reporting year, the new structure and concept of the site were developed and approved.

By carrying out the role of a coordinator in the Latvian financial sector for financial education issues, in 2012, FCMC launched cooperation and discussions about an official partnership with international movement *Child and Youth Finance International* that promotes financial awareness of children and young people. At the end of the year, within that partnership a decision was taken to take part in the global activities of that movement and hold a financial week for children and young people in 2013.

EDUCATION ACTIVITIES FOR MARKET PARTICIPANTS

In the reporting year, FCMC continued provision of consultations and methodological support to market participants in the area of application of regulatory requirements and held workshops for market participants about significant regulatory changes.

In 2012, FCMC experts assessed the impact of the requirements of capital adequacy regulation (leverage, capital adequacy, liquidity ratio) and introduced banks with the outcomes and analysis thereof. As well, a workshop was held

about changes in the regulatory provisions governing the establishment of an internal control system.

In November 2012, in the Association of Commercial Banks of Latvia FCMC presented draft Law on Alternative Investment Fund Managers; the aim of the presentation was to introduce investment management companies, potential financial market participants that were not subject to supervision at that time and other stakeholders with the draft Law that had been developed by FCMC to introduce new rules for AIF managers in line with Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers; FCMC requested comments and suggestions.

FCMC also provided information about the developments and publications of draft regulatory provisions by EC and European supervisory authorities and invited market participants to study them in order to prepare for the implementation of the new requirements; it also invited comments and proposals.



MAJOR TASKS FOR 2013

MAJOR TASKS FOR 2013

Improving financial sector regulation is one of the strategic priorities of FCMC and for this reason FCMC's work plan includes a number of projects covering nearly all financial market segments supervised by FCMC:

- Amendments are envisaged to Credit Institution Law and to a number of FCMC's regulatory provisions for the implementation of CRD IV/CRR (Basel III) requirements aimed at enhancing capital requirements and introduce macrosupervision.
- Most significant planned changes in the regulations governing the banking sector are as follows:
- more stringent requirements will be introduced for the quality of own funds elements;
- in addition to currently valid capital adequacy ratio, Tier I core capital and Tier I capital adequacy ratios will be introduced;
- introduction of capital buffers (capital conservation buffer, countercyclical capital buffer, systemic risk buffer and SIFI buffer) is planned;
- quantitative liquidity ratios (liquidity coverage ratio and net stable funding ratio) will be established;
- funding structure indicator will be introduced;
- single reporting format will be introduced in all member states.

Latvian regulatory provisions will govern licensing, supervisory powers and cross-border supervisory cooperation, sanctions, 2nd pillar issues, governance and remuneration aspects, supervisory measures and sanctions, consolidated supervision requirements, macrosupervision and application of options in line with CRR.

Most part of regulatory provisions will be set out in a regulation that is a directly applicable EU legal act. CRR impact assessments carried out by FCMC in 2012 provided an opportunity for banks to understand the nature of the new requirements, assess their readiness to ensure compliance with these requirements and plan the necessary measures to ensure full compliance. Preparatory work and consultations along with the provision of methodological assistance will continue also in 2013. For the introduction of the new uniform reporting forms banks will need to make changes in their IT systems. Depending on the finalisation of the uniform reporting forms by EC, FCMC will take a decision about the deadline for the submission of the first report but it may be extended.

 As to the implementation of CRDIV/CRR, amendments will be made to the Law on the Financial Instruments Market. CRR requirements will not apply to those investment brokerage firms that are licensed to simply receive and transfer for execution customer instructions for transactions in financial instruments, execute customer instructions on the customers' or third party's account, provide individual management services of customer portfolios and provide advice about investments in financial instruments. As to the regulatory provisions governing the insurance sector, work is planned to introduce Solvency II interim guidelines to strengthen the insurance sector and improve protection of the insured.

Solvency II Interim Guidelines are developed by EIOPA to ensure gradual implementation of Solvency II requirements (monitoring) in the area of governance, assessment of own risks and solvency, approval process of internal models and reporting in the time when the deadline for Solvency II Directive requirements taking effect (1 January 2014) is extended due to the necessity to carry out impact assessment to clarify the impact of Solvency II requirements on insurers that offer long-term guarantees assessment (LTGA). The requirements of interim guidelines are expected to take effect on 1 January 2014. FCMC assesses possibilities and usefulness of introducing these requirements in Latvian regulatory provisions governing the insurance sector. FCMC plans to take the decision on implementing these guidelines by autumn 2013 when EIOPA approves the final wording of guidelines.

For the introduction of Directive Solvency II requirements FCMC has developed draft Law on Insurance and Reinsurance that will replace the current Law on Insurance Companies and Supervision Thereof and Reinsurance Law. Advancing of the draft Law for approval depends on the adoption of the Directive Omnibus II that will amend Directive Solvency II. To assess the readiness of the industry for the capital requirements of Solvency II, in 2013, FCMC plans to make quantitative impact assessment of Solvency II.

With the approval of the Law on AIF Managers that is expected in 2013, the scope of entities subject to FCMC supervision will be extended also to AIF.

Law on AIF Managers intends to establish uniform legal framework for all financial market participants that provide AIF management services in line with the relevant EU directive. Until now, uniform EU requirements governing activities of entities were set only for UCITS and their management companies. UCITS may invest only in transferable securities (admitted to trading on the regulated market) and other liquid financial instruments under certain investment restrictions.

The new legal framework will apply to those investment management companies that are currently authorised and supervised by FCMC and that manage closedend investment funds and also to managers of venture capital funds that up to present have not been subject to supplementary financial supervision. With the introduction of the new legal framework AIF could be established not only by aggregation of property, but also as a legal person; as well, open-end AIF could be established to which requirements set for UCITS will not apply.

Depending on whether AIF managers are registered or licensed, the regulatory provisions will establish requirements governing their activities, responsibility and supervision and uniform requirements for disclosing information to investors. Any registered manager will be entitled to carry out activities only in Latvia. Where assets of an AIF exceed the thresholds established for registered managers or the manager wishes to carry out activities outside Latvia, AIF manager will need a licence.

To ensure readiness of the Latvian financial market to introduce the euro, several amendments to FCMC regulations are planned; they are related to the conversion of amounts in lats into euros and replacing lats as the currency with the euro.

- FCMC will continue to participate in the development of a single crisis management framework and work on the measures to ensure that Latvian legal framework governing the financial market complies with that framework.
- New Financial Action Task Force (FATF) recommendations and requirements of the EU Directive will be introduced in the area of preventing money laundering and terrorist financing, including developing of draft amendments to the Law on the Prevention of Laundering the Proceeds from Criminal Activities (Money Laundering) and of Terrorist Financing.

Since implementing supervision of financial market participants is also one of FCMC priorities, the main tasks in this area for 2013 will be as follows:

- On the basis of the performance of market participants and plans for 2013, carry out analysis of the risks and trends thereof of the financial sector and plan and implement the necessary supervisory measures.
- Improve supervisory methodology, in particular in view of the assessment of the internal control system, corporate governance and capital adequacy compliance.
- Continue active participation in the colleges of supervisors and represent the interests of the Latvian financial system.
- Make risk assessment of every market participant and implement the necessary supervisory measures in view of its outcome.
- Strengthen supervisory methods by advancing elimination of weaknesses and deficiencies in the area of disclosure of issuer-related information, develop guidelines for disclosing issuer-related information.



GOVERNANCE AND STRUCTURE OF FCMC

PERSONNEL POLICY

Personnel is the most import resource of FCMC that ensures achieving FCMC's goals and further development of the institution. In 2012, FCMC started the assessment of the distribution of workload and responsibilities in support structures and continued the job performance assessment project by paying more attention to assessing the goals to be achieved and linking it to remuneration, training and professional improvement opportunities.

CHANGES IN THE NUMBER OF EMPLOYEES AND OTHER PERSONNEL CHANGES

In the reporting year, the number of the persons employed by FCMC increased and was 124 (see Chart 8).

Of the five newly recruited employees, four were performing core functions (they were supervision experts and legal advisors) and one was involved in support functions as Head of Communications Division.

In 2012, FCMC organisational structure changed: three new structural units were established with three positions in each. To enhance FCMC communication with general public and promote development of financial awareness and knowledge, on 1 February 2012, the Office of FCMC was reorganised by delegating the communication function to the Communications Division. That structural unit is directly accountable to FCMC Chairman. To ensure immediate action, coordinate the necessary measures in case of unavailability of deposits, insolvency or bankruptcy of an insurer and payment of compensation to investors, on 1 March 2012, a Guarantee Funds Division was established within the Supervision Department. On 1 November 2012, the Methodology Division was established within the Supervision Department that would ensure development of documents governing off-site aspect of supervision and on-site inspections. That structural unit is directly accountable to the Director of Supervision Department.

Chart 8



Dynamics of the number of employees (2001-2012)

The average number of employees, including employees that had been absent for a long time, was 123 in 2012, of which:

- 95 (77%) were performing core activities and 28 (23%) were performing support functions;
- 87 (71%) were public officials and 36 (29%) were employees;
- all employees were performing intellectual work.

Chart 9

In the reporting year, 55 (44%) employees were assigned for 246 business trips and of these employees:

- 44 were involved, on a regular basis, in the work of EU bodies and working groups of European financial supervisory authorities (EBA, ESMA, EIOPA);
- Chairman of FCMC as a representative of the Republic of Latvia participated in the Spring and Annual Meetings of the IMF and World Bank, and also met the representatives of the Central Bank of Russian Federation.

In 2012, 90% (112) employees had worked in FCMC for more than one year, 46% (57) employees had been employed with the Commission for 11 years, i.e., as of its establishment, and 10% (12) had worked in FCMC for less than a year (see Chart 9).



The staff turnover rate in 2012 was 4%. In the reporting year, 15 new employees were recruited, of which three employees had a job contract with FCMC to replace an employee during an extended absence (a child care leave). After the trial period, in accordance with the established adaptation period plan all 12 employees received a positive assessment and continued their employment with FCMC. In the reporting year, FCMC terminated job relationship with five employees, of which three had decided to devote more time to their families and make professional careers later, one took a position in another public administration body, and on 26 October 2012, the Saeima did not approve Jānis Brazovskis as Deputy Chairman of FCMC for another term of office.

STAFF QUALIFICATIONS

FCMC values educated and professional employees. In the reporting year, 97% (120) FCMC employees had university education (of which 71% had a Master's Degree), and 3% (4) employees had general secondary school or professional secondary school education (see Chart 10).



DEMOGRAPHIC AND AGE PROFILE OF THE COMMISSION'S STAFF

In 2012, 74% of all FCMC's employees were women and 26% were men. Age profile of the staff is disclosed in Chart 11. The average age of FCMC employees was 40 years, as in 2011.



PERFORMANCE MANAGEMENT ASSESSMENT

44%

22%

Year 2012 was the third year when FCMC carried out Performance Management Assessment (PMA). In due course of FCMC's procedures, 116 employees participated in PMA in the reporting year, of which 23 were heads of structural units (incl. four Board members) and 83 were experts.

Four criteria were assessed: attaining the established goals, fulfilment of professional duties, compliance with the required qualifications (incl. the level of education, professional experience, expert knowledge and skills, language proficiency and computer skills) and the required job-related competencies.

After assessing all criteria, 74% employees were recognised as "compliant with the requirements", 25% were recognised as "partially exceeding the requirements", and 1% was recognised as "exceeding the requirements". No employee was recognised as "partially complying with the requirements" and "fail to comply with requirements" (see Chart 12).



For the overall assessment by criteria, see the assessment profile in Chart 13.

Chart 13 Overall assessment under PMA by criteria (%)



IMPROVING THE STAFF QUALIFICATIONS

In order to ensure ongoing improvement of FCMC's activity processes, increase efficiency and productivity of FCMC's performance as well as ensure the supervision of the financial sector, the banking sector in particular, in line with the FCMC's strategy, 84% (104) FCMC employees improved their qualifications in the reporting year by attending job-related training both in Latvia and other countries. In Latvia, they attended workshops to improve their knowledge in the area of legislation, financial analysis, risk management, electronic payments, procurement management, record keeping, information technology, job protection, presentation and management skills. To supplement knowledge in the area of banking risk management, stress testing methodology and practice, capital requirements for the insurance sector Solvency II, bank capital requirements or Basel III and other areas related to financial supervision, 56 (45%) FCMC's employees attended seminars abroad.

FCMC STRUCTURE



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

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

FINANCING OF FCMC'S ACTIVITIES

In the reporting year, FCMC activities were fully financed from the payments by the participants of the financial and capital market. Within the budget for ensuring its activities, in the reporting year, FCMC also managed the DGF and the FPI and also administered FSF (the task had been vested with FCMC as of the introduction of FSF in 2011). Assets accrued in DGF and FPI are used for the intended purposes only and the funds thereof are not used for the benefit of FCMC for carrying out the administration tasks. FCMC does not get payment from the state for administering FSF and FSF is credited to the State budget.

Table 7 shows the budget for FCMC activities and budget execution.

Table 7

Financing of FCMC's activities, 2011-2012

		IN 2012			
	ACTUAL RESULT IN 2011 ¹² , IN LATS	ACTUAL RESULT ¹² IN I LATS	BUDGET IN THE REPORTING YEAR ¹² , IN LATS	BUDGET RESULT IN THE REPORTING YEAR, %	SHARE OF ACTUAL RESULT ¹² , %
INCOME (+)	4 069 576	4 224 632	4 178 315	101.1	100
PAYMENTS BY PARTICIPANTS OF THE FINANCIAL AND CAPITAL MARKET	4 059 506	4 208 517	4 159 825	101.2	99.61
INCOME RELATED TO THE SUPERVISION OF MONETARY FINANCIAL INSTITUTIONS	2 859 945	2 767 040	2 939 910	94	65.5
Payments by credit institutions	2 841 947	2 744 589	2 919 000	94	65.0
Payments by credit unions	15 983	17 809	17 510	102	0.4
Payments by payment institutions	1823	3 323	2 900	115	0.08
Payments by electronic money institutions	192	1 319	500	264	0.03
INCOME RELATED TO THE SUPERVISION OF INSURANCE	930 940	1 102 646	932 250	118	26.1
Payments by life insurance companies	146 530	161 337	136 385	118	3.8
Payments by other insurance companies	784 410	941 309	795 865	118	22.3
INCOME RELATED TO THE SUPERVISION OF FINANCIAL INSTRUMENTS MARKET AND PRIVATE PENSION FUNDS	268 620	338 831	287 665	118	8.02

¹² In accordance with accrual principle, excluding accruals for annual holidays that are not included in the budget.
Payments by participants of the financial instruments market	213 510	253 935	215 665	118	6.02
Payments by private pension funds	55 110	84 896	72 000	118	2
OTHER INCOME FROM MARKET PARTICIPANTS	-	9 200	10 600	87	0.22
ADJUSTED INCOME OF PREVIOUS PERIOD	-	210	-	-	-
OVERDUE PAYMENTS	-	2	-	-	-
INCOME FROM TERM DEPOSITS	10 071	6 703	7 890	85	0.16
EXPENSES (-)	3 639 102	4 085 538	4 575 160	89.3	100
REMUNERATION	2 782 829	3 056 369	3 273 960	93.35	74.8
Salaries, other payments to employees, mandatory contributions to the State Social Insurance ¹³	2 782 829	3 039 762	3 255 660	93	74.4
Insurance of employees	-	16 607	18 300	91	0.4
IMPROVING PROFESSIONAL QUALIFICATION OF THE STAFF AND BUSINESS TRIPS	186 168	243 216	351 140	69	6
SERVICES AND COMMODITIES TO ENSURE ACTIVITIES	471 525	534 022	602 530	88.63	13.1
Telecommunication, liaison and information	115 722	126 419	129 560	98	3.1
Information to the general public, internal and external communication	26 766	10 906	33 430	33	0.3
Maintenance and maintenance-related expenses	273 195	310 261	346 000	90	7.6
Professional services	55 842	86 436	93 540	92	2.1
PARTICIPATION FEES IN INTERNATIONAL ORGANISATIONS	100 504	183 599	286 130	64	4.5
AMORTISATION/ DEPRECIATION OF CAPITAL INVESTMENT	53 974	68 332	61 400	111	1.7

Taking into account the planned increase in budget expenses in 2012 (11.6%) in comparison with the plans for 2011, the payments by the participants of the financial and capital market to finance FCMC activities were only slightly increased (by 1%). FCMC committed to covering the difference from the funds accrued in previous reporting years. By making notable savings in separate expenditure items, FCMC managed to finish the year with a surplus of income over expenses. The payments by the participants of the financial and capital market to FCMC's

¹³ Payments equivalent to salary include one-off benefits to employees for a significant personal event, in case of the death of a family member (LVL 200), or a benefit when retiring (in 2011) and a compensation for correcting the eyesight with medical means (i.e., to buy glasses) as prescribed by a special doctor for vocational illnesses to particular employees (LVL 100). These payments included also a supplementary payment for replacing employees who had been absent for a long time and , in 2011, for fulfilment of job duties under intensive working conditions during the suspension of the activity of JSC "Latvijas Krājbanka"; the amount was up to 20% of the daily salary rate for a particular number of days.

income budget depend on the payment rates established to them for financing FCMC activities and 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 FCMC's activities (see Table 8).

Table 8

Changes in the actual financing of FCMC, 2007-2012, %

	2012/2011	2011/2010	2010/2009	2009/2008	2008/2007
Payments by the participants of the financial and capital market	4%	2%	-22%	45%	4%
Income related to the supervision of monetary financial institutions	-3%	1%	-25%	58%	3%
Income related to the supervision of insurance	18%	-1%	-11%	21%	0%
Income related to the supervision of the financial instruments market and private pension funds	26%	29%	-17%	20%	36%

The dynamics of the funding for FCMC is also related with the share of the costs for supervising the respective sector and the sector's ability to ensure the necessary amount of financing. Over years, market sectors had provided financing to FCMC in proportion to the share of the costs needed to supervise the respective sector. In 2012, with the performance indicators of the financial instruments market increasing, the ability of this sector to cover the costs for its supervision increased as well, whereas due to the fact that assets of credit institutions failed to reach the planned volume, the financing by the sector decreased (see Charts 14 and 15).

Chart 14

Structure of FCMC financing, 2007-2012, share, %



Chart 15

The number of funding providers to FCMC and of the entities of the financial and capital market subject to supervision, excluding the entities that do not provide financing to FCMC, number, 2007-2012



In 2012, staff remuneration costs formed the largest part (75%) of FCMC's expenses; the volume of remunerations changed along with the changes in the number of employees and in view of salary changes in the financial sector that served as a benchmark for the remuneration of FCMC's employees; FCMC also observed the restrictions on remuneration and social guarantees in public administration bodies. As of 1 March 2011, monthly remuneration of FCMC's officials and employees had been determined in accordance with the Law on Remuneration of Officials and Employees of State and Self-government Authorities, taking into account the importance of the position (the level of responsibility and job complexity), assessment of individual qualifications and competencies of the respective official or employee, as well as the remuneration of the employees in the financial sector. Remuneration of FCMC Chairman did not exceed the average monthly salary disclosed by the Central Statistical Bureau in its Statement about employees of the financial and insurance sector in the year before the previous year, i.e., in 2009, and to that salary a ratio of 4.95 was applied. FCMC had demonstrated its solidarity with other public administration bodies and, as of 2008, had gradually reviewed the remuneration system. Table 9 shows the remuneration structure of FCMC employees in 2012.

Table 9

The remuneration structure of FCMC employees in 2012.

Type of remuneration	Amount in lats	Share,%
Salary	2 110 752	69.06
Supplement	5 306	0.17
Payment for absence related to disability	22 299	0.73
Holidays (annual, supplementary, holiday compensation)	244 440	8.00
Study leaves	40 492	1.33

¹⁴ In the cases stipulated by Labour Law and established by FCMC.

Paid day off ¹⁴ while retaining the salary	6 815	0.22
Benefits or rewards (for a birth of a child, death of a relative, notable personal event)	8 553	0.28
Compensation for optical means correcting eye sight	3 274	O.11
Holiday benefits	3 845	0.13
Payment for meetings of Consultative Council ¹⁵	3 150	0.10
Contract for performing a certain work	2 542	0.08
Mandatory contributions to the State Social Insurance	588 294	19.25
Health insurance of employees	16 607	0.54
Total	3 056 369	100

Table 10

Structure of remuneration and other payments to the employees by structural units in 2012:

STRUCTURAL SEGMENT	AVERAGE NUMBER OF EMPLOYEES	SHARE OF EMPLOYEES, %	AMOUNT, IN LATS	SHARE OF REMUNERATION, %
Board of the Commission	5	3.9	232 941	9.49
Advisor to Chairman ¹⁶	1	0.8	241 80	0.99
Personnel Division	2.7	2.3	43 982	1.79
Financial Division	4	3.1	73 058	2.98
IT Division ¹⁷	8.7	7.1	170 835	6.98
General Service Division	2	1.6	26 422	1.08
Internal Audit and Quality Management Division	2	1.6	43 449	1.77
EU and International Affairs Division	2	2.4	55 240	2.25
Communication Division ¹⁸	3	3.1	49 348	2.01

¹⁵ Eight meetings in 2012.

¹⁶ One position for less than a year during 01.02.2012-28.12.2012.

 $^{\rm 17}$ One position for less than a year as of 01.05.2012.

 $^{\mbox{\tiny 18}}$ One position for less than a year as of 01.05.2012.

Records and Archives Management Division	7	5.5	81 150	3.31
Supervision Department ¹⁹	50.95	43.4	1 017 714	41.51
Legal and Licensing Department	15.25	12.6	276 413	12.5
Regulations and Statistics Department	16	12.6	351 045	14.32
Total	119.6	100	2 445 777	100
Consultative Council (6) and contract for the performing of a certain work (1)	4 ²⁰	-	5 692	-

As of its establishment, FCMC had invested notable funds in information technologies in order to optimise supervisory processes and its own organisational management processes, including flow of electronic documents, and ensure more efficient processing of the financial information submitted by the entities of the financial and capital market for supervisory purposes. 80 FCMC employees had a certificate of a safe electronic signature that was used daily to sign documents and the related costs were LVL 334, whereas by electronically signing 7 222 documents with an electronic signature with a time seal the expenses incurred on FCMC amounted to LVL 817. At the end of 2012, IT book value comprised 75% of all long-term investments (see Table 11).

Table 11

Dynamics of FCMC's long-term investment, 2007-2012 (end of the year)

2012	2011	2010	2009	2008	2007
211 528	212 436	196 970	193 126	182 898	88 948
3 949	3 859	3 710	3 564	3 363	2 966
95 091	90 529	75 925	65 044	53 443	47 853
2386	2 344	2 246	2 166	2002	1 759
62 473	68 100	68 521	72 321	66 542	23 021
384	360	382	367	374	307
	211 528 3 949 95 091 2386 62 473	211 528212 4363 9493 85995 09190 52923862 34462 47368 100	211 528212 436196 9703 9493 8593 71095 09190 52975 92523862 3442 24662 47368 10068 521	211 528212 436196 970193 1263 9493 8593 7103 56495 09190 52975 92565 04423862 3442 2462 16662 47368 10068 52172 321	211 528212 436196 970193 126182 8983 9493 8593 7103 5643 36395 09190 52975 92565 04453 44323862 3442 2462 166200262 47368 10068 52172 32166 542

Investments in IT included regular changing of the stock of computers to ensure their optimum performance for processing supervisory IS, advanced use of equipment, developing and improving of IS as well as using licensed software. In order to ensure the flow of statistical, supervisory and record-keeping documents,

¹⁹ Five positions for less than a year: three as of 01.03.2012 and two as of 01.11.2012.

²⁰ Four members of the Consultative Council attended meetings of the Consultative Council on a regular basis.

several IS had been developed and adjusted for FCMC'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 12).

Table 12

Dynamics of changes of FCMC's capital investment, 2008–2012

					Changes in	
	2012 ²¹	2011 ²¹	2010 ²¹	2009 ²¹	2008 ²¹	2007 ²¹
Total capital investment, in lats	47 559	3 199	56 291	38 236	99 222	32 156
Total units	90	133	146	196	388	307
of which software and IS, in lats	34 684	32 435	33 105	35 074	32 394	30 798
number of units	42	77	87	156	229	265
of which improvements of existing units	3	22	7	11	7	9
of which IT equipment, in lats	9 776	-37 886	19 660	10 547	51 712	3 094
number of units	19	-22	21	-7	67	7
of which improvements of existing units	4	1	6	1	2	1

The financial statements for 2012 of FCMC as well as of DGF and FPI managed by FCMC along with the opinion of independent auditors are available on FCMC's website at <u>www.fktk.lv.</u>

INTERNAL AUDIT AND QUALITY MANAGEMENT

AUDIT RECOMMENDATIONS ENSURE ELIMINATION OF DETECTED WEAKNESSES: BY THE END OF THE REPORTING YEAR, OVER 80% OF APPROVED RECOMMENDATIONS WERE IMPLEMENTED In 2012, the Internal Audit and Quality Management Division performed objective inspections of FCMC's functions and processes and provided the FCMC management with an opinion about:

- efficiency of the established internal control system and its suitability for achieving the set objectives;
- compliance of the activities of structural units with regulatory provisions, established functions and approved work plans;
- improving overall governance process by providing information on risks and control in the relevant areas.

Internal audits were planned and carried out on the basis of risk assessment and attention was in particular paid to FCMC's core activity processes. Outcomes of each internal audit were reported to the FCMC Board.

In the reporting year, seven internal audits were carried out covering the following areas subject to audit: supervision of insurance companies, summary and analysis of the weaknesses identified during the crisis management process of JSC "Latvijas Krājbanka" and "Swedbank" JSC, process for preventing money laundering and terrorist financing that is FCMC's competence, establishing and using the access rights defined by FCMC in respect of documents in the electronic document management system, observing the stock-taking procedure and assessment of two complaints.

As a result of the internal audits performed during the reporting year, it was found that in the audited areas the internal control system had been established and was functioning efficiently in all material aspects, yet separate improvements were still needed; overall, the assessed control procedures were adequate, sufficient and efficient and provided sufficient evidence that the FCMC risks were managed and the institution had reached its objectives.

Auditors provided 149 recommendations to improve the functioning of the internal control system and mitigate the likely risks and adverse effects thereof; of those recommendations, 57 or 38% were assigned high priority, 75 or 50% were of a medium priority and 17 or 11% were assigned a low priority. Provided audit recommendations ensure elimination of detected weaknesses and improving the existing internal control system to contribute to an orderly and efficient performance of FCMC. By the end of the reporting year, FCMC management had implemented 81.4% of the approved recommendations to be implemented during the reporting year and is continuing its work to implement other recommendations.

To improve the functioning of its internal control system, in the reporting year, by implementing the recommendations of audit reports, FCMC developed Communication Strategy for 2012-2015, took several measures to improve its reputation and raise the level of public awareness of financial issues, improved the regulatory framework of the financial sector, strengthened banking supervision, improved the functioning of the deposit guarantee scheme, started its work to improve the supervisory processes in the area of anti-money laundering and

terrorist financing and also revised the established access rights to the documents in the electronic document management system and improved the process for assigning and cancelling such rights.

To ensure compliance of FCMC's services with the interests of the State, people and customers as well as with regulatory requirements, the improvement possibilities and available resources were used to establish quality management system pursuant to the requirements of ISO 9001:2008 standard (activity scope "Financial and capital market, regulatory provisions and supervisions of its activities"); the system is constantly improved in view of the best practice and experience of the supervisory authorities of the financial sector. On the basis of the FCMC management decision, the quality management system had been maintained without certification as of 8 May 2012. According to the outcomes of internal audits, FCMC is constantly improving the quality management system and its efficiency.



PERFORMANCE OF THE PARTICIPANTS OF THE FINANCIAL AND CAPITAL MARKET IN 2012

ECONOMIC DEVELOPMENTS IN 2012²²

FOR THE SECOND CONSECUTIVE YEAR, LATVIA WAS ONE OF THE MOST RAPIDLY GROWING ECONOMIES IN THE EU For the second consecutive year Latvia was one of the most rapidly growing economies in the EU: in 2012, GDP increase was 5.6%.

Despite economic recession in the EU, which was the main external trading partner of Latvia, export volume continued to increase also in 2012 (an increase by 15%). The rapid growth of export was due to the improved competitiveness of Latvian producers and diversification of the export market (in 2012, export grew more rapidly to non-EU countries).

Increase in export supported larger investment. Even if the growth rate was slower than the year before, the growth of total core capital formation was still at a double digit (12.3%).

In contrast to 2011, economic growth was underpinned not only by larger export volumes but also stronger private consumption growth: during the year, the volume of purchases increased by 5.4%.

Despite the rapid economic growth, the pressure on inflation was still weak, and with the weakening of external factors the average annual inflation decreased to 2.3% in 2012. Even if employment rate continued to grow rapidly, salary growth rate decreased to 3.7%, but, in contrast to 2011, real net salary increased by 1.6% in 2012 due to lower inflation.

Since economic growth exceeded the forecasts, government budget deficit was also less than forecasts (1.2% of GDP in 2012), and overall government debt decreased by 1.2 percentage points and was 40.7% of GDP at the end of the year. Even if, following sovereign debt crisis and repeated recession in several EU MS, the credit rating of those countries was downgraded in 2012, Latvia's credit rating was upgraded and positive outlook determined due to robust fiscal discipline and stabilisation of the economy.

PERFORMANCE OF CREDIT INSTITUTIONS

DUE TO THE FAVOURABLE DEVELOPMENT OF DOMESTIC MACROFINANCIAL ENVIRONMENT, STABILITY OF THE FINANCIAL SECTOR IMPROVED IN THE REPORTING YEAR At the end of 2012, 20 banks and nine branches of banks of EU member states operated in Latvia. During the year, two branches of banks of member states started their operations in Latvia: Pohjola Bank plc (Finland) in April and at the end of the year DNB Bank (Norway) opened a branch to provide support services to DNB group enterprises.

For the Latvian financial sector, year 2012 was important because the licences for the operations of a credit institution were cancelled for JSC "Parex banka" (on 15 March) and JSC "Latvijas Krājbanka" (on 10 May) (hereinafter, problem banks). This marked the end of reorganisation of JSC "Parex banka" as the bank was reregistered and became a commercial company not engaging in the activities of a credit institution. On 20 September, Allied Irish Bank (Ireland) discontinued the operations of its Latvian branch and thereby it implemented its decision to quit the Latvian market.

With JSC "Parex banka" exiting the Latvian banking sector, state holding in total paid-up share capital of banks decreased during the year by 9.6 percentage points and was 17.2% at the end of the year. Market share of both banks with state capital (JSC "Citadele banka" and State JSC "Latvijas Hipotēku un zemes banka" (Latvian Mortgage and Land Bank) in total assets was 9% at the end of 2012. At the same time, market share of four subsidiaries of banks of MS and of nine branches of banks in assets was 57.1% and it was even larger in the credit portfolio of banks (73.7%), of which 79.9% in lending to residents.

Due to the favourable development of domestic macrofinancial environment, stability of the financial sector improved in the reporting year and profit indicators of banks improved as well. In 2012, banking sector was operating with a profit and it was LVL 122.3 million, i.e. by 25.4% more than in 2011²³ (see Chart 16); 19 Latvian banks and branches of foreign banks (representing 94.1% of total assets of the banking sector) operated with a profit.

In 2012, bank profitability was positively affected by the further stabilisation of credit portfolio and consequently smaller loan loss provisions as well as larger income from commission fees and trading in financial instruments.

²³ For the purposes of data comparison, problem banks are not included in data for 2011.



Chart 16 Income and expenses structure of banks (in million lats)

In 2012, operating (financial activity) profit of the banking sector was LVL 631.5 million, i.e. by 10.6% larger than in 2011. Bank's income and expenses structure is influenced by its business model. As to 1st group of banks²⁴, net interest income and net commission fee income accounted for the largest share in their net operating profit (64% and 24%, respectively). Operating profit structure of the 2nd group of banks²⁵ was dominated by interest income (36%) and commission fee income (36%) along with income from trading in financial instruments (20%), mainly as a result of currency conversion.

²⁴ Banks that predominantly engage in crediting (credits account for around 72% of assets), i.e., subsidiaries of banks of EEA countries, branches of banks of those countries and Latvian state-owned banks (hereinafter, 1st group of banks).

²⁵ Banks that do business mainly with non-residents engage less in crediting (credits account for around 30% of assets) and hold their funds in correspondent accounts with other credit institutions or the Bank of Latvia to ensure execution of settlement transactions for customers, and they engage more actively in making investments in securities (around 20% of assets) (hereinafter, 2nd group of banks).

In the income structure of the banking sector, income as a result of a reduction in provisions by individual banks accounted for around 23%; however, the volume of that income continued to decrease (by 24 % year-on-year) and in future that income will no longer be an important part of income.

With the quality of credit portfolio stabilising, expenses for provisions for loan loss provisions were diminishing (by 13% in comparison with 2011); however; they still form a significant part of bank expenses (39%). Administrative expenses, the second most important item of bank expenses, accounted for 29% of total expenses at the end of 2012. As banks optimised their expenses already during the crisis, in 2012, they had found a possibility to continue restricting their expenses (e.g., by optimising the network of branches) and during the year, overall administrative expenses diminished by 4.8%.

In 2012, capitalisation of the banking sector remained high: several banks used the opportunity to strengthen their capital base by both including into it the audited profit of the current year of operation (interim profit) and increasing their share capital (overall, 10 banks increased their share capital by LVL 86.3 million).

Even if several banks, while optimising the costs of attracted resources, partially repaid subordinated investments and Tier II capital was reduced by 25% (predominantly in the second quarter) thereby contributing to the decrease in both own funds of banks and capital adequacy ratio, capital adequacy ratio of banks was still high at 17.6% at the end of December (minimum capital requirement was 8%), whereas Tier I capital ratio²⁶ stood at 15.3% (at the end of 2011, they were 17.4% and 14.2%, respectively) (see Chart 17). Tier I capital dominated the structure of banks' own funds and at the end of the year, it was 86.6% of banks' own funds.

Chart 17

Dynamics of own funds and capital requirements (at the end of the period, in million lats)



²⁶ Tier I capital includes only top quality capital elements: paid-up share capital, share premium, reserves, also retained profit or losses of previous years.

At the end of 2012, capital adequacy ratio of all banks complied with the regulatory requirements; moreover, for all banks, except two, it exceeded 12% (see Chart 18). In total assets of the banking sector (excluding branches of banks of MS), approximately 96% were assets of those banks whose capital adequacy ratio exceeded 12%. Overall, capital adequacy ratio was broad and for individual banks it ranged from 8.4% up to 75.1%.



With the shrinking of the credit portfolio and increase in deposits the need for additional funding also decreased, and in 2012, banks attracted less funding from monetary financial institutions (MFI) (it had shrunk by LVL 980 million or 19.1%) and the main reason was that the funding attracted by subsidiaries and branches from parents banks diminished (by LVL 827 million) (see Chart 19).



Chart 19

²⁷ Source: public quarterly reports of banks.

²⁸ Source: The Bank of Latvia at www.bank.lv.

Funding structure of the 1st group of banks was still dominated by resident deposits and funding from related MFI, whereas 2nd group of banks whose business is mainly focused on payment services to non-residents, financed their activities mainly by non-resident deposits; they attracted more than 80% of all non-resident deposits. With resident deposits on the increase, at the end of 2012, the funding structure of the 1st group of banks was dominated by resident deposits (more than 53% in comparison with 45% at end-2011), whereas liabilities to related MFI continuing to decrease their share decreased to 34% (42% year-on-year). At the same time, the funding structure of the 2nd group of banks was increasingly dominated by non-resident deposits and their share during the year grew to 85% (75% at end-2011).

At the end of 2012, the volume of deposits reached LVL 12.5 billion (see Chart 20) and during the year, they had grown by 12.7% or LVL 1.4 billion, of which resident deposits increased by LVL 530 million (mainly deposits by the government, non-financial institutions and households), whereas non-resident deposits increased by LVL 876 million (excluding indicators of problem banks, total deposits during the year grew by LVL 1.6 billion or 15.8%).



Chart 20

Dynamics of bank deposits (in million lats)²⁸

Deposits by resident households

With deposit rates staying at a low level, in 2012, the share of demand deposits continued to grow in total deposits and this trend was evident for both resident and non-resident deposits. At the end of 2012, the share of demand deposits reached 72.7% (64% at end-2011), whereas the share of all term deposits decreased. A slight increase in volume was recorded for deposits with a maturity of 1 to 6 months (see Chart 21).





Liquidity ratio of the banking sector remained restrained: banks maintained high levels of liquid assets and also liquidity ratio²⁹ was high, i.e., 59.7% at end-December, thus nearly twofold exceeding the minimum requirement³⁰ (63.9% at the end of 2011) (see Chart 22). Profile of the liquidity ratio remained broad and, depending on each bank's business model, ranged between 39.8% and 84.3%, but for six banks it even exceeded 110%.



Chart 22

Liquid assets, current liabilities and liquidity ratio

²⁹ Liquid assets (cash in hand; claims on the Bank of Latvia and solvent credit institutions, whose maturity does not exceed 30 days and deposits with a different maturity provided that, according to the agreement, there is an option to withdraw them ahead of maturity; investments in financial instruments provided that they have a permanent and non-restricted market) shall not be below 30% of total current liabilities whose residual maturity does not exceed 30 days.

³⁰ Minimum liquidity requirements was 30%.

In 2012, there was a slight increase in the volume of liquid assets of banks in the 1st group (by 2%); some banks used the funds accumulated in correspondent accounts with other credit institutions to partially repay subordinated investments and, with lending on the increase, banks channelled more funds for new loans. With deposits growing, for banks of the 2nd group the volume of liquid assets grew more rapidly (by 21%). To ensure settlement operations to customers, banks of the 2nd group held large amounts in correspondent accounts with other credit institutions and placed larger portion of their free funds in the securities portfolio therefore maintaining a notably higher level of liquidity (see Chart 23).



Steady increase in deposits and slow growth of lending facilitated an increase in bank investments in securities. During 2012, securities portfolio of the banking sector increased by more than 20% or nearly LVL 370 million reaching LVL 2 billion at end-December (see Chart 24). About 30% of all deposits were made in Latvian securities (including 83% in Latvian government securities) and, above that, more than a third was invested in the securities of other EU MS, predominantly Germany, the Netherlands, Sweden and UK (see Chart 25). At the same time, total deposits in the securities of the countries hit by the crisis (Spain, Italy, Portugal, Cyprus, Greece and Ireland) accounted for only 0.9% of the securities portfolio. One half of the total securities portfolio of the banking sector was invested in central government securities.



Chart 24

Chart 25

Profile of issuers of EU MS (excluding Latvia, as at 31.12.2012)²⁸



The dynamics of the credit portfolio in 2012 could be characterised as an attempt to break the downward trend evident for four years: in the 2nd and 3rd quarter, even a slight increase in credit portfolio was recorded, though this trend appeared unsustainable³¹.

In 2012, banks issued new loans for nearly LVL 2 billion (of which LVL 655 million was granted for the development of Latvian enterprises, LVL 286 million were granted to Latvian financial institutions, LVL 184 million were granted to resident households and LVL 819 million were granted to non-residents); this was by 28% more than in 2011. In the reporting year, loans were mainly issued to those sectors that were oriented towards domestic consumption: energy (LVL 151 million), trade (LVL 105 million), real estate operations (LVL 70 million) followed by export-oriented sectors: agriculture (LVL 63 million) and manufacturing (LVL 58 million).

³¹ For the purposes of data comparison, problem banks are not included.

Since the volume of repaid and written off loans still exceeded the flow of new loans, total credit portfolio of the banking sector decreased also in 2012; however, the reviving lending activities contributed to decelerating the decrease rate and during the year, total credit portfolio decreased by 2.8%³¹. The decrease in the credit portfolio was mainly affected by the downward trend in real estate related sectors in which a particularly rapid increase was evident before the crisis, and also the diminishing credit portfolio of households. The largest increase was evident in energy, loans to non-residents and agriculture (see Chart 26).

Chart 26

Changes in the credit portfolio in 2012 by sector and category of borrowers (in million lats) $^{\scriptscriptstyle 31}$



In 2012, loans to resident households decreased by 8%, whereas loans to corporate customers was nearly at the level evident at end-2011 (they decreased by only 0.9%). Credit portfolio of non-residents increased by 7.4% in 2012.

Even if in 2012, the quality of the credit portfolio continued to improve, there was still considerable credit risk, especially in the household segment. Improvements in the quality of the credit portfolio were mainly driven by removing bad loans from bank balance sheets, increased lending activity and improved solvency of enterprises. During the year, the share of loans that were 90 days overdue continued to diminish in the credit portfolio of the banking sector: at end-2012, it reached11.1% (13.3% at end-2011 and 15.3% at end-2010). At the end of 2012, for the 1st group of banks, the share of those loans was 10.8% and it was 12.8% for the 2nd group of banks.

During the year, the quality of household loans did not change significantly and, in view of the high unemployment rate and relatively low income level, high credit risk persisted in the household segment. Even if the share of loans that were 90 days overdue decreased in the credit portfolio of households from 16.2% at end-2011 to 15.2% at end-2012 (see Chart 27), this improvement was largely triggered by writing off lost loans and for one part of household loan repayment discipline deteriorated in 2012. At the same time, the share of total overdue loans in the credit portfolio of households decreased during the year from 26.3% to 24.5%, that was a positive sign, especially in view of the notable growth of the

burden posed by an increase in payments for amenities. The quality of household mortgage loans was better than the quality of other loans to households: during the year, the share of loans that were more than 90 days overdue decreased from 13.8% to 13.2%, whereas the share of total overdue loans decreased from 24.1% to 22.7%.

Chart 27





Due to the economic growth and improved profitability of undertakings, the quality of loans issued to corporate customers continued to improve. In the credit portfolio of corporate customers, the share of loans that were more than 90 days overdue diminished from 12.7% at end-2011 to 9.2% at end-2012 and the trend was mainly triggered by the decreasing volume of loans in real estate related sectors that accounted for one half of the decrease in the volume of loans that were more than 90 days overdue in the corporate sector. As well, the share of total overdue loans in the corporate sector decreased from 18.1% to 13.2%.

During the year, improvements were evident in both export-related industries (manufacturing, transport and agriculture), and those sectors that were focused on domestic consumption (trade and real estate operations) (see Chart 28). In the sectors related to real estate, the share of loans that were more than 90 days overdue was still higher than in other sectors and work with bad loans of those sectors will be a challenge for banks also in 2013.

Chart 28

Share of loans that are more than 90 days overdue (% of the credit portfolio of the respective industry) $^{\rm 31}$



As to loans to non-residents, the share of loans that were more than 90 days overdue increased from 6.1% to 6.5% during the year, but the quality of those loans was still better than the quality of loans issued to residents.

Even if the share of restructured loans and loans under recovery continued to diminish, it was still high. During the year, the volume of restructured loans (it is an important source of risk for banks) decreased by 21.6% and their share in total credit portfolio of the banking sector decreased from 15.5% to 12.5%. At the same time, the volume of loans under recovery also decreased (by 20.2%) and their share decreased as well (from 12.3% to 10.1%). Since restructured loans and loans under recovery are mainly concentrated in real estate related segments, the stabilisation trend in the real estate market gave grounds to state that the credit risk deriving from those loans did not increase during the year.

In 2012, new loans amounting to LVL 655 million were included in the category of restructured loans that was by half less than in the previous year; this showed that the number of borrowers who experienced difficulties in meeting their debt liabilities decreased during the year. New loans amounting to LVL 383 million were included in the category of loans under recovery ; it was by 12.3% less than in 2011 and also evidenced that the situation was improving.

Since the loan quality was improving gradually and banks were writing off lost loans, the balance of loan loss provisions made by banks decreased by 20.6% in 2012 and reached 8% of total credit portfolio of banks at the end of the year (it was 9.8% at the end of 2011). The proportion of the provisions made to loans that were more than 90 days overdue was still high and reached 71.7% at the end of the year (73.4% at the end of 2011).

Banks were more active in cleaning their balance sheets. In 2012, the banking sector wrote off loans amounting to LVL 338 million (of which LVL 136 million were loans to resident households, LVL 193 million were loans to resident corporate customers and LVL 9 million were loans to non-residents) that by 11% exceeded the indicator in 2011.

BUSINESS WITH NON-RESIDENTS IN THE LATVIAN BANKING SECTOR

There are two segments in the Latvian banking sector: banks whose business is oriented towards the domestic market and banks that do business with nonresidents and service cash flows of non-residents. Services to non-residents has been a notable part of the business of the Latvian financial system for 20 years. As a result of the global financial crisis, deposits by both residents and non-residents were on the decrease, but as of mid-2009, a gradual recovery has been evident. In 2012, non-resident deposits accounted for about one half of total deposits of the banking sector (LVL 6.1 billion or around 48.8% at the end of December), similar to the trend that started back in 2001.

Development of the business with non-residents in Latvia has been promoted by several factors: geographic location, EU membership with a safe and more regulated environment and, from the perspective of a foreign national, the possibility to communicate in Russian when receiving the service. As well, a significant factor is the fact that Latvian banks offer quality services for an acceptable price. In comparison with rival banks in other EU MS, Latvian banks offer up-to-date services because both internet banking and telephone banking are available to customers 24/7 that is not always the case in other countries.

DYNAMICS OF DEPOSITS

It should be noted that non-resident deposits are not significantly more volatile than resident deposits. From the outset of the crisis, non-resident deposits decreased by 20% a year (excluding JSC "Parex banka"), whereas resident deposits decreased by 16% (excluding deposits by the government and the financial sector). The flow of non-resident deposits to Latvia resumed in mid-2009 when cash flows started to recover.

PLACING OF NON-RESIDENT FUNDS

Banks that do business with non-residents place funds in highly liquid assets. Even if slightly more than 80% of total non-resident deposits were demand deposits, banks kept very high proportion of their total assets (50% on average) in liquid assets (assets with residual maturity of up to 30 days and liquid securities). Moreover, banks that do business with non-residents engage less in lending: the proportion of the credit portfolio to assets is about twofold smaller than it is usually for universal credit institutions (full service credit institutions).

AS OF MID-1990, SERVING NON-RESIDENTS HAS BEEN A NOTABLE PART OF THE BUSINESS OF THE LATVIAN FINANCIAL SECTOR

MAIN BENEFITS FROM SERVING NON-RESIDENTS

Exporting financial services with a high value added gives a number of benefits, e.g., improved balance of payments, tax revenues and quality jobs with a high value added. In accordance with the study of KPMG in 2011, the influence of the financial sector services provided to non-residents on the Latvian economy accounts for about 1.7% of GDP.

RISKS RELATED TO BUSINESS WITH NON-RESIDENTS

From supervisory perspective, it is important for FCMC that banks that do business with non-residents are aware of the likely risks and take measures to mitigate those risks. Business with non-resident customers is mainly associated with country risk, legal risk and reputation risk. As well, the likelihood of cessation of non-resident deposits as a funding source should be taken into account. It should be noted, that as a result of taking non-resident deposits, there is a relatively greater risk that a bank may be involved in money laundering or terrorist financing activities. Therefore, banks have to pay more attention to those customers (e.g., obtain more information about the customer and his/her transactions). Latvia has introduced legal acts that comply with international standards and target restricting all kinds of risks, including risks related to non-residents.

PERFORMANCE OF COOPERATIVE CREDIT UNIONS

At the end of 2012, 33 cooperative credit unions were operating in Latvia and during the year, their total earnings amounted to LVL 160 thousand that was by 23% more than the year before when their profit was LVL 130 thousand. Increase in their profit was promoted by both the growing credit portfolio and, consequently, higher interest income from loans (by 5%), and increased income from commission fees (by 10%), whereas due to low interest rates interest expense for attracted funds decreased (by 8%).

Capital adequacy ratio of cooperative credit unions remained high and was 20.1% at the end of December (20.1% at the end of 2011) (the minimum capital adequacy requirement was 10%).

The largest source of funding was deposits by members; they increased by 12% during the year and reached LVL 9.9 million at the end of December. The main activity of credit unions is issuing loans to members: during the year, their volume increased by 11.7% and stood at LVL 10.2 million at the end of December (see Chart 29).

Chart 29



Even if unemployment rate in Latvia had decreased slightly in comparison with the previous years (except in Latgale region), it was still high and affected the quality of the credit portfolio of credit unions. The part of the credit portfolio that was assessed as problem loans increased by 22% and even if the volume of nonperforming loans (i.e., substandard, doubtful and lost loans) decreased during the year (by 7.7%), the volume of lost loans increased (by 48%). At the end of 2012, 64% of the credit portfolio of credit unions were assessed as standard loans, 29.3% were problem loans and 6.7% were non-performing loans (at end-2011, the figures were 65%, 26.8% and 8.1%, respectively). Provisions for doubtful loans continued to increase during the year (by 27%) and were 7.9% of total credit portfolio of credit unions at the end of December (7% at the end of 2011).

PERFORMANCE OF INSURERS

DUE TO PERSISTING ECONOMIC GROWTH THE INSURANCE MARKET CONTINUED TO GROW AT A MODERATE PACE At the end of 2012, nine insurance companies were operating in Latvia (two were life insurance companies and seven were non-life insurance companies) along with 13 branches of insurance companies of EU MS (five were braches of life insurance companies and eight were branches of non-life insurance companies).

Three non-life insurance companies (IJSC "Gjensidige Baltic", IJSC "Balta", IJSC "ERGO Latvija") are subsidiaries of insurance companies of EU MS and their market share in total gross premiums written by insurance companies was 36.1% at the end of 2012 (39.7% at the end of 2011).

Due to persisting economic growth the insurance market continued to grow at a moderate pace. Amount of gross premiums written by insurance companies increased in respect of all major types of insurance, including an increase in voluntary insurance types.

During the reporting year, gross premiums written by insurers (insurance companies and branches of foreign insurance companies) increased by 13% year-on-year and reached LVL 314 million (of which gross premiums written by branches of foreign insurance companies increased by 27.7% and reached LVL 65 million lats or 21% of total premiums written) (see Chart 30), whereas the amount of paid gross indemnities increased by 8.6% and was LVL 169 million.

Chart 30



Of total written gross premiums, the major part or 68% were gross premiums written in Latvia (see Chart 31), and other gross written premiums were written by insurers when providing services in other EU MS (France, Estonia, Lithuania, UK, Poland, Spain and Germany); of the latter, the major share of premiums were for liability for transport ownership insurance and land vehicle insurance (56% and 12%, respectively).



Chart 31 Profile of premiums written in Latvia and other EU MS

The most rapid increase in written gross premiums were in the health insurance market in which the demand of the public sector had resumed. During the reporting year, written gross premiums in health insurance increased by LVL 7.1 million year-on-year (see Chart 32). At the same time, written gross premiums also increased for land vehicle insurance (by LVL 6.1 million) and liability for transport ownership insurance (by LVL 4.2 million). The largest decrease in written gross premiums was for miscellaneous financial losses insurance (minus LVL 0.7 million).

Chart 32



In 2012, written gross premiums by life insurer (life insurance companies and branches of life insurance companies of member states) increased by 7.7% yearon-year (see Chart 33) and reached LVL 55 million (of which LVL 24.5 million for life insurance companies). At the same time, the amount of paid gross indemnities increased by 13% and reached LVL 32.3 million.

Chart 33

Gross premiums written by life insurance companies by insurance type (in million lats)





In 2012, the portfolio structure of gross premiums written by life insurers did not change significantly (see Chart 34). The share of gross premiums of life insurance products in the portfolio of written premiums reached 77.7%. Of gross premiums written under life insurance, the major part was insurance products with an accrual (63%) and premiums written in respect of market-related contracts (34%).

In 2012, the amount of written gross premiums by non-life insurer (non-life insurance companies and branches of foreign non-life insurance companies) increased by 14.2% year-on-year and totalled LVL 259 million (of which LVL 224 million were premiums written by non-life insurance companies), whereas the amount of paid gross indemnities increased by 7.7% and was LVL 136.4 million (see Chart 35).



Chart 35

Year-on-year, written gross premiums increased in all major types of insurance and the structure of insurance types did not change significantly, including 21.6% were liability for transport ownership insurance, 21% was land vehicle insurance, 13% were compulsory liability insurance, 12% were fire and natural elements insurance and 10% were health insurance (in 2011, the figures were 23%, 21%, 13%, 12% and 9%, respectively).

In 2012, total investments by insurance companies increased by 9.2% and were LVL 315 million at the end of the year. Insurance companies followed a conservative investment policy and major investments were made in debt securities and other fixed-income securities (LVL 152 million) and in term deposits with credit institutions, (LVL 74 million), representing 48% and 23%, respectively, of investments by insurance companies (see Chart 36).



Year-on-year, the amount of investments by insurance companies in Latvia increased by 14% and was LVL 150 million at the end of 2012, representing 48% of total investment (see Chart 37). Investments in other EU MS accounted for 50% of total investment or LVL 157 million (of which LVL 50 million in Lithuania, LVL 15 million in Germany, LVL 22 million in Luxembourg and LVL 11 million in France).

Chart 37

Investment structure of insurance companies by country



As from the beginning of the year, return on investments (RoI) of insurance companies were on the increase and ensured a stable profitability to insurance companies in 2012. For life insurance companies average annual RoI was 7.7% (in 2011. it was negative, -7.9%) and for non-life insurance companies it was 3.9% (2.7% in 2011).

In 2012, total earning of insurance companies was LVL 10.2 million, of which life insurance companies earned nearly LVL 2.9 million and non-life insurance companies earned LVL 7.4 million (six out of nine companies were operating with a profit).

In the reporting year, profitable activities were liability for transport ownership insurance (LVL 4.5 million) and general liability insurance (LVL 3.5 million), but losses were incurred as a result of fire and natural elements insurance (minus LVL 3.5 million), compulsory liability insurance (minus LVL 1.9 million), land vehicle insurance (minus LVL 0.9 million) and also health insurance (minus LVL 0.6 million).

Solvency margin of insurance companies³² remained high and at the end of the year it was 141% for life insurance companies and 186% for non-life insurance companies (100% and 193%, respectively, at the end of 2011) (see Chart 38).



Chart 38

Solvency margin of insurance companies (%)

³² Shows whether the funds at disposal of an insurance company are sufficient to ensure its minimum solvency; the minimum level of this indicator is 100%.

PERFORMANCE OF THE SECOND AND THE THIRD TIER PENSION SYSTEMS

MANAGEMENT OF ASSETS OF THE STATE-FUNDED PENSION SCHEME (SEC-OND TIER PENSIONS)

At the end of 2012, assets of the State-funded pension scheme (SFPS) (second tier pension system) were managed by eight investment management companies by offering 26 investment plans.

During the year, the increase in the number of SFPS participants was stable (1% per quarter on average) and by the end of 2012, 1 194 100³³ participants had joined SFPS, of which 58.6% had joined on a mandatory basis³⁴.

At the end of 2012, pension capital accrued in SFPS investment plans for the first time exceeded LVL 1 billion (i.e. it had grown by 17.2% year-on-year).

In the reporting year, the asset volume of investment plans of SFPS assets increased by 17% and reached LVL 1.03 billion at the end of 2012. Of total investment plan assets, 62% were active investment plans, 28% were conservative investment plans and 10% were balanced investment plans (see Chart 39).



In the investment structure of active investment plans, nearly one half was investment fund investment certificates (46%), whereas 62% of funds of conservative plans and 49% of funds of balanced plans were investments in debt securities and other fixed-income securities (see Chart 40).

³³ Information collected by the State Social Insurance Agency about participants of the State-funded pension scheme and distribution by the type of investment plan (conservative plans with low investment risk, whereas active and balanced plans are associated with a high investment risk because they depend more on market fluctuations).

³⁴ All persons who were born after 1 July 1971 and are registered for State pension insurance are registered as scheme participants by the State Social Insurance Agency on a mandatory basis.

BY THE END OF 2012, 207 523 PERSONS PARTICIPATED IN PRIVATE PENSION PLANS

Chart 40





Investments by investment plans of SFPS assets in Latvia increased by 5.5% during the year and at the end of 2012, they amounted to LVL 485.6 million or 47.2% of total investments (of which 54% of all investments in Latvia were funds of active plans, 37% were funds of conservative plans and 9% were funds of balanced plans). Of total investments abroad, LVL 505.7 million or 93.2% were investments in other EU MS, of which major investments were in Luxembourg (LVL 179.2 million), Ireland (LVL 76.6 million) and France (LVL 51 million).

During the year, the average profitability of investment plans of SFPS assets continued to improve and reached 9% (in 2011, profitability was negative, -2%); the increase was underpinned by the high profitability of the Latvian Treasury bond market and also favourable developments in global bond and share markets. All investment plans operated with a positive profitability (profitability of individual plans ranged between 0.7% and 11.5%).

Expenses for managing investment plans in 2012 were 1.5% of the average net assets of investment plans: 1.2% for conservative plans, 1.5% for balanced plans and 1.7% for active plans.

PRIVATE PENSION FUNDS (THIRD TIER PENSIONS)

At the end of 2012, seven private pension funds were operating in Latvia (six were open-end funds and one was closed-end pension fund) and overall they offered 19 pension plans.

Overall in 2012, the earnings of private pension funds were LVL 163.9 thousand³⁵ (of which four private pension funds operated with a profit), i.e. the amount was threefold larger year-on-year. In 2012, assets of pension funds increased by 8.8% and were LVL 2 million at the end of December.

AT THE END OF 2012, PENSION CAPITAL ACCRUED IN STATE-FUNDED PENSION SCHEME INVESTMENT PLANS FOR THE FIRST TIME EXCEEDED LVL 1 BILLION

³⁵ In accordance with the requirements of the Law on Private Pension Funds, the excess of income over expenses must be credited in full amount to the individual accounts of participants of pension plans.

By the end of 2012, 207 523 persons participated in private pension plans, i.e., by 8.9 thousand (4.5%) more year-on-year (representing 19.8% of all economically active people in Latvia³⁶). Of all participants of pension plans, 50.9% had made contributions themselves or contributions had been made on their behalf during the past 12 months, 23.9% were passive participants who continued their participation without making contributions and 25.2% had reached the retirement age determined in the pension plan and no longer made contributions but continued their participation and received portions of the accumulated retirement benefit capital.

Despite the economic growth in Latvia, solvency of Latvian people improved very slowly. Larger contributions to pension plans were made during the last quarter of the year and overall in 2012, contributions to pension plans in increased by 16.2% year-on-year (of which contributions by individual participants of pension plans increased by 28.9% and contributions by employers decreased by 5.6%). During the year, the amount of contributions paid to pension plans was LVL 21.2 million (see Chart 41).



Contributions to pension plans (in thousand lats)

Chart 41

Other constributions

From the retirement benefit capital, LVL 8 million lats were paid out (an increase by 21% year-on-year); the largest portion of this amount (98%) were paid to the retiring participants of pension plans whereas 2% were paid because of the death of a pension plan participant.

The retirement benefit capital accumulated in pension plans increased rapidly, by 19% in comparison with the level of funds at the end of 2011 and at the end of 2012, it was LVL 142 million.

Year-on-year, pension plan assets increased by 22.8% and were LVL 139.2 million at the end of 2012. Asset structure of pension plans was practically unchanged: the most part of assets was invested in investment fund invetsment certificates (55% of total pension plan assets or LVL 76.9 million (see Chart 42).

³⁶ Information of the Central Statistical Bureau; www.csb.lv.



Chart 42

Structure of the investment portfolio of pension plans by financial instrument

At the end of 2012, pension plan investments in Latvia reached LVL 45 million or 32% of total investments (an increase by 0.3% year-on-year). Of total investments abroad, investments in other EU MS were LVL 89.9 million or 95.4%, of which major investments had been made in Luxembourg (LVL 39.1 million) and Ireland (LVL 19.5 million) (see Chart 43).



Due to a significant recovery of the financial market in the second half of the year and successful investment policy, pension plan investments appreciated and in 2012, the average profitability of pension plans was 8.5%: for individual pension plans it ranged from 2.2% to 11.3% (in 2011, it was negative, -2.7% and was between negative, -13.9%, and positive, 2.9%, for individual plans).

In 2012, the expenses for managing pension plans reduced slightly (by 0.2 percentage points) and was 1.9% of the average net assets of investment plans (in 2011, they were 2.1%).

PERFORMANCE OF INVESTMENT MANAGEMENT COMPANIES AND INVESTMENT FUNDS

IN 2012, ALL OPEN-END INVESTMENT FUNDS, EXCEPT TWO, WERE ABLE TO ENSURE POSITIVE ANNUAL PROFITABILITY AND FOR SEVERAL FUNDS IT REACHED A DOUBLE DIGIT At the end of 2012, 15 investment management companies were operating in Latvia and they managed 40 investment funds (20 open-end and 20 closedend funds). During the year, the earnings of investment management companies were LVL 4.5 million (an increase by 22.5% year-on-year).

In 2012, the assets of investment funds managed by investment management companies decreased by 1.6% and amounted to LVL 233 million. Assets of closedend funds decreased by 12.5% and were LVL 95 million at the end of December (see Chart 44); it was mainly affected by liquidation of individual closed-end funds and revaluation of assets. At the same time, assets of open-end funds increased by 7.6% and were LVL 138.2 million at the end of December and this was due to the favourable market situation that contributed to appreciation of investments.

Chart 44

Investment fund assets (in million lats)



Overall, the year 2012 was successful for the sector of investment funds. All openend investment funds, except two that had made investments in the shares by issuers in Ukraine and Caspian Sea region, were able to ensure a positive annual profitability and for several funds it even reached a double digit. This positive trend was to a large extent supported by ECB activities that were aimed at relieving pressure in financial markets, in particular by ECB liquidity support to banks in the euro area at the end of 2011 (long-term refinancing operations, LTRO) and ECB announcement in August about launching a new securities buying programme (outright monetary transactions, OMT). In the last quarter of the year, along with concerns about the US "fiscal cliff" that could have an adverse effect on global economic growth, investors grew less optimistic and funds (predominantly those that pursued an active investment policy) suffered losses. Overall during the year, the share of cash decreased in the portfolios of investment funds and that evidenced growing optimism of investment fund managers and larger risk appetite. On the one hand, low interest rates in the money market gave grounds for concern that risks in the financial sector were likely to increase due to larger risk appetite of investors and investments in riskier assets, whereas, on the other hand, low interest rates helped enterprises to improve their profit levels that, in turn, had a positive effect on the price dynamics of the securities issued by those enterprises and also the value of certificates of those investment funds that had made investments in those enterprises.

Open-end bond funds and money market funds³⁷ invested predominantly in Latvia (see Chart 45); at the end of December, their investments in Latvia reached LVL 69 million or 58.5% of their total investment portfolio, of which the major part (LVL 46 million) were cash (demand claims on credit institutions and term deposits with credit institutions). 10.6% of the financial instruments held in portfolios of those funds were placed in other EU MS and 22.5% were placed in CIS (including 15.5% in Russia, mainly in debt securities of commercial companies that were admitted to trading on the regulated market). At the end of 2012, the average 12-month profitability³⁸ of open-end bond and money market funds was 8.4% and it was positive for all funds. Funds whose core investment currency was the euro were performing better because during the year, the US dollar depreciated slightly to lats. At the end of December, total investment portfolio of those investment funds was LVL 118 million.

Chart 45



Structure of the investment portfolio of investment funds by country group³⁹

³⁷ In accordance with the division of investment funds according to their investment policy available at the Bank of Latvia's website at http://www.bank.lv/statistika/mfi-un-citu-finansu-starpnieku-saraksti/latvijas-republikas-ieguldijumu-fondu-sarakstshttp://www.bank.lv/statistika/mfi-un-citu-finansu-starpnieku-saraksti/latvijas-republikas-ieguldijumu-fondu-saraksts.

³⁸ Profitability has been calculated as the ratio of changes of the value of investment fund's investment certificate in the reporting period to the value of investment fund's investment certificate at the beginning of the reporting period, expressed as a percentage.

³⁹ Financial instruments (incl. of investment funds) are grouped according to the home (registration) country of the issuer and for investment funds it can be different from the location of their actual investments.

Open-end mixed funds predominantly invested in EU MS (76.4%). Year-on-year, the share of cash had decreased notably in their portfolios (from 38.2% to 22%) (see Chart 46). At the end of 2012, the average 12-month profitability of open-end mixed funds was 5.3% and it was positive for all funds. At the end of December, total investment portfolio of these funds amounted to LVL 3.4 million.



Chart 46 Structure of the investment portfolio of investment funds by financial instrument

At the end of the reporting year, open-end share funds had invested 42.2% of their total investments in CIS countries (of which slightly more than one third (35.7%) of their total investment portfolio were investments in Russia). 28.5% of the total investment portfolio were investments in the US and 28.2% were investments in EU MS (of which 16.5% in Latvia). The most significant indices of open-end share funds increased during the year (RTS: +10.5%, Micex: +5.2%, Eurostoxx 50: +13.8%, S&P 500: +13.4%) and this had a positive effect on the performance of these funds. At the end of 2012, the average 12-month profitability of open-end share funds was 3.6% and it was positive for all funds, except two, and for four funds it was a double digit. At the end of December, total investment portfolio of these funds amounted to LVL 16.9 million.

At the end of 2012, the major part of investments by closed-end funds was made in Latvia (70%) and year-on-year the share of investments in Latvia had increased (it was 61% at the end of 2011). At the end of December, total investment portfolio of closed-end funds amounted to LVL 95 million.

PERFORMANCE OF INVESTMENT BROKERAGE FIRMS

At the end of 2012, five investment brokerage firms were operating in Latvia and overall their earnings in 2012 amounted to nearly LVL 1.5 million that was notably more than in 2011 when their profit amounted to LVL 928 thousand.

97.4% of total income of investment brokerage firms were income from commission fees and other similar income from services to customers, whereas administrative expenses accounted for the largest part of expenses (54.5%).

In 2012, two investment brokerage firms were engaged in holding financial instruments of customers according to their licences for the provision of ancillary investment services, but none had customer assets transferred for managing during the reporting year even if two investment brokerage firms held licences for managing the financial instruments of customers on an individual basis. The volume of cash of customers held by investment brokerage firms for the purposes of making transactions in financial instruments amounted to LVL 1.947 thousand at the end of the year (at the end of 2011, it was LVL 995 thousand).

At the end of the year, capital adequacy ratio of investment brokerage firms was 24.6% (it was 30.2% at end-2011) (minimum capital adequacy requirements was 8%).

PERFORMANCE OF PAYMENT INSTITUTIONS AND ELECTRONIC MONEY INSTITUTIONS

DURING THE YEAR, THE AVERAGE MONTHLY VOLUME OF PAYMENTS BY PAYMENT INSTITUTIONS INCREASED BY 60% At the end of 2012, 24 payment institutions and eight electronic money institutions were operating in Latvia, and three electronic money institutions were entitled to provide also payment services (overall, there were 34 registered payment institutions and 14 registered electronic money institutions).

During the year, the average monthly volume of payments by payment institutions increased by 60% and amounted to LVL 5.8 million while the average monthly volume of payments by electronic money institutions did not change (it was still LVL 2 million) but the average outstanding electronic money of electronic money institutions increased by 5% and amounted to LVL 1.3 million.

At the end of 2012, total liquid assets of payment institutions amounted to LVL 1.6 million and exceeded liabilities by LVL 0.15 million, whereas for electronic money institutions they were LVL 4.1 million and exceeded liabilities by LVL 0.9 million.