Annual Report and Activity Report
OF THE FINANCIAL AND CAPITAL MARKET COMMISSION
for 2016

FINANŠU UN KAPITĀLA TIRGUS KOMISIJA

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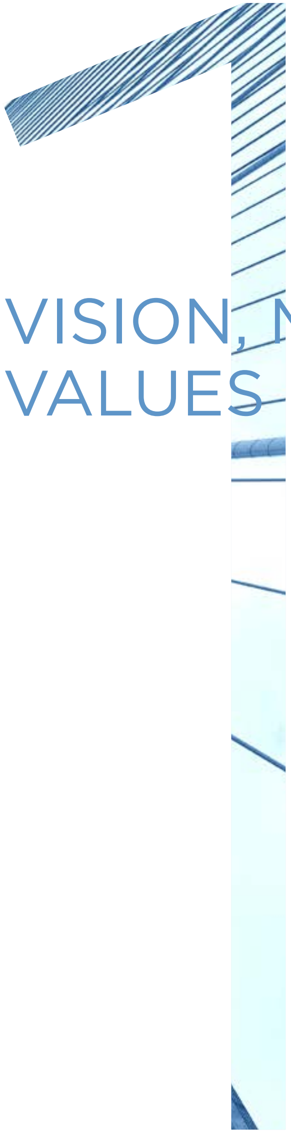
INTRODUCTION



VISION, MISSION, VALUES

FCMC VISION

A sound Latvian financial market integrated into the European Union (EU) single market, associated with professional, rigorous and fair supervision.

FCMC MISSION

To regulate and supervise the activities of the financial and capital market and the participants thereof, promote the protection of the interests of depositors and insured persons, as well as the development and stability of the financial and capital market.

FCMC VALUES

Accountability – we are aware of the impact of our activities on the performance of individual market participants and on the financial system as a whole. We are responsible for the protection of the interests of investors, depositors and insured persons, as well as for the development and stability of the financial and capital market.

Openness – in our activities, we are open to dialogue before making decisions. We are available and cooperative, as well as being able to professionally make use of our knowledge, finding solutions to a wide spectrum of challenges.

Transparency – we explain each and every one of our decisions to the public in an explicit manner, complying with the regulatory restrictions on the disclosure of information.

CHAIRMAN'S FOREWORD

A new level of accountability

The period preceding this reporting year could have been considered a dividing line for the new order in the Latvian financial sector, owing to important changes in the regulatory framework coming into force as well as on the supervisory approach. Consequently, in 2016, we were working under more stringent requirements assuming fully fledged accountability.

This has indeed been a phase of intense work, during which the FCMC had to make a lot of important decisions as well as to ensure, in the field falling under its responsibilities, a positive outcome of the negotiations for our country to join the organization of the developed countries, i.e., the OECD. And we did make it: on 11 May 2016, Latvia received an invitation from the OECD Council to join the organization. Before that, we were working hard for almost half a year to eliminate the deficiencies identified by the international experts. Last April, the OECD Working Group on Bribery in International Business Transactions acknowledged the changes made, and we agreed on the way forward. As a result, we strengthened our international reputation as the supervisor of the Latvian financial sector. During his visit to Latvia, Vice President of the United States Joe Biden highlighted the progress made in our country, which was achieved by reducing the amount of inappropriate transactions in the Latvian banking system. This was the first time that our strategic allies gave us such a positive rating.

> " We are now part of the world's most advanced countries, and the bar of our standards has been set very high. The work aimed at strengthening the international reputation of supervision will need to be carried on in the light of this new national dimension, and the financial sector will need to take account of it.

Nevertheless, the supervisor of the sector carries out its routine duties regardless of any major milestones in the life of the country. The FCMC is a thoroughly structured mechanism engaged in effective and rigorous decision-making when necessary. In 2016, both the supervisor and market participants had to leave their conventional comfort zone. Several Latvian commercial banks and their responsible officials were subject to significant penalties for deficiencies in their internal control systems and for inadequate management of risks in providing services to foreign customers. In 2016, we withdrew the licence from AS TRASTA KOMERCBANKA, which had been continuously violating the statutory requirements. For the first time, the FCMC prepared a proposal for the withdrawing of a licence under the Single Supervisory Mechanism (SSM) of banks, and the decision passed by the European Central Bank (ECB) confirmed the validity of our action as well as appropriateness in the identified circumstances. Thus, in this regard, this was again a new phase in our history. However, the decision regarding AS TRASTA KOMERCBANKA was an exceptional case in the Latvian financial sector. In general, order and stability is part of the financial sector. That is why the national institution, i.e., the FCMC , has been established in the country, commissioned with the duty of handling it in a discreet manner.

In 2016, along with the above-mentioned processes, three US consulting firms conducted independent testing in 12 Latvian banks, which provided services mainly to foreign customers. This, too, happened for the first time. The good news after the inspection was that the situation was close to what we had expected, and in any case, not worse. Subsequently, each of the inspected commercial banks received the FCMC's recommendations on how to implement the necessary changes to eliminate the identified deficiencies. It is essential that all the identified problems can be resolved. At present, specific tasks to be carried out pursuant to the requirements of supervision and the strategic objectives of each bank have been set for the longer term. In the future, we plan to carry out such compliance inspections on a regular basis – every two to three years.

In terms of assets, commercial banks undoubtedly represent the most significant segment of the Latvian financial sector. However, looking for new strategic approaches and diversifying the existing business models should be considered by all participants of the Latvian financial market. The pace of the country's economic growth is moderate, the business environment is changing rapidly, and competition in the field of innovative services is increasing, whereas any further reduction of administrative expenses aimed at reaching the expected profit level, has been exhausted.

The analysis of the earnings level of Latvian banks in 2016 suggests that in the absence of a one-off transaction effect (the selling of VISA Europe stocks), the banking sector experienced a significant drop in total earnings (-19%) in 2016 compared to the previous year. Employing tactical short-term solutions will not suffice to remedy the existing situation. Of course, income will be generated, and this segment will maintain its earning capacity. However, the transformation process of transiting from conventional service models to new forms has already begun, and this is a milestone of major changes. Furthermore, in 2016, there were changes in the structure of deposits attracted to Latvian banks. We are now relying on the financing attracted from domestic customers, whereas the foreign customer business segment had already shrunk to 43% in terms of total deposits by the middle of 2016.

Keeping abreast with the times, we are interested in exporting our financial services. This is determined by the geographical location of Latvia as well as other factors, such as a considerable number of market participants, the staff and technology resources at their disposal, the experience accumulated by them, the knowledge of languages, and skills to handle foreign customers. In order to use this potential rationally with a view to ensuring the long-term success of the financial sector, the risks involved need be analysed on a timely basis, while at the same time striking a balance between technology development and the regulation corresponding to the risk level, risk management and appropriate monitoring of compliance. This is a matter of the international competitiveness of our financial sector; we will seek ways to contribute to this in carrying out the supervisory process, i.e., where we should not go beyond what is needed in terms of interfering on the part of the supervisor, allowing for freer development.

At the national level, the conceptual activity framework for the next few years has been set for us. In February 2017, the Cabinet approved the Financial Sector

Development Plan for three years (2017-2019). An agreement has been achieved that Latvia, as an OECD country, with a view to ensuring for its capital city Riga the status of a regional and international financial centre in the long run, will have to consider the new circumstances and carry out certain tasks. New standards are also needed for the management of the sector's staff resources – ensuring improvement in the level of competence of subject-matter experts on a regular basis, ensuring new educational programmes and corresponding investments by market participants.

The workload of the FCMC has been growing year on year – we must ensure cooperation and exchange of information with all partner organizations at a European level, including in all positions where we collaborate with the specialists of the European Central Bank, including also participation in the OECD task forces. New tasks comprise new functions for the institution and also new employees. In 2016, we have created 18 new jobs. We have properly reformed the structure of the institution and increased payments by the sector for the provision of supervisory functions. In the coming years, this trend will continue, and we will give timely advance notice to market participants of the expected changes. This is necessary to align the remuneration system operated by the FCMC to the average salary in the financial sector.

The performance of the FCMC in 2016 suggests that we are capable of accomplishing the tasks entrusted to us at the milestones that are important for the development of our country, that we are capable of changing and eliminating deficiencies, and that we are capable of acting radically and expediently when necessary. This speaks of the institution's potential, strength and flexibility in adapting to the new development-related challenges and a higher level of accountability. Such experience encourages us to handle the contemplated change management. I would like to thank the employees of the FCMC for their contribution. Together we have made an important step forward!

Pēters Putniņš
Chairman of the FCMC

REPORT OF THE BOARD

The FCMC has been operating as an autonomous public institution since 1 July 2001, regulating and supervising the Latvian financial and capital market, ensuring the protection of the interests of the customers of market participants and promoting the stability, competitiveness and development of the whole sector. The work of the FCMC is managed by the Board, which consists of five members: Chairman of the FCMC, his deputy, and three members of the Board.

In 2016, significant changes occurred in the composition of the management of the FCMC. At the beginning of the year (28 January), the Saeima of the Republic of Latvia removed, based on his own request, Kristaps Zakulis from the position of the Chairman of the FCMC, whereas on 11 February, the Saeima appointed the incumbent deputy Chairman of the FCMC (Pēters Putniņš) as Chairman of the FCMC. At the end of the year (27 October), Gunta Razāne was appointed as Deputy Chairwoman of the FCMC. In 2016, work in the Board was continued by the Director of the Compliance Department Jeļena Ļebedeva, the Director of the Legal and Licensing Department Gvido Romeiko, and the Director of the Regulatory Requirements and Statistics Department Ludmila Vojevoda.

PHOTO: Board of the FCMC at the beginning of 2017

Pēters Putniņš

Gunta Razāne

Jeļena Ļebedeva

Ludmila Vojevoda

Gvido Romeiko

Once a week, the Chairman of the FCMC convenes and chairs the meetings of the Board aimed at reviewing the most important matters and at decision-making. In 2016, the Board of the FCMC held 45 meetings, during which 223 decisions were passed (in 2015, 51 meetings had been held and 238 decisions had been passed, respectively).

To promote the efficiency of the monitoring of the financial and capital market, ensuring the cooperation of the FCMC with the professional associations of the financial sector, the meetings of the Consultative Council of the financial and capital market are also convened on a regular basis. In 2016, twelve such meetings were held during which 33 draft laws and regulations binding on the financial and capital market were reviewed (in 2015, 37 draft laws).

On 4 November 2016 two years had passed since the establishing of the Single Supervision Mechanism for banks, and in the area of the supervision of the banks that are significant for Latvia, work carried on, with the staff of the FCMC getting actively involved in the work of the SSM joint supervision task forces of the European Central Bank as well as in the development of supervisory practice. Three Latvian banks, i.e., Swedbank, SEB banka, and ABLV Bank are subject to supervision by the ECB, and the supervision of these systemically significant banks is carried out in cooperation between the staff of the ECB and the FCMC, and it forms a significant basis for the everyday supervision of banks. The FCMC continued to supervise less significant banks, whereas the ECB continued to prescribe single key principles and guidelines for supervising such banks.

The FCMC, ensuring continuous monitoring of market participants, carried out standard supervisory measures; namely, the monitoring of the performance of market participants after completing the analysis of the financial statements thereof, as well as carrying out on-site inspections. Overall, in 2016, FCMC carried out on-site inspections of 34 market participants, including 22 inspections of banks, one paying institution and two electronic money institutions, two investment management companies, three credit unions, one alternative investment fund manager, one on-site inspection of one state-funded pension scheme asset manager, one private pension fund inspection, as well as the inspection of one insurance broker. Within the scope of the inspections carried out by the FCMC, on-site inspections of information systems were carried out in six banks.

In 2016, for the first time, an independent testing was started in 12 Latvian banks which had a focus on providing services to foreign customers, and completed at the end of the year. The inspection was carried out by the US consultancy companies Navigant Consulting Inc., Exiger LLC, and Lewis Baach Kaufmann Middlemiss, using a uniform methodology pursuant to US regulatory requirements in the area of anti-money laundering and the combating of terrorist financing (AML/CTF). The purpose of the inspection was to improve the functioning of the internal control systems of these banks in the AML/CTF area. It is envisaged that the banks will take the specified measures to eliminate the deficiencies by the end of 2017.

In 2016, within the scope of carrying out regular supervision in the AML/CTF area, the FCMC imposed a penalty of EUR 5,933,636 on four banks for failure to comply with the requirements laid down in the AML/CTF law, as well as a specified a number of duties to be carried out in order to fine-tune and improve the internal control systems of the banks. In addition, a fine of EUR 25,000 was imposed on one board member of the bank, whereas in one case a warning was issued to the board member responsible for AML/CTF.

At the initiation of the FCMC, the ECB passed the decision to withdraw the licence of AS TRASTA KOMERCBANKA on 3 March 2016. The FCMC submitted such a proposal for consideration by the ECB because the bank had been continuously and seriously violating a number of key areas of banking activity. Subsequent to withdrawing the licence from the bank, the decision of the Board of the FCMC regarding deposit inaccessibility at the bank followed; and the FCMC provided information regarding the procedure for disbursing the state-guaranteed compensations and the timing thereof, i.e., the State guarantees to each customer and the disbursement of EUR 100,000 in each Latvian bank in the case of deposit inaccessibility. Following the withdrawing of the licence, AS TRASTA KOMERCBANKA had sufficient liquid assets to ensure the disbursement of all guaranteed compensations to customers, and the guarantee system covered 95.4% of AS TRASTA KOMERCBANKA depositor claims in the amount of 100%.

In September 2016, the FCMC passed a decision to ban the Estonian *Versobank AS* from providing financial services in Latvia, i.e., attract new customers in the territory of Latvia, as well as requiring any contractual relations with existing customers to be terminated by the bank. The decision to ban the provision of any financial services in Latvia was made because *Versobank AS* had been continuously violating the procedure prescribed in the Credit Institutions Law, i.e., under which a credit institution registered in another Member State may start providing cross-border services in Latvia via a branch. *Versobank AS* had been providing financial services in Latvia, having a physical presence in Latvia, as supported by a number of facts.

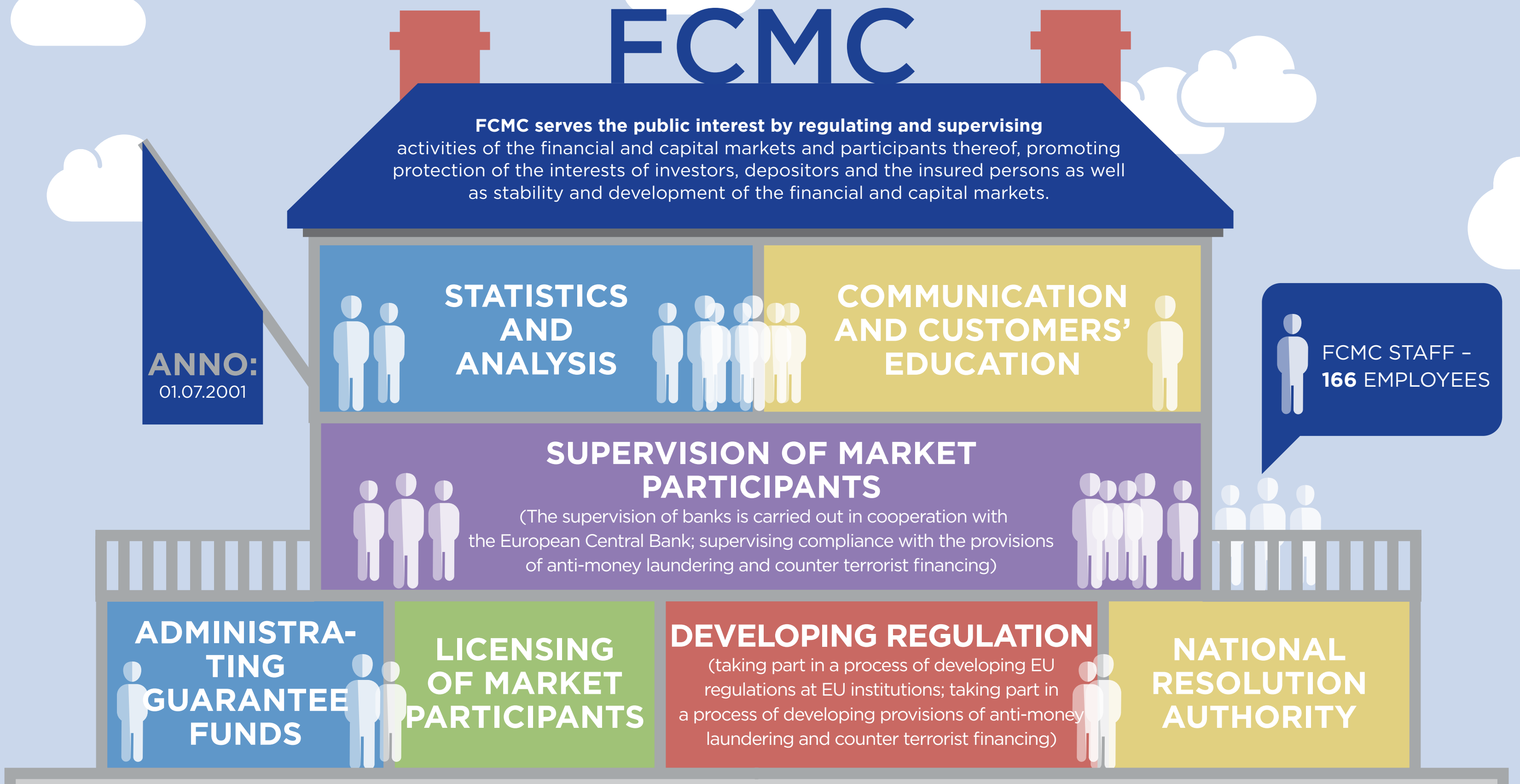
In 2016, subsequent to amendments to the AML/CTF law, the definition of the persons qualifying as politically exposed persons was extended. Therefore in 2016, credit institutions asked their customers to complete a questionnaire in order to determine whether the customers thereof qualify as politically exposed persons. The FCMC developed recommendations for banks for the determining and examining of politically exposed persons, the family members thereof, and closely-related persons thereto, as well as for the monitoring of transactions. These guidelines are used by banks to meet the statutory requirement to regularly aggregate information about their customers.

During the reporting year, there have been changes in the structure of the FCMC, i.e., with a view to strengthening the AML/CTF area, a new structural unit, i.e., the Compliance Control Department was established. The new department carries out supervision of financial and capital market participants in relation to AML/CTF, develops laws and regulations governing this area of activity, and ensures compliance with national and international sanction requirements. There are five divisions in the Compliance Control Department, i.e., the Banking Supervision Division, Non-Banking Supervision Division, Transaction Supervision Division, Compliance Division, and Sanctions and Compliance Division. Whereas in order to strengthen the internal audit, strategic and annual planning, risk management, project management, and internal control functions, as a result of the reorganization of the Internal Audit and Quality Management Division, the Internal Audit Division and the Strategic Planning and Risk Management Division were established.

On 4 April 2016, the OECD Working Group on Bribery in International Business Transactions, having assessed Latvia's performance in implementing its priority recommendations, provided a positive opinion to the OECD Council regarding Latvia's readiness to join the OECD. The opinion of the Working Group confirmed the progress made by Latvian supervisory authorities and the financial sector in preventing money laundering and terrorist financing as a high-quality and timely completed task. On 7 September, Pēteris Putniņš, Chairman of the FCMC, received a Statement of Acknowledgment from the Cabinet for his significant contribution in ensuring the successful joining of the Organization for Economic Co-operation and Development (OECD) by Latvia.

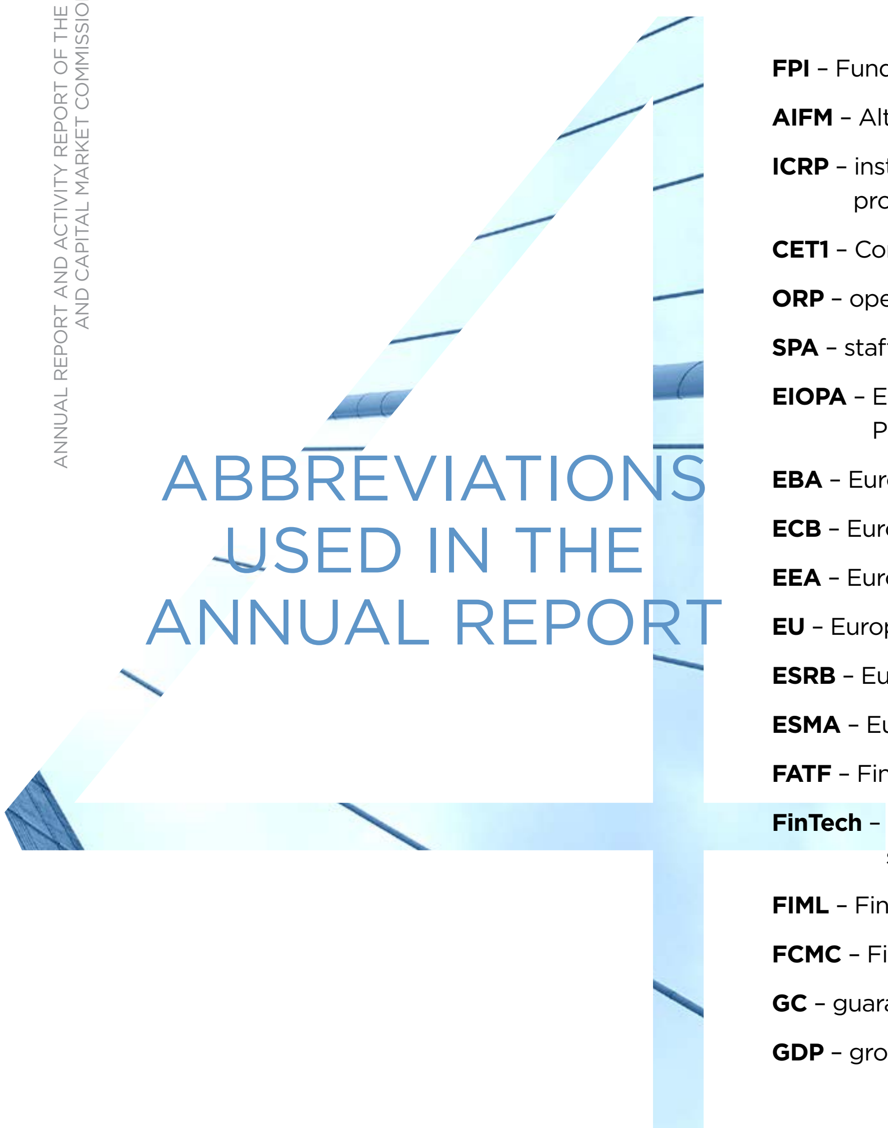
On 1 January 2016, the Single Resolution Mechanism became operational in the EU, and the Single Resolution Board that is engaged in decision-making regarding the required action in case any of the Eurozone credit institutions is exposed to difficulties. The Single Resolution Mechanism is aimed at ensuring the resolution of eurozone banks exposed to difficulties at the lowest possible cost and the reduction of the potential impact thereof on the overall economic situation. The institution in charge of resolution in Latvia is the FCMC, and it is responsible for the preparation of resolution plans, as well as for carrying out resolution activities or the rescuing of such institutions, the resolution whereof is required in the interests of the general public, or for decision-making on non-application of the resolution.

In 2016, aimed at ensuring the stable growth of the Latvian financial and capital markets, and based on the regulatory enactments issued by the EU institutions, as well as taking into account the nature and dynamic environment of the Latvian financial sector, the FCMC continued to improve the legal framework of financial and capital market participants, within the scope of the powers conferred on it. The most important amendments to the regulatory framework developed and approved for the financial and capital market participants are summarised in the section "Changes to the framework of regulatory requirements".



FINANCIAL AND CAPITAL MARKET PARTICIPANTS

23 banks and foreign branches
34 credit unions
6 private pension funds and **17** pension plans
19 insurance companies and foreign branches
12 investment management companies and **27** funds
20 State funded pension scheme investment plans
7 alternative investment fund managers and **16** funds
4 investment brokerage firms
84 insurance brokerage firms
29 payment institutions
15 electronic money institutions, financial instruments market, stock exchange, depository



ABBREVIATIONS USED IN THE ANNUAL REPORT

FPI – Fund for the Protection of the Insured

AIFM – Alternative investment fund manager

ICRP – institutions for occupational retirement provision

CET1 – Common Equity Tier 1 capital ratio

ORP – operational recovery plan

SPA – staff performance appraisals

EIOPA – European Insurance and Occupational Pensions Authority

EBA – European Banking Authority

ECB – European Central Bank

EEA – European Economic Area

EU – European Union

ESRB – European Systemic Risk Board

ESMA – European Securities and Markets Authority

FATF – Financial Action Task Force

FinTech – information technology based financial services innovations

FIML – Financial Instruments Market Law

FCMC – Financial and Capital Market Commission

GC – guaranteed compensation

GDP – gross domestic product

CAR – capital adequacy ratio

LCR – liquidity coverage ratio

MFI – monetary financial institution

SME – small and medium enterprises

DGF – Deposit Guarantee Fund

AML/CTF – Anti-Money Laundering and Combating Terrorist Financing

CTPLI – compulsory third-party liability insurance

OECD – Organisation for Economic Cooperation and Development

CCCB – counter-cyclical capital buffer

PEP – politically exposed person

PRIIP – packaged retail and insurance-based investment product

ROE – return on equity

SRB – Single Resolution Board

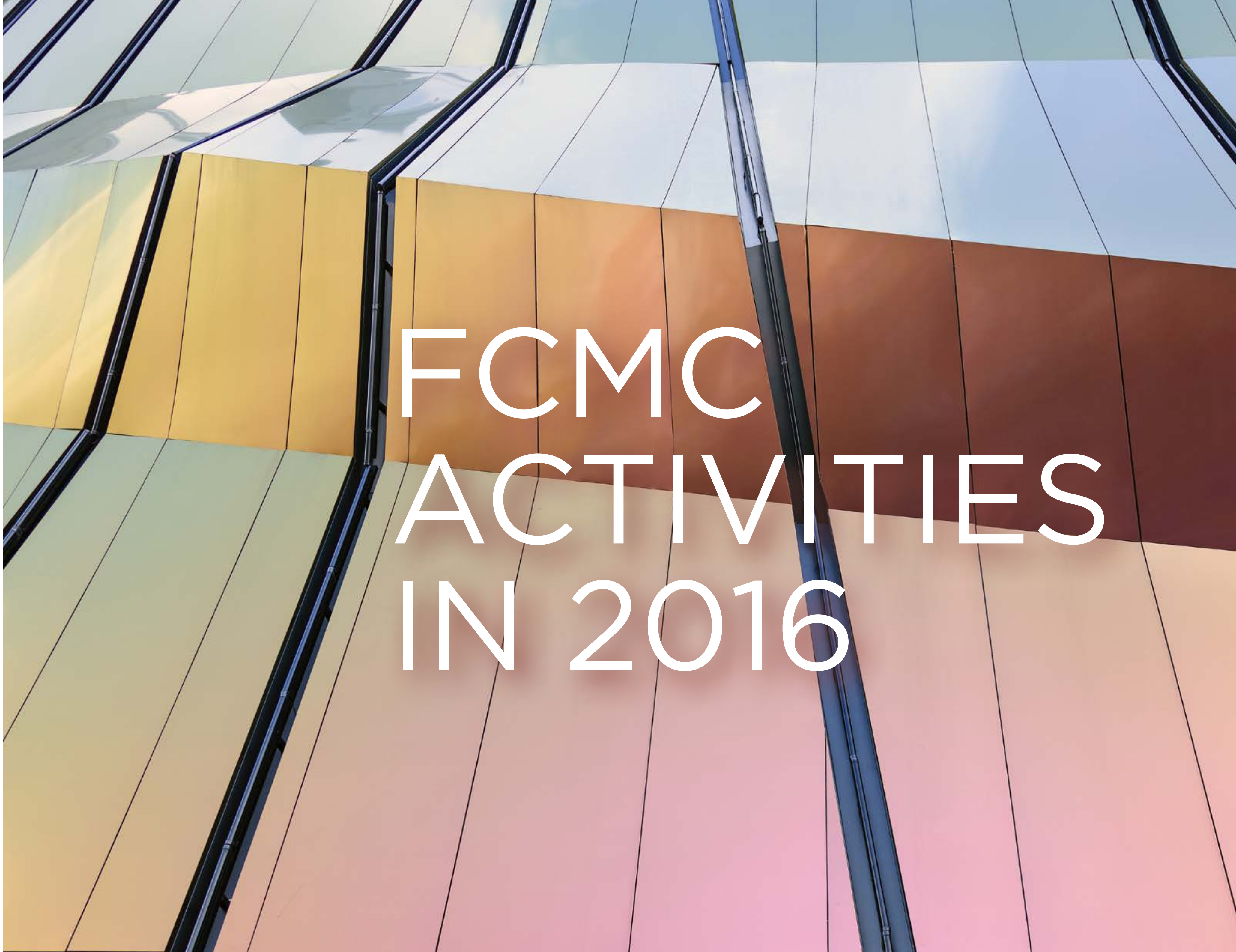
SREP – Supervisory Review and Evaluation Process

TKB – AS TRASTA KOMERCBANKA

SFPS – state-funded pension scheme

SRB –Single Resolution Board

SSM– Single Supervisory Mechanism



FCMC ACTIVITIES IN 2016

5 SUPERVISION

Supervisory principles

The FCMC regulates and oversees the financial and capital market in close cooperation with the European Central Bank within the scope of the Single Supervisory Mechanism and with the European Supervisory Authorities, and pursuant to the best international credit institution supervisory practices and operational frameworks.

> "The main principle of supervision is to identify, as soon as practicable, any problems in the financial market or in the activity of an individual market participant in order to immediately issue the supervisor's opinion and recommendations or to require the elimination and reduction of the problems.

Supervision is one of the key pillars of a sound financial system, which complements the self-regulation of financial markets and the internal control mechanisms of each financial institution. The main objective of supervision is to ensure that each supervised institution is managed professionally and prudently in accordance with the nature of its activities and exposure to risks.

With a view to promoting the protection of the interests of investors, depositors and the insured, as well as the stability of the financial and capital market, the FCMC has been undertaking continuous and comprehensive supervision over market participants by:

- determining the priorities of the supervision of each financial sector for the coming year, based on risk assessment and trends in the financial market;
- developing supervisory programmes for each sector as well as for each market participant, based on the defined priorities;
- maintaining a constant dialogue with market participants and professional associations regarding the new requirements, sectoral trends, and the risks and problem issues pertaining thereto;
- ensuring that new market participants with a sound capital base and clear and viable strategy enter the market;
- carrying out off-site analysis of the indicators characterising the activities of market participants, risks and risk management systems, continuously focusing on the qualitative and quantitative changes of the financial indicators as well as compliance with regulatory requirements and the effectiveness of corporate governance;
- ensuring, within the scope of its competence, the disclosure of true and fair information about the activity of market participants;
- carrying out on-site inspections;
- assessing the quality of financial services and ensuring consumer protection within the scope of its competence;
- in cases of non-compliance with regulatory

requirements, imposing preventive and corrective measures on the market participants in a timely manner.

The FCMC has been continuously paying attention to improving the methods applied in the supervision of all market participants.

Banking sector

General information

At the end of 2016, there were 16 banks and seven branches of banks from EU Member States in the Republic of Latvia. Recently, improved banking regulation as well as capital requirements have made the banking sector stronger and better capitalised than before the crisis.

In March 2016, following a proposal of the FCMC, the European Central Bank approved the decision to withdraw the licence of AS TRASTA KOMERCBANKA. Whereas the branch of *Pohjola Bank Plc*, in the same way as other companies within the financial group, changed its name, and since April 2016, has operated under the name the *Branch of OP Corporate Bank Plc* in Latvia.

In 2016, the activity of Latvian banks was affected by the external and internal macro-financial environment.

> Along with the steady growth of the national economy, the positive development of the labour market, and the gradual increase in the level of household income, the solvency of domestic enterprises as well as households continued to grow, and so did the quality of the loan portfolio.

The share of loans, which are overdue for over 90 days, in the total loan portfolio of the banking sector has returned to its pre-crisis level, and the post-crisis bad loan restructuring process has effectively ended. There has been a steady increase in the balance of deposits of domestic customers.

An increase in the level of domestic deposits supports not only the growing solvency of customers, but also their likely caution considering the slowing of the economic growth rate in the first half of the year, which in turn was affected both by the unstable external environment as well as the delay in commencing the absorption of EU funds, which in recent years has also resulted in the prudent lending growth rate. The slow growth rate of lending and low interest rates have led to increasing challenges for the banking sector to maintain its earning capacity at the existing level, which is additionally affected by the limited opportunities to reduce costs.

An increase in the growth rate of the Latvian economy in the last quarter of the reporting year (reaching 2% overall during the year), a favourable external demand forecast, more active absorption of EU funds, an increase in investment activity, as well as steady growth in consumption trends enable a prediction of a further acceleration of the growth rate. Although due to a more rapid economic growth an increasing demand for credit resources can be expected, in the medium-term, however, banks will be exposed to significant challenges. They are driven by growing competition on the part of the providers of non-bank financial services in certain service segments and the gradual narrowing of the market due to negative demographic trends.

> The year 2016 was marked for Latvian banks by significant changes in foreign customer deposits. The introduction of more stringent AML/CTF requirements has contributed to the reviewing of the foreign customer base, which resulted in the banks discontinuing cooperation with customers who do not meet the new requirements.

Although the size of the business of the banks providing services to foreign customers has dropped considerably, overall, this has contributed to greater consolidation of the banking sector. Banks continue to maintain a high capitalisation and liquidity levels.

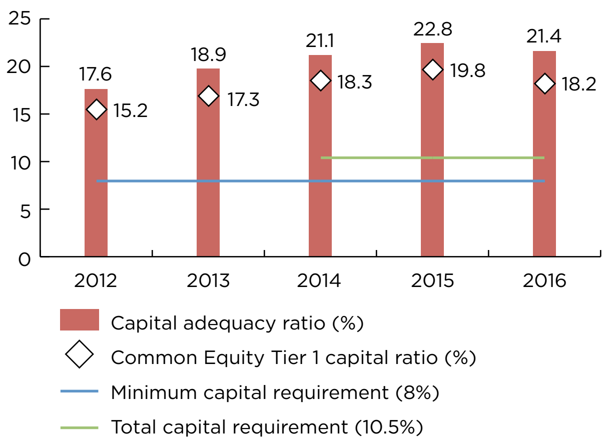
Significant risks to the Latvian financial sector are still related to the uncertainty of the external macro-financial environment in regard to *Brexit*, the policy of the new US administration, and the upcoming results of elections in a number of EU countries. Should uncertainty persist, it can negatively affect the forecasts of positive trends in the growth of Latvian economy.

Overall, however, the earning capacity of banks increased during 2016, but this was largely driven by one-off transactions with VISA stocks, as *VISA Europe* was changing its strategy and redeeming its stocks from the banks issuing *VISA* payment cards to their customers. Concurrently, banks had to take on the expenditure related to AML/CTF areas and consolidating the capacity thereof. The current challenges for maintaining the earning capacity at the present levels remained, and it is expected that banks will continue to focus on them in 2017. Concurrently, with the capitalisation and liquidity levels remaining quite high, the level of shock absorption by Latvian banks has strengthened and increased.

Banking sector performance indicators

The capitalisation level of banks has remained high. At the end of 2016, the combined capital adequacy ratio of the banking sector reached 21.4%, whereas the Common Equity Tier 1 capital (hereinafter referred to as CET1) amounted to 18.2%. As some banks streamlined their capital at the group level, overall the banking sector experienced a slight decrease in capital adequacy ratios (CAR – by 1.4 percentage points, whereas CET1 – by 1.6 percentage points). At the end of 2016, the CAR of individual banks ranged from 14.6% to 37.6%, whereas CET1 ranged from 11.7% to 37.5%.

Figure 1.
Bank capital adequacy ratio (%)



The banks also ensure that the leverage ratio[1] is at a sufficiently high level. And at the end of the reporting year, it reached 9.6%, whereas for individual banks it ranged from 6.1% to 17.6% (the minimum threshold set by the Basel Committee on Banking Supervision for the supervisory monitoring period until 1 January 2017 is 3%).

Liquidity of banks. Despite a significant decrease in foreign customer deposits, banks had sufficient liquid assets to cover their current liabilities and maintain a high liquidity ratio required by the FCMC, i.e., 61.9% at end of December (the minimum liquidity requirement was 30%).

On 1 October 2015, the single liquidity coverage ratio (LCR) for banks came into force, i.e., the ratio of a bank's liquid assets to its "net liquidity outgoing cash flows" within a 30-calendar day stress period. By the end of 2016, the banks had to ensure that the ratio was at least 70%. At the end of December, the average size of the LCR of the Latvian banking sector amounted to 341.4%, whereas for individual banks it ranged from 144% to 936%, thus significantly exceeding the minimum requirements.

As a result of the drop in foreign deposits, the ratio of total banking sector loans over deposits increased, reaching 71% at end of December (63% at the end of 2015). With domestic deposits growing faster than the domestic loan portfolio, the loans to deposits ratio dropped from 115% to 105% during the year, which means that only a small share of the domestic loan portfolio is financed by foreign resources (primarily the loans issued by parent banks).

Earning capacity. During the reporting year, the earnings of banks[2] amounted to EUR 453.8 million (in 2015 approx. EUR 416 million). Moreover, the performance of all 16 Latvian banks and three (of seven) branches of foreign banks, (the market share whereof made up 98% of the total assets of the banking sector) was a profit.

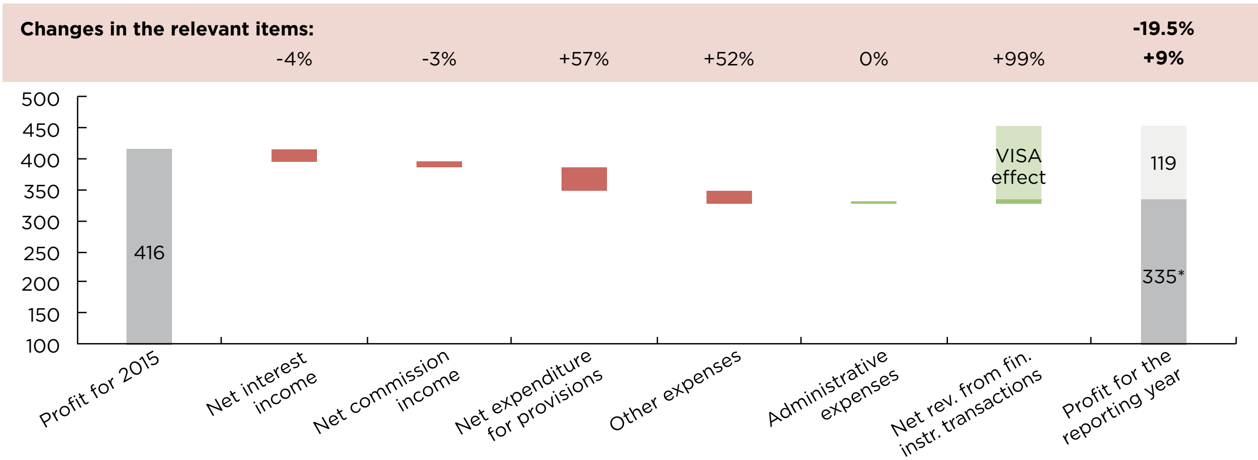
1 The leverage ratio is calculated as the Common Equity Capital Tier 1, divided by the total amount of its non-risk weighted assets in percentage.
2 Unaudited.

> The only factor influencing the growth of profits in the reporting year was the redemption of VISA Europe stocks owned by Latvian banks, which offset the decrease in the major banking revenue items

(net interest income as well as net commissions dropped by 4% and 3%, respectively) as well as the increasing expenditure for provisions for doubtful debts (by 26%). Excluding the positive effect of the VISA transaction, the net operating income of the banking sector dropped by 3% compared to the previous year, whereas the earnings dropped by almost 20%, and without this transaction they would have been around EUR 335 million.

At the end of December, the return on equity (ROE) of banks reached 14.3% (12.5% at the end of 2015), whereas, excluding the impact of the VISA transaction (according to the FCMC estimates), ROE was approx. 10.4%.

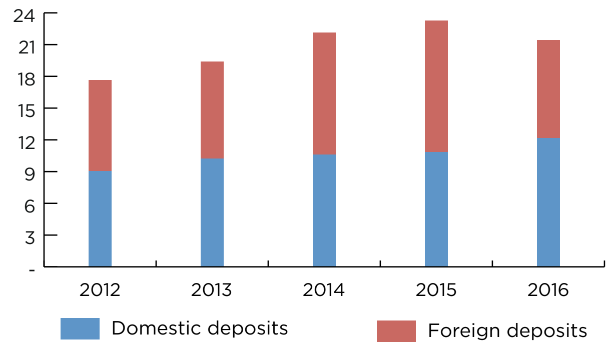
Figure 2.
Impact of income and expenditure changes on the increase in earnings in 2016 (in million euros)



Amount of deposits. In 2016, concurrently with a significant drop in foreign deposits (of 26.3% or EUR 3.3 billion), a healthy increase in domestic deposits was observed (12.6% or EUR 1.4 billion). The drop in foreign deposits was driven not only by the introduction of more stringent AML/CTF requirements, but also by weak economic development in the home countries of customers, and the withdrawing of the licence of AS TRASTA KOMERCBANKA in March 2016. Whereas, delays with the absorption of EU funds and uncertainty in the external environment contributed to an increase in the accumulation of domestic assets, which pushed up a significant increase in the deposits of domestic households and private non-financial enterprises.

As a result of opposing trends in domestic and foreign deposits, foreign currency deposits dropped from 53.4% to 42.8% over the year, and at the end of the reporting year, most of the deposits with Latvian banks were domestic customer deposits.

Figure 3.
Dynamics of deposits with banks (in billion EUR)



Financing attracted by banks. The increase in domestic deposits has reduced the need to raise funds from monetary financial institutions. During the year, it dropped by 4.6%, thus the financing provided by parent banks has been gradually replaced by domestic deposits.
In order to balance out the term structure of financing, banks continued to issue long-term bonds. The share of issued debt securities increased by EUR 27 million (4%) during the year, amounting to EUR 710 million at the end of December.

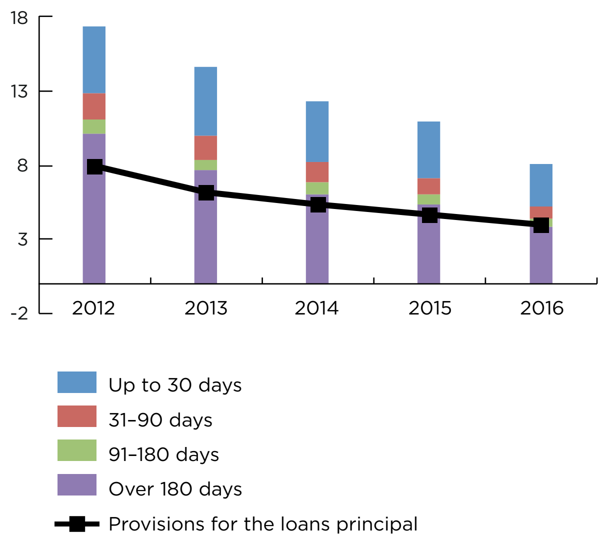
Loan portfolio.

> In 2016, the loan portfolio showed an increase of 3.1% for the first time since the pre-crisis period. There has been a significant increase in the volume of newly issued loans to domestic households (by 46.1%) as well as domestic non-financial enterprises (by 32%) for the purchase of a home.

The annual growth rate of the loan portfolio of domestic non-financial enterprises returned to being positive again (+ 0.9%), whereas the decline in the balance of the loans of the domestic households dropped down to -1.6% (-4.2% in 2015). At the same time, the increase of the USD to EUR exchange rate largely affected the increase in the non-resident loan portfolio (by 3.1%), whereas along with the adjustments in the USD value changes, the non-resident loan portfolio only grew by 1.3%.

Quality of the loan portfolio. During the reporting year, the quality of the loan portfolio continued to improve, and the share of loans overdue for over 90 days decreased from 6% to 4.4% in the aggregate bank loan portfolio, effectively reaching the pre-crisis level. Improvement was observed both in the domestic household and corporate loan portfolio, whereas the increase of the share of non-resident loans overdue for over 90 days (from 8.9% to 9.6%) was affected by the adverse economic circumstances in their home countries. The total share of overdue loans in the loan portfolio decreased from 10.9% to 8.1% during the year.

Figure 4.
Overdue loans and provisions (% of the loan portfolio)



During the year, the volume of restructured loans also dropped (by EUR 81 million or 6.4%) along with a decrease in the volume of newly included loans in this category of loans. Restructuring was mainly required for foreign customer loans, and the volume of such loans in the relevant portfolio slightly increased during the year (+EUR 6 million or 1.8%). Whereas, the volume of restructured loans in the loan portfolio of domestic customers dropped by EUR 87 million (9.4%). The volume of write-offs also declined, albeit insignificantly.

Bank supervisory measures

In 2016, the FCMC continued to consolidate the framework of intensive supervision, the purpose of which is to take risk-based and result-orientated supervisory measures and enable the FCMC to get involved in the activities of the banks and take the necessary measures to resolve potential and existing problems or reduce losses in a timely manner.

At the beginning of 2016, based on the assessment of the operational risks of credit institutions and of the trends of the financial system, the FCMC set banking supervision priorities.

Banking supervisory priorities set in 2016:

- Assessing the sustainability and earning capacity of the relevant business models and maintaining dialogue with market participants;
- Assessing and reducing compliance risk;
- Assessing credit risk and early identification of potential problems, with an emphasis on problem

loans and concentration risk;

- Assessing management risk strategies, risk appetite and governance.

Based on the priorities, the minimum amount of supervisory measures has been identified and, taking into account the existing resources, the supervisory measure plan was drawn up for 2016, which comprised on-site as well as off-site supervisory measures.

Assessing the sustainability and earning capacity of the relevant business models and maintaining dialogue with market participants. For the implementation of this priority, a number of off-site measures was taken in accordance with the approved supervisory measures plan:

- The reports submitted by banks, performance indicators and other information at the disposal of the supervisors were analysed, the risks significant for banks were assessed, and quarterly reports were prepared for the FCMC Board. The bank's capital adequacy assessment process was evaluated and minimum capital adequacy and liquidity requirements were established in accordance with the banking business models. Credit risk, liquidity risk and payment stress tests were also carried out. The results of stress tests were used, maintaining and identifying new corrective measures;
-
- In 2016, the process for reviewing the strategies of all banks was launched aimed at assessing the sustainability and earning capacity of banks. One of the key elements in this process is the independent review carried out by US consultants in the AML/CTF area in 2016 and the measures developed by banks aimed at improving the internal control system. These factors can have a significant impact on the overall strategy and business models of banks. Given the intensity of labour and complexity of the process, as well as the time required for banks to thoroughly review their strategies, the most significant work in terms of a comprehensive review of the strategies of all the banks is expected to occur in 2017;
- In 2016, the assessment of the recovery activity planning (RAP) of banks was launched in a new quality, i.e., in line with the methodology developed by the EBA and the ECB. The analysis of the RAP of several banks identified significant deficiencies. Taking into account that the RAP is an important element in ensuring the stable and continuous functioning of the bank, the FCMC required banks to improve their RAP within two months. A repeated RAP assessment cycle will continue in 2017;
- In 2016, pursuant to the documents submitted by banks, applications for new financial services were examined.

> "The submitted applications, as well as the banks seeking advice from the FCMC on the possibility of launching new financial services, demonstrates a trend to adapt to the modern requirements in the banking business and focus on new services, which have been developed as an alternative to the conventional term deposit and which are related to various innovations (such as e-commerce, the use of FinTech elements) and the remote identification of customers.

Assessing and reducing compliance risk. Two horizontal inspections were carried out to implement this priority:

- The horizontal inspection of the internal governance of banks, paying greater attention to risk assessment and the independence and operational efficiency of internal control functions (including risk director functions, operational compliance functions and internal audit functions);
- The horizontal inspection of the processes of launching new products and services.

Concurrently, in 2016, within the scope of off-site supervision, regular meetings were held with the members of the board of directors of each bank (on average, four meetings per year) and with risk managers (on average two meetings per year) with a view to maintaining and developing a dialogue with banks, to better understand banking strategies and business models, as well as strengthening the internal control functions of banks. In the scheduled meetings with the members of the boards of directors of banks, the performance, earning capacity and the capital situation of the relevant bank was discussed as well as the ability to implement the bank's strategy. In turn, when meeting with the risk managers of banks, the main topic of discussion was the key risks to which the bank is exposed, risk reports, the quality of risk management and control, the possible new financial services that banks were planning to launch, and the results of the inspections carried out by the FCMC.

Assessing credit risk and early identification of potential problems, with an emphasis on problem loans (overdue and restructured loans) and concentration risk. In order to implement this priority, in 2016, a horizontal inspection was carried out to assess the control measures of large exposures and the loan restructuring processes in banks.

At the same time, in 2016, monitoring of the off-site supervision of the loan portfolio continued, corrective measures regarding the structure and amount of the loan portfolio were identified for six banks, and, if necessary, based on supervisory ratings, adjusting of capital or creating additional provisions to problem assets was required.

Assessing management risk strategies, risk appetite and governance. This priority was taken into account when setting objectives for the horizontal inspection of the internal governance of banks, assessing the role of risk managers and how the bank's board of directors and council:

- discharge their duties, especially on matters relating to the definition of the bank's and group's strategy, supervision and governance arrangements;
- in performing their supervisory and management functions, have established appropriately composed committees and ensure that they effectively support the board of directors and council in decision-making, the bank committees are adequately managed and effectively monitored;
- receive and review reports on key risks, the course of the implementation of the strategy and the key information that ensures appropriate decision-making.

Within the scope of off-site supervisions, in assessing the capital adequacy process evaluated by banks, the results thereof and the RAP of banks, attention was paid to the development plans of banks, risk assessment processes and whether the required capital level set by the bank conformed to its risk profile.

In 2016, the FCMC continued to actively participate in the SSM by the ECB in the bank supervision field. Intensive work was carried out in the working groups set up by the SSM of the ECB in order to identify existing supervisory practices, identify and adopt best supervisory practices, harmonizing, as far as practicable, the supervisory approach, including by ensuring the principle of proportionality. Within the scope of these processes, the FCMC exchanged experience with their peers from other countries and participated in the development of the SSM of the ECB, which in future will form the basis for establishing a single supervisory mechanism and developing best supervisory practices and the implementation thereof across the eurozone.

> In terms of supervising the important Latvian banks (Swedbank, ABLV Bank and SEB banka), the employees of the FCMC continued to be actively involved in the work of the SSM overall supervisory working groups of the ECB and developing supervisory practice.

Whereas in regard to the sector of less important Latvian banks, the FCMC continued to carry out its supervisory functions and concurrently worked closely with the SSM of the ECB, providing as complete a picture as possible of the sector and the supervisory methods and practices used by the FCMC.

In 2016, supervision of banks was constantly based on related methods – the off-site monitoring of the performance of banks, based on the analysis of their financial statements and other operational information at the disposal of the FCMC, as well as on-site inspections.

Off-site monitoring of bank performance

In 2016, the FCMC carried out intensive off-site monitoring of banking activities, which was based on the analysis of the regular reports submitted by banks, as well as the analysis of the following additional operative statements, information and reports on the banking activities:

- a daily report about the dynamics of deposits;
- reports about liabilities to related-party financial institutions;
- minutes of the meetings of bank credit committees, of the management board and supervisory board as well as internal audit reports of banks on the reviews;
- reports on the results of risks and stress tests.

Banks were also invited to present a part of the above-mentioned operative information to the FCMC, thus promoting a mutual dialogue between the FCMC and the banks.

Risk-based supervision is still one of the key principles of supervision. Under this principle, the FCMC, using information disclosed in the reports received from banks, as well as other information available thereto, assessed, on a quarterly basis, the performance of banks, the level of risks and the quality of their management; and based on the results of the monitoring of these risks, planned the necessary supervisory measures, including on-site inspections.

> For several years now, based on the results of the analysis of bank performance and the results of performed inspections of the FCMC, the FCMC has been assessing the risks of banks by rating each bank according to its risk size and risk management quality.

The rating system is a tool used by the FCMC to identify, analyse and assess risks inherent to the activities of the institutions subject to supervision (i.e. to assess the risk profile) and to assess the quality, adequacy and appropriateness of the risk management methods applied by them in terms of the volume and complexity of the operations of the relevant institution.

The key objectives of the rating system are:

- to assess the risks inherent to the activities of the supervised institutions, as well as their risk management systems;
- to establish a standardised supervisory approach to identify, analyse and assess risks;
- to summarise the results of the assessment in a concise and comparable manner (i.e., assigning a rating to each supervised institution);
- to ensure an efficient and targeted planning of supervision;
- to ensure the continuity and transparency of the supervisory process;
- to promote the establishing of a more advanced approach to risk management in the banks being supervised;
- to promote communication and dialogue with banks.

As a result of the rating assignment process, each supervised institution is assigned, for supervisory purposes, a rating from 1.0 to 4.0, where 1.0 is the highest, whereas 4.0 is the lowest rating. The planning of the supervision of an institution is performed based on the rating assigned to it – the required supervisory measures applied to an institution that has been assigned the highest rating (the institution's activities have a low inherent risk and its risk management is sufficient) are minimal, whereas an institution with the lowest rating (the institution's activities have a high inherent risk and its risk management is weak) attracts continuous and enhanced supervisory control.

In 2016, on the basis of the results of the inspections carried out by the FCMC, as well as those of the off-site analysis of banking activities, the ratings of five banks were reviewed. Overall, at the end of the reporting year, the following ratings were assigned to banks:

RATING SCALE	1–2	2.1–3	3.1–4
Number of banks:	3	12	1

In 2016, the key risks identified for banking activities comprised credit risk, liquidity risk, reputation risk, strategy risk, and business risk. Particular attention was paid to the operational strategies, business models, and the earning capacity of banks.

Sanctions and corrective measures

In carrying out the supervision of banking activity, in 2016, the FCMC issued a warning to one bank regarding the deficiencies in the bank's internal control system and the failure to provide information to the FCMC. The FCMC also carried out corrective measures, setting additional requirements on four banks in the field of credit risk.

Group supervision

In 2016, the FCMC cooperated with the supervisory authorities of the credit institutions of the Member States, which pursuant to the requirements of the laws and regulations implement the supervision of groups of credit institutions. In 2016, FCMC staff took part in the work of the boards of supervisory authorities of the credit institutions of five EU Member States, including the chairing of one board of supervisory authorities in the capacity of the responsible supervisory authority. As regards two major Latvian banks, along with the establishment of the ECB's SSM the EC's SSM takes part in the boards of the supervisory authorities with the status of a member, while the FCMC has assumed observer status in these boards of supervisory authorities, enabling the FCMC to participate in the work of the boards of supervisory authorities and ensuring access to the information necessary for the FCMC to carry out supervisory work.

In 2016, the most significant directions in the agendas of the boards comprised the coordination of supervisory measures, the assessment of the evaluation process of internal capital and liquidity adequacy processes by banks and the risk profile at the group level, as well as the assessment of the recovery activity plans developed by banks.

On-site inspections in credit institutions

In 2016, the FCMC carried out 22 inspections in banks, paying particular attention to assessing capital adequacy ratios, the lending process as well as risk management functions — management of credit risk, operational risk, liquidity risk, strategy, and business risk, as well as the control function over operational compliance (including four on-site inspections carried out in the major banks). The deficiencies and irregularities identified during the inspections were discussed with the management of the relevant bank and action plans were agreed upon for implementing the necessary improvements. Follow-up monitoring is carried out within the scope of off-site supervision by controlling the progress of the implementation of the action plan to eliminate deficiencies.

Horizontal off-site inspections

In 2016, three horizontal off-site inspections were carried out. Horizontal inspections were carried out in all sixteen banks operating in Latvia. One of the objectives of horizontal inspections is to get a comprehensive insight into a single risk, an activity area or any aspect thereof concurrently. In 2016, horizontal inspections comprised such matters as:

- the conformance of the internal control systems of banks to the requirements of laws and regulations;
- large exposures of banks and the quality thereof;
- bank restructuring and new product launch and control processes.

> " The results of horizontal inspections enabled the FCMC to gain a comprehensive insight into the issues to be inspected, identifying overall trends and practices in the activities of banks and specifying the general requirements for building best practices.

Based on the results of the inspection, the FCMC developed best practice recommendations for banks, as well as used them in carrying out everyday supervision of individual banks.

Capital adequacy

The level of the capitalisation in the banking sector remained high, and at the end of 2016, the combined capital adequacy ratio of the banking sector reached 21.4%, whereas the Common Equity Tier 1 capital (hereinafter referred to as CET1) was 18.2%. The quality of the capital of the banking sector is ensured by the key element of the own funds of banks, i.e. CET1 capital, which currently equals CET1 capital in the case of Latvian banks.

During 2016, several banks used the opportunity to consolidate their capital base, including therein the audited (interim) profit for the current operating year. The increase in the capitalisation level was also driven by the gradual improvement of the quality of the bank loan portfolio and relatively slow lending growth rates. In 2016, five banks increased their paid-up share capital by EUR 15.1 million in total.

Within the scope of the supervisory process, the FCMC paid attention to and assessed the adequacy of provisions made by the banks for foreseeable losses. A positive difference between the volume of expected losses and the provisions made under the requirements of the accounting standards was taken into account when assessing the capital adequacy ratio of banks. In 2016, the capital adequacy ratio calculations of eight banks were adjusted.

In addition to the minimum capital adequacy ratio requirements, banks also assessed their internal capital adequacy ratio to ascertain that the capital of the bank, in terms of the amount, elements and the breakdown thereof, is adequate for covering the risks inherent in the current and planned activities of the bank, as well as for covering potential risks, and that a sufficient capital buffer is ensured in the case of the occurrence of potential significantly adverse circumstances affecting their operations.

> During 2016, within the scope of the supervisory inspection and assessment process, the capital adequacy ratio assessment process performed by the banks and the results thereof were assessed in all banks, as well as the conformity of the assessment process of the banks' internal capital adequacy ratio to the requirements of the laws and regulations.

Some areas for improvements were identified during the inspections performed by the FCMC (such as the procedure for the determination of the size of capital necessary for the covering of material risks inherent in the current and planned activities of the bank, and methods applied in the stress testing and the analysis of the results thereof). In some cases, the FCMC requested that the results of the process of assessment of the internal capital adequacy be updated and submitted repeatedly. Concurrently, the FCMC engaged in further dialogue with several banks about their business model, strategy and capital planning process.

During the assessment of bank capital adequacy ratios, the FCMC paid particular attention to whether the capital adequacy ratio was consistent with the future operational strategy of the bank and the size of the risks inherent to the bank's planned operations, as well as to the methods employed for managing these risks. In 2016, within the scope of the supervisory process, upon identifying an unduly high risk, the FCMC, according to the rights vested in the supervisor under the *Credit Institutions Law*, imposed an obligation on 15 banks to maintain their own funds above the minimum capital requirement.

Risk management function

In providing financial services, banks need to ensure not only the effectiveness of every business unit or activity type but also establish and efficiently implement the overall risk management function which is important for banking activities. In 2016, carrying out the inspections of banking activities, the FCMC continued to focus closely on the quality of management of each key risk. The size of the particular risk and the effect of changes on the bank's overall operations, as well as the effectiveness of the internal control system and of the efficiency of the activities of bank management in identifying, measuring and managing each relevant risk were considered in the assessment of each risk management function. Particular attention was paid to establishing whether, in managing key risks, banks were using tools such as stress tests and scenario analysis, and the quality of those stress tests and selected scenarios, as well as their appropriateness for the nature of each bank were assessed. If necessary, the banks were requested to carry out improvements.

Single Supervisory Mechanism

On 4 November 2016, it was two years of establishing the Single Supervisory Mechanism (SSM) of banks. It has three key objectives:

- to ensure the security and stability of the European banking system;
- to improve financial integration and stability;
- to ensure coordinated supervision.

In 2016, the SSM directly and indirectly supervised 26 trillion of assets of the eurozone banking sectors, exceeding the GDP of the eurozone by 2.6. Within a short-time, the SSM has become the largest bank supervisor globally. Excepting the ECB, 26 competent authorities operated within the scope of the SSM (19 national competent authorities and seven national banks) from 19 EU Member States. Overall about 6,000 employees are involved in supervision. In 2016, there were 126 important banks, which were subject to the direct supervision of the ECB (82% of the assets of the eurozone banking sector), whereas the national competent authorities supervised about 3,500 less important banks (18% of the assets of the eurozone banking sector).

Three Latvian banks – Swedbank, SEB banka, and ABLV Bank are supervised by the ECB. These banks are supervised, with ECB and FCMC staff participating in established joint supervisory teams, which forms the basis of everyday supervision of significant banks. The FCMC continued to supervise less important banks, whereas the ECB continued to prescribe a uniform framework and guidelines for supervising such banks.

In 2016, the ECB was actively working on the matter of non-performing loans by developing appropriate guidelines for banks. Various measures were taken to improve the solvency of the euro area banking sector, as well as to actively work towards the development of common supervisory standards by improving one of the key banking supervisory tools – the supervision inspection and assessment process (SIAP).

Due to the Chairman of the FCMC being a member of the Supervisory Board of the ECB, the FCMC was also involved in the process of adopting SSM decisions, adopting the decisions on both all the major banks under direct supervision of the SSM, and regarding the methodological issues determining the procedure for the implementation of the banking supervision process in the eurozone as a whole. In 2016, the Supervisory Board of the ECB adopted 1,800 decisions (1,191 licensing decisions, 192 decisions on own capital matters and 130 decisions in regard to SREP), 28 board meetings and draft decisions were coordinated and approved in 1708 written procedures. FCMC experts assessed and provided their view on the issues to be reviewed at the Board meetings as well as on the documents examined under written proceedings.

In line with the operational principles of the SSM, providing for the involvement of all Member States in the processes of planning and implementation of the supervision, FCMC experts constantly took part in the committees and work groups set up by the ECB, contributing to the development of the ECB's single supervision methodology and further coordination of the statutory regulation in the European Banking Union space.

The involvement of FCMC experts and management, as well as intensive information exchange with the ECB remained one of the key challenges in 2016. In addition, however, the insight gained into the developments of the supervisory processes implemented by the Member States has been invaluable and facilitated experience exchange, thus ensuring single application of best practice for banking supervision across the eurozone.

Insurance sector

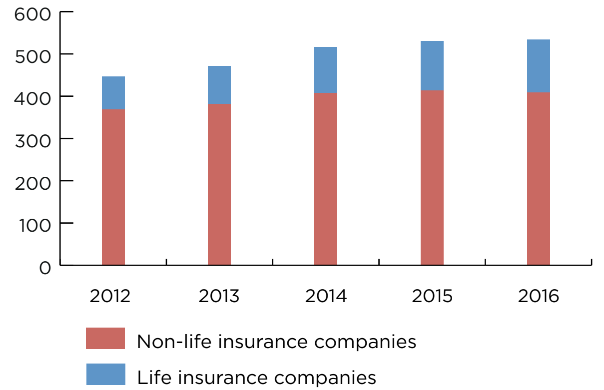
Insurance sector performance indicators

At the end of 2016, there were seven insurance companies in Latvia (two life insurance and six non-life insurance companies), as well as 12 branches of EU Member State insurance companies (four life insurance and eight non-life insurance company branches).

The gross premiums written by insurers (insurance companies and the branches of foreign insurance companies) remained close to the level of the previous year (up by 0.2%), amounting to EUR 532 million (including life insurance premiums written of EUR 124 million and non-life insurance premiums written of EUR 409 million).

The gross premiums written by branches of foreign insurance companies amounted to 32% of total premiums written or 45% of premiums written in Latvia. During the year, the volume of services provided by insurance companies in other Member States of the European Economic Area (EEA: Lithuania, Estonia, Poland, France, Germany, Spain, Italy) slightly exceeded 30% of the total gross premiums written in the insurance market.

Figure 5.
Premiums written by insurers (in million EUR)

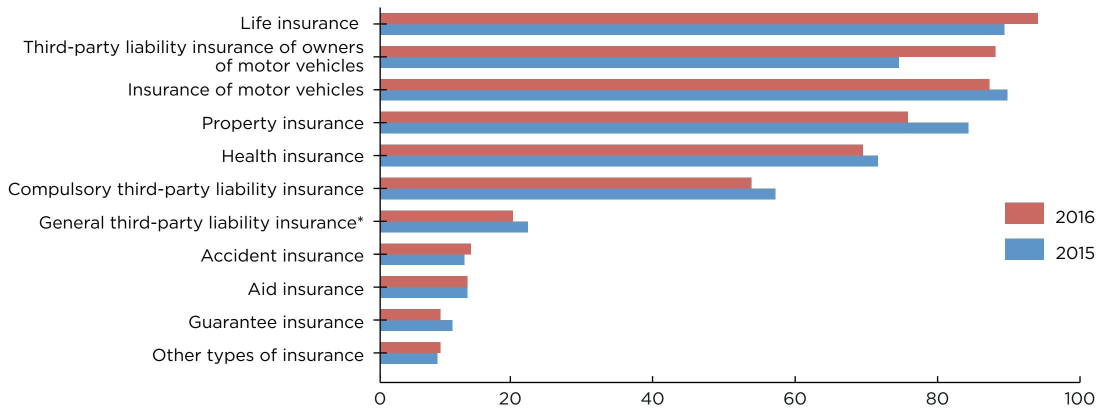


In 2016, life insurance premiums written had a stable growth, which was sustained by linking state-funded pension capital to life-annuity insurance policies, thus becoming the most significant kind of insurance (18% of the total insurance market).

> The fastest growth in premiums written was made up by third party liability insurance for motor vehicle owners (EUR 14 million, accounting for approx. 17% of the total insurance market).

Premiums written for other major types of insurance (road transport insurance, health insurance, property insurance and compulsory third-party liability insurance)) dropped which was driven by the reorganisation of one insurance company, without generally impacting the structure of the types of insurance significantly. Whereas in EU Member States, in terms of the share of the premiums written, third-party liability insurance of the owners of motor vehicles, property insurance, and motor vehicles insurance accounted for the highest shares (55%, 16% and 15%, respectively).

Figure 6.
Gross written premiums by type of insurance (in million EUR)



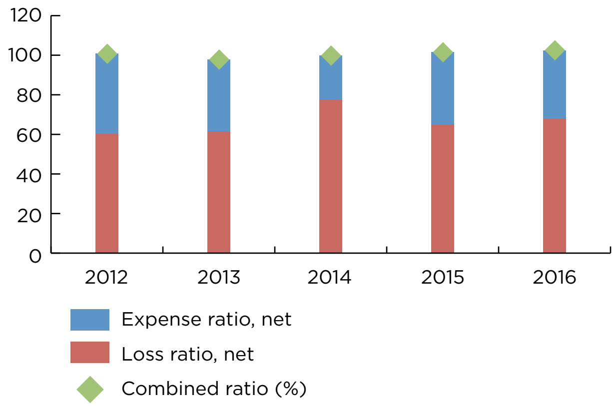
* Third-party liability insurance

In 2016, the earnings of insurance companies amounted to EUR 105 million (conversely to the previous year's loss of EUR 0.9 million), including the earnings of non-life insurance companies of EUR 103 million; life insurance companies as a whole earned EUR 1.8 million.

> The significant increase in earnings was mainly due to the transaction involving a sale of the subsidiary of one non-life insurer. Excluding the impact of this factor, the total earnings of non-life insurance companies were approx. EUR 5 million.

Although the operating expenses of non-life insurance companies dropped during the year, the pace of increase in claims received was much faster than that in earned premiums, which further aggravated the combined indicator of the earning capacity of non-life insurance companies; at the end of the year, it amounted to 102.6% (an indicator over 100% indicates losses from non-life insurance activities, excluding investment income).

Figure 7.
Combined ratio (%)



The favourable trends in financial markets significantly improved the return on investment of insurance companies, i.e., it increased from 1.5% to 2.7% for non-life insurance companies (excluding the above-mentioned one-off sale of a subsidiary), whereas for life insurance companies the ratio increased from 1.1% to 9.5%.

Insurance companies are well-capitalized, and their average solvency ratio (characterising the adequacy of own capital in terms of the risk-based solvency capital requirement); at the end of the reporting year, it was 147%, including 143% for non-life insurance companies and 173% for life insurance companies (the lowest allowable limit of the indicator is 100%).

Supervisory measures taken in regard to the insurance sector

In 2016, the priority of the supervisory process of insurance companies was to ensure effective supervision pursuant to the requirements laid down in the *Insurance and Reinsurance Law* (effective from 1 January 2016), by examining the submitted documents for compliance with the statutory requirements.

In 2016, the FCMC carried out an off-site supervision and monitoring of insurance companies, based on the analysis of the reports submitted by insurance companies as well as based on other submitted information. Insurance companies were also encouraged to present their approved operational strategies to the FCMC, thus contributing to the mutual dialogue between the FCMC and insurance companies.

> Based on the results of the analysis of the activities of insurance companies, the FCMC carried out, for the first time, a risk assessment of insurance companies, assigning a risk grade to each insurance company depending on the level of its risks and the quality of the management thereof, as well as pursuant to the impact of the insurance company on the insurance market.

The risk assessment and risk grading processes form a part of a supervisory review process, which is based on an assessment of the impact of risks, and is one of its stages. This is a method used by the FCMC to identify, analyse and assess risks inherent to the activities of insurance companies and to assess the quality, adequacy and appropriateness of the risk management methods applied by them in terms of the nature, volume, and complexity of the operations thereof.

The key objectives of the risk assessment and risk grading process are:

- to assess the risks inherent in the activities of insurance companies, as well as their risk management systems;
- to establish a standardised supervisory approach to identify, analyse and assess risks;
- to summarise the results of the assessment in a concise and comparable manner (i.e., assigning a risk rating to each insurance company);
- to ensure an efficient and targeted planning of supervision;
- to ensure the continuity and transparency of the supervisory process;
- to promote the introduction of more advanced risk management approaches in insurance companies;
- to promote communication and dialogue with insurance companies.

In the future, once a year, after receiving the annual quantitative report and the periodic supervisory report and the evaluation of the information provided therein, the FCMC will assign, for supervisory needs, a risk grade to each insurance company on a scale from 1 to 4, in which "1" stands for the highest rating, and "4" stands for the lowest rating.

According to the methodology approved by the FCMC, the risk level assigned to the insurance company will be reviewed after completing a fully fledged on-site inspection and after obtaining essential information about the activity of the insurance company, which might affect the previously assigned risk level.

The FCMC uses the risk grades of insurance companies determined as a result of risk assessment and risk grade determining process to carry out an effective supervision of insurance companies, by setting priorities and intensities for the off-site and on-site supervisory measures to be taken. According to the risk grade assigned to the insurance company, the supervision of the activity thereof is planned: for an insurance company with the highest rating (i.e., low risk activity), the necessary supervision measures are minimal, whereas for an insurance company with the lowest rating (i.e., high risk activity), continuous and enhanced supervision and control of the activity is required.

In 2016, based on the outcome of the risk assessment carried out by the FCMC and determining of the risk grade, the following risk grades were assigned:

Risk grade	1 (An activity characterised by a low level of risk and the risk management methods used are sufficient)	2 (An activity characterised by a moderate level of risk and/or while the risk management methods used by the insurance company are satisfactory, there is room for improvement)	3 (An activity characterised by a heightened level of risk and/or while the risk management methods used by the insurance company are not satisfactory, there is room for improvement)
Number of insurance companies:	1	5	2

In 2016, the FCMC carried out a thematic off-site inspection of all life insurance companies and branches of EU Member State insurance companies in order to assess the preparation for fulfilling the requirements laid down in Regulation (EU) No. 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based products (PRIIPs).

> In the supervisory process carried out in 2016, no material violations of the laws and regulations were identified, which would attract sanctions provided for in the Insurance and Reinsurance Law.

In 2016, the FCMC cooperated with the supervisory authorities of insurance and reinsurance companies of EU Member States, which are implementing the supervision of the insurance groups and reinsurance groups whose members were insurance companies licensed in Latvia. In 2016, FCMC staff participated in the colleges of insurance and reinsurance supervisors of four EU Member States and ensured the preparation and provision of information in accordance with the requests of group supervisory authorities.

In 2016, the FCMC also cooperated with Estonian and Lithuanian insurance supervisory authorities by providing information pursuant to the cooperation agreements entered into in 2013 on the supervision of cross-border insurance companies as well as by participating in the joint meeting of the Baltic Insurers Supervisors organized by the Estonian Supervisory Authority.

In 2016, the FCMC participated in the work of the European Insurance and Occupational Pension Authority (EIOPA) in the field of insurance supervision, ensuring the participation of insurance companies in the stress test according to the specified criteria, ensuring the provision of information in accordance with the requests of the EIOPA, i.e., providing, on a quarterly basis, information for the needs of the preparation of a *Risk Dashboard*, providing information for the needs of the preparation of the *Consumer Report, Spring Financial Stability Report* and *Autumn Financial Stability Report*, as well as providing answers to other information requests and ensuring the provision of information in accordance with the information requests from the International Association of Insurance Supervisors and the OECD.

Guarantee fund of compulsory third-party liability insurance of the owners of motor vehicles

In 2016, under Section 51 of the *Compulsory Civil Liability Insurance of Owners of Motor Vehicles Law* and Paragraph 19 of Cabinet Regulation No.195 *On the Procedure for Establishing the Guarantee Fund of Compulsory Third-Party Liability Insurance of the Owners of Motor Vehicles, for Accruing Assets in the Fund and Managing the Fund* of 22 March 2005, the FCMC carried out a compliance inspection of the establishing, provisioning and administration procedures of the guarantee fund of the compulsory third-party liability of the owners of motor vehicles administered by the association *Motor Insurers' Bureau of Latvia* and notified the Ministry of Finance and the association *Motor Insurers' Bureau of Latvia* of the findings of the inspection.

Insurance and reinsurance intermediaries

The FCMC, in accordance with the delegation provided for in the Law on the Activities of Insurance and Reinsurance Intermediaries, developed and approved at the Board meeting of 9 March 2016 the regulatory provisions No. 59 *Regulatory Provisions for the Preparation of the Insurance and Reinsurance Intermediaries Reports.*

In 2016, the FCMC carried out an off-site supervision of insurance brokers and of the Latvian branches of the insurance broker firms of EU Member States registered in the Register of insurance and reinsurance intermediaries maintained by the FCMC, which is based on the analysis of the submitted reports and other submitted information.

In 2016, the FCMC conducted a thematic on-site inspection of the activity of one insurance broker, assessing its compliance with the requirements laid down in the Law of the Activity of Insurance and Reinsurance Intermediaries.

The FCMC carried out an off-site inspection of the insurance brokers and the Latvian branches of EU Member State insurance broker firms registered in the register of insurance and reinsurance intermediaries maintained by the FCMC, which are engaged in providing intermediary services in life insurance in order to assess the progress of the preparation for complying with the requirements laid down in the Regulation (EU) No. 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based products (PRIIPs).

In the supervisory process carried out in 2016, no material violations of the laws and regulations were identified, which would attract sanctions provided for in the *Law of the Activities of Insurance and Reinsurance Intermediaries.*

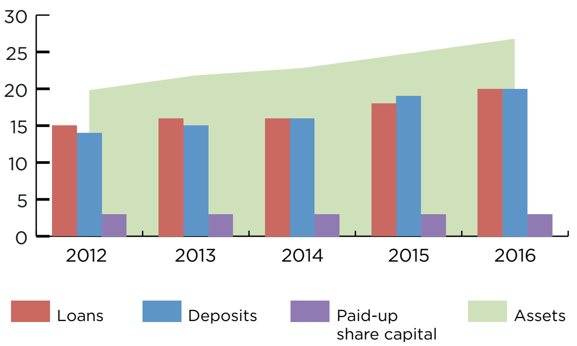
Cooperative credit unions

Performance indicators of cooperative credit unions

At the end of the reporting year, there were 34 cooperative credit unions in Latvia; their total assets increased by 8.1% during the year reaching EUR 27.2 million at the end of the year. The increase in assets was driven by the rise in the contributions by members (by 6%). Contributions by members is the major source of the assets attracted by unions (99%); at the end of December they amounted to EUR 19.6 million, whereof the majority (93%) consisted of the deposits by private persons.

The own funds of cooperative credit unions/the sum total of the assets and off-balance items ratio, i.e. capital adequacy was 21.9% at the end of December (the set minimum capital adequacy requirement being set at 10%). Whereas for individual credit unions it ranged from 15.4% to 99.5%.

Figure 8.
Assets, loans, deposits and paid-up share capital of credit unions (in million EUR)



The main type of activity of credit unions is granting loans to their own members. Loans to members continued to grow at a similar level to the previous year, i.e. by 9.6%, amounting to EUR 19.5 million at the end of December, furthermore, 99% of the loan portfolio had been issued to private persons. The quality of the loan portfolio continued to improve: at the end of December, 63.1% of credit unions' loan portfolio was rated as standard loans, 32.1% as to be supervised, whereas 4.8% of total loans were assessed as substandard, doubtful and lost (at the end of 2015 - 60.6%, 33.5%, and 5.9%, respectively). During the reporting year, as the quality of the loan portfolio improved, the amount of provisions created for bad debts slightly dropped amounting to 6.9% of the total loan portfolio of credit unions at the end of December (7.8% at the end of 2015).

In 2016, credit unions earned EUR 419 thous. in total, which was 2.7% higher than in the previous year, when the earnings amounted to EUR 408 thous. During the reporting period, the result of 24 credit unions was a profit, earning EUR 458 thous. in total, whereas the total losses of the remaining credit unions amounted to EUR 39 thous.

> The increase in the earnings of credit unions was mainly due to the improved quality of the loan portfolio, an increase in commission income, and an ever-increasing loan portfolio that contributed to an increase in interest income.

Supervisory measures applied to cooperative credit unions

In 2016, the supervision of cooperative credit unions was carried out both by monitoring their performance based on the analysis of financial statements, with a special focus on the sufficiency of the provisions for doubtful debts made by the credit unions, the covering of losses, as well as by carrying out on-site inspections. In 2016, FCMC experts carried out three on-site inspections and two off-site inspections aimed at assessing the financial standing of the cooperative credit unions, management performance, quality of assets, income and cost structure, the management of anti-money laundering and terrorism financing risk, as well as the compliance of their activities with the requirements of laws and regulations.

In implementing the supervision of the activity of cooperative credit unions, two administrative proceedings were instigated in 2016.

Payment institutions and electronic money institutions

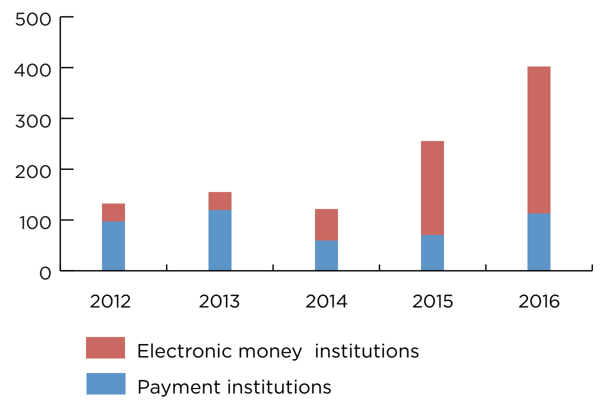
Performance indicators of the payment institutions and electronic money institutions

At the end of 2016, there were 29 payment institutions (26 registered and three licensed payment institutions) and 15 electronic money institutions (12 registered and three licensed electronic money institutions) operating in Latvia.

> Along with the general increase in economic activity, electronic payments (mobile technologies) have also been developing rapidly, i.e., payment and electronic money institutions are increasingly active in the financial market, offering new payment services using electronic payment means.

The total amount of payments made during the year amounted to EUR 402 million, i.e., considerably more (approx. 59%) compared to the previous year. At the end of December, the sum total of the liquid assets of the payment institutions (funds for the fulfilment of the payments performed by customers) comprised EUR 2.6 million, including claims towards the banks for securing payment services - EUR 2.5 million, and which fully ensured the covering of the payables owed to the users of payment services (EUR 2.1 million).

Figure 9.
Total annual amount of performed payments (in million EUR)



In the reporting year, the average amount of electronic money in circulation increased by 31%, reaching EUR 6.4 million, whereas the sum total of the total liquid assets of these institutions (funds exchanged for electronic money) amounted to EUR 27.4 million at the end of December, including claims against banks on securing the obligations related to the issued electronic money of EUR 8.3 million and claims against banks for provision of payment services – EUR 19.1 million. Whereas payables to the holders of electronic money amounted to EUR 7.9 million, and payables to the users of payment services amounted to EUR 14.2 million.

Supervisory measures applied to payment institutions and electronic money institutions

In 2016, the FCMC carried out supervisory measures of payment institutions and electronic money institutions, based on the service business model provided by the institutions, the associated risks and the risk grade to which greater attention was paid, by performing on-site inspections.

In 2016, the supervision of payment institutions and electronic money institutions was carried out, taking into account also the monitoring of the performance of the institutions, which was based on the scope of activity and the trend analysis, as well as the analysis of the submitted financial statements.

> In 2016, special attention was paid to the total amount of payments by payment institutions and electronic money institutions and the average amount of electronic money in circulation.

Payment institutions and electronic money institutions are required to submit a report on customer assets, in which payment institutions present information about transactions which were commenced and completed by the institution, specifying the mean average value of the payments performed within the previous

12 months, whereas electronic money institutions present the average volume of electronic money in circulation for the last six months, as well as information on the amount of repurchased electronic money.

Furthermore, in 2016, there was a focus on the financial stability of payment institutions and electronic money institutions: The FCMC requested information about the amount of own funds of institutions not only from the licensed institutions, but also from registered institutions; the monitoring of websites was carried out, and meetings were held with the members of the board of directors of the institutions.

In 2016, on-site inspections were carried out in one payment institution and two electronic money institutions. These inspections were aimed at assessing the compliance of the operational model and the performance of the management of payment institutions and electronic money institutions with the requirements of the laws and regulations, especially those laid down in the *Law on Payment Services and Electronic Money* and *Law on the Prevention of Laundering the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing.*

Sanctions and corrective measures

In carrying out the supervision of the activities of payment institutions and electronic money institutions, in 2016, the FCMC initiated six administrative cases and applied the following sanctions, i.e., two payment institutions were removed from the Register of Payment Institutions and Electronic Money Institutions of the FCMC. The registration in the FCMC payment institution register was cancelled for five payment institutions at the initiative of the institutions (discontinuation of the provision of payment services or changes in the business model).

Investment management companies and managers of alternative investment funds

Performance indicators of the investment management companies and managers of alternative investment funds

At the end of 2016, there were 12 investment management companies in Latvia, whereof six also held licences for the management of alternative investment funds, and seven registered managers of alternative investment funds were operating in Latvia. At the end of the reporting year, the amount of funds managed by the investment management companies amounted to EUR 3.46 billion, including EUR 2.79 billion making up the second-pillar pension investment plans, EUR 381.9 million – third-pillar pension plans, 218.4 million – investment funds registered in Latvia (including EUR 7.6 million – open-end investment funds), EUR 63.9 million – alternative investment funds registered in Latvia, as well as EUR 7.6 million – alternative investment funds registered in other countries. In turn, at the end of December, the funds managed by the managers of alternative investment funds amounted to EUR 79.4 million.

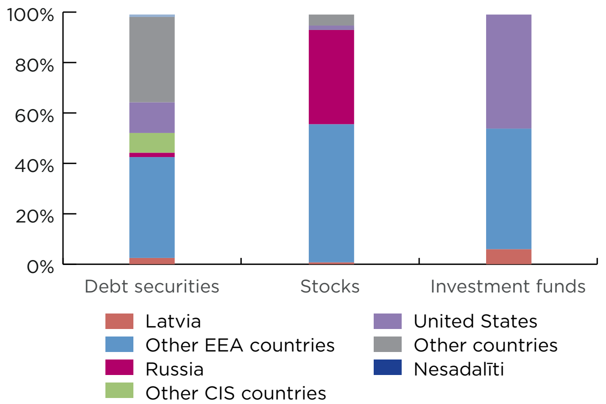
Performance indicators of investment funds

At the end of 2016, there were 27 open-end investment funds in Latvia, including 14 bond funds, three mixed funds and ten stock funds.

During the year, the assets consisting of bonds and mixed funds increased slightly (in both groups by approx. 4%), while the assets of equity funds decreased by 19%. Total investment fund assets increased by 0.6% over the year, reaching EUR 218.4 million at the end of December, including the assets of bond funds amounting to EUR 180.4 million and EUR 13.2 million - of mixed funds, and EUR 24.7 million of equity funds.

Debt securities accounted for the major share of the overall securities portfolio of the investment funds (85%), followed by investment fund investment certificates (11%), as well as stocks and other variable-yield securities (4%). An important share of all asset classes consists of investments in securities issued by EEA-based issuers. Investments in debt securities are focusing on a high-yield/high-risk segment, i.e., 65% of debt securities have a credit rating below the investment level (below BBB-). The majority, i.e., two-thirds of the investment certificates of investment funds are exchange traded funds (ETFs) (source: *Bloomberg*). Whereas equity investments are focused on the financial, energy, consumer goods, communications, and commodities sectors.

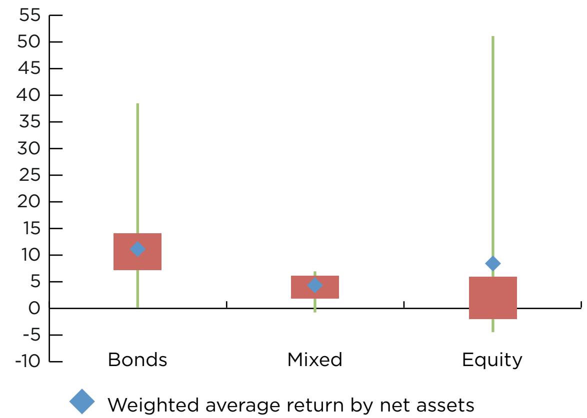
Figure 10.
Securities portfolio of investment funds by type of financial instruments and by group of countries (by the country of registration of the issuer) at 31 December 2016



> The majority of investment funds had a positive return in the reporting year, and their performance was largely determined by the currency of fund investments, namely, high performance in terms of the EUR was shown by the funds whose investment currency is Russian Rouble or USD.

For bond funds, the annual return ranged from 0.4% to 38.6%, for mixed funds – from -0.5% to 7.2% (negative for only one fund), whereas for equity funds – from -4.4% to 51.5% (negative for four out of ten funds).

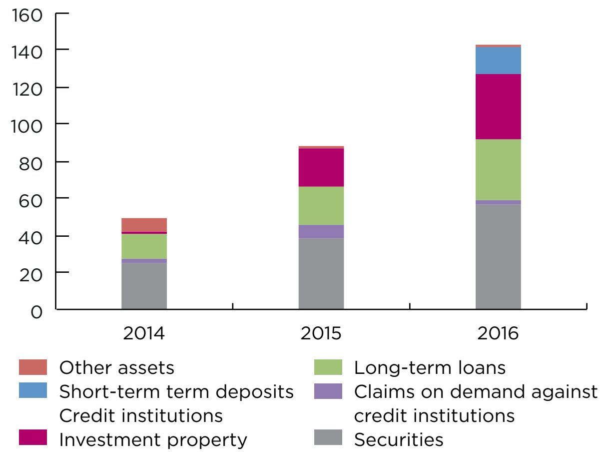
Figure 11.
Annual return of investment funds by type of fund at 31 December 2016 (%)



Performance indicators of alternative investment funds

At the end of the reporting year, there were 16 alternative investment funds in Latvia. During the year, the assets thereof increased by 62%, reaching EUR 143.3 million at the end of December. The assets of private equity investment strategy funds increased by 50%, reaching EUR 79.4 million at the end of the year, whereas the assets of real estate investment strategy funds grew by 79%, reaching EUR 63.9 million at the end of the year. The majority of the aggregate assets of alternative funds consisted of securities (EUR 56.9 million), investment property (EUR 35.4 million), and long-term loans (32.7 million EUR). At the end of the year, 86% of the assets of alternative funds were invested in Latvia, 12% in Estonia and 1% in the UK.

Figure 12.
Dynamics of the assets of alternative investment funds (in million EUR)



Supervisory measures of investment management companies and managers of alternative investment funds

In 2016, the FCMC carried out off-site supervision of investment management companies and investment funds to assess their financial standing, quality of assets, income and costs structure and compliance of their activities with the requirements of the laws of the Republic of Latvia, FCMC regulations and guidelines, as well as other laws and regulations.

As part of off-site supervisory measures, in 2016, 711 regular reports of investment management companies and investment funds were received and analysed.

Conformity assessment of key information aimed at investors was carried out, as well as assessment of whether the synthetic indicators of investment funds set by the investment management funds corresponded to the fluctuation of the profitability of the funds.

Closer attention was paid to off-site analysis of the internal control system and internal audit of investment management companies, as well as the assessment of the key risks to companies, their strategic objectives, changes in the management information system, the assessment of risks related to outsourced services received, as well as the planned changes in the area of investment management.

Large exposure profile assessment of investment management companies and investment funds was carried out.

In 2016, on-site inspections of two investment management companies were also carried out. The purpose of the inspections was to assess the main areas of activity of the companies, their compliance with the requirements laid down in the law of the Republic of Latvia, the regulations and guidelines issued by the FCMC, and other laws and regulations.

> "In the course of each inspection, particular attention was paid to the control system developed by the company and to risk management, by assessing the compliance and usability of internal legal basis.

During the inspections, the transparency of the company's activity and compliance with best practice principles, as well as observance of the interests of the clients were assessed. Concurrently, inspection of the activity of the custody banks of investment funds was carried out.

The deficiencies and inconsistencies identified during the inspection were discussed with the management of the pension fund and action plans for making the necessary adjustments were agreed upon to ensure the successful functioning of the pension fund.

Follow-up monitoring was carried out within the scope of off-site supervision by controlling the implementation of the action plan and, where necessary, recommending the necessary adjustments.

Supervisory measures applied to the managers of alternative investment funds and alternative investment funds

In 2016, off-site supervision of the managers of alternative investment funds (MAIF), to assess the structure of investments in the alternative investment funds managed by them, the income and costs structure thereof, as well as the compliance of their activities with the requirements of the laws of the Republic of Latvia, FCMC regulations and guidelines, as well as other laws and regulations.

As part of off-site supervisory measures, in 2016, 678 regular reports were received of alternative investment plan managers and alternative investment funds for analysis.

There was a special focus on the identification of the MAIF's business models and risks. In order to perform this analysis, several meetings with the representatives of MAIF were organised, debating over the introduction of regulations and the application thereof in practice, in order to achieve uniform understanding on the MAIF business model and the risks inherent thereto.

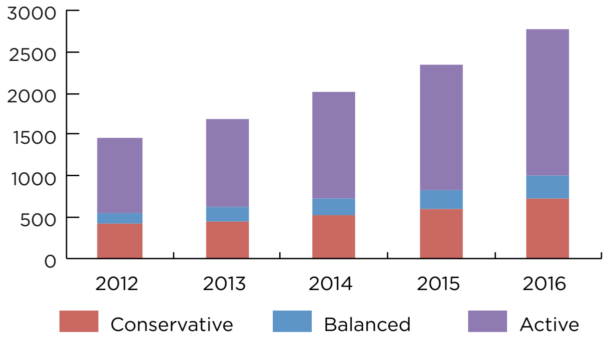
In 2016, one on-site inspection of MAIF was carried out, in the course of which special attention was paid to the appropriateness of the segregation of functions of MAIF to the established organisational structure, decision-making and fulfilment of management decisions, conformity and application of the internal regulatory base and established reporting system. Special attention was paid to the attraction and use of outsourced services. The deficiencies and inconsistencies identified during the inspection were discussed with the management of the pension fund and action plans for making the necessary adjustments were agreed upon to ensure the successful functioning of the pension fund. Follow-up monitoring was carried out within the scope of off-site supervision by controlling the implementation of the action plan and, where necessary, recommending the necessary adjustments.

State-funded pension scheme

Performance indicators of the state-funded pension scheme investment plans

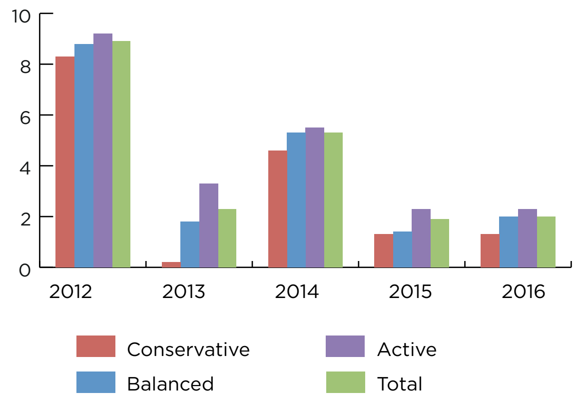
At the end of 2016, there were 20 state-funded pension scheme investment plans in Latvia. In 2016, the contribution rate to second pillar pensions was increased; and as a result of successful investments, earnings amounted to EUR 53.35 million, i.e., 46% higher than in the previous year. Pension capital accrued in the investment plans of the state-funded pension scheme assets grew by 18.3% or EUR 428 million, reaching EUR 2.76 billion at the end of the year. Across all types of investment plans an increase in net assets could be observed. Of all the contributions made during the year, 59% were made into active plans, 29% were made into conservative plans and 12% – into balanced plans.

13. Figure.
Uzkrātais pensiju kapitāls ieguldījumu plānu dalījumā (milj. eiro)



Although 2016 was marked by large fluctuations in financial markets, all second-pillar pension investment plans reported a positive return – for conservative investment plans it ranged from 0.4% to 4.9%, for balanced funds – from 1.2% to 3.6%, whereas for active funds, it ranged from 1.1% to 5.0%. The performance of investment plans in the first half of the year was negatively affected by the sharp decline in stock markets, which was largely driven by concerns about the decline in China's economic growth rate, as well as the result of the Brexit vote. Whereas in the second half of the year, the financial markets were dominated by a strongly positive mood, mainly driven by investor expectations regarding the US economic outlook.

Figure 14.
Weighted average (by net assets) annual return of investment plans (%)

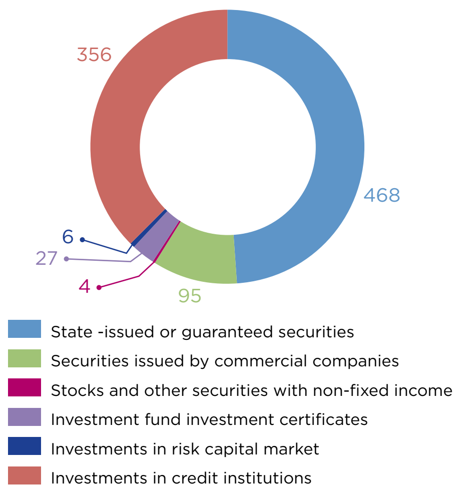


During the reporting year, as the managers were in search of investment opportunities with potentially higher returns, the share of term deposits in the aggregate investment portfolio dropped (from 6.4% to 4.5%), so did claims on demand to banks (from 13.2% to 8.3%), whereas the share of investment fund certificates increased (from 31.6% to 36.9%). 51% of investment fund certificates had a focus on investments in equities or the funds thereof, and 42% on fixed income instruments (source: *Bloomberg*). Also, the share of debt securities in the total investment portfolio increased slightly (from 46.5% to 48.1%) compared to the end of 2015. 90% of the debt securities had the investment credit rating (data source:). *Bloomberg*). During the year, investments in alternative investment funds increased, which at the end of 2016 amounted to 2.1% of total investments (1.2% at the end of 2015).

As investment plan deposits in credit institutions declined, investments in Latvia dropped by 9% during the year, reaching EUR 956.5 million at the end of the year or 34.3% of total investments (including EUR 467.6 million investments in the securities issued or guaranteed by the government, EUR 95.4 million – in debt securities issued by commercial companies, EUR 3.5 million – in stocks, EUR 26.5 million – in investment funds, EUR 6 million – in the Latvian venture capital market, and EUR 356 million was placed with credit institutions). In turn, 94% of all foreign investments were made in EU Member States.

Figure 15.

Investments of second-pillar pension plans in Latvia at 31 December 2016 (in million EUR)



Supervision of the asset managers of the State-funded pension scheme

In 2016, the FCMC carried out off-site supervision of the asset managers of the state-funded pension scheme (SFPS) to assess the quality of assets of investment plans managed by them, the income and expense structure, and compliance of their activities with the requirements of the laws of the Republic of Latvia, FCMC regulations and guidelines, as well as other laws and regulations.

As part of off-site supervisory measures, in 2016, 740 regular reports were received from investment plans for analysis.

In 2016, within the scope of off-site supervision, the FCMC also assessed the critical situation analysis submitted by the asset managers of the SFPS for the investment portfolio of each investment plan. The specified risk factors, the likely scenarios and anticipated activities to be carried out in the event of occurrence of adverse scenarios were assessed.

Within the scope of carrying out off-site supervision, the internal audit function of asset managers was also assessed by requesting them to submit internal audit plans and prepared opinions and evaluating them. Also, meetings were held with the management of asset managers to monitor the key events in the activities of market participants and the fulfilment of business strategies in between on-site inspections.

In 2016, the large-scale assessment of the risk portfolio of the SFPS investment plans was carried out.

Also:

- Key information aimed at the members of all SFPS investment plans were received and reviewed in accordance with the 10 December 2014 FCMC Regulation No. 295 *Regulations on the Preparation of the Key Information to the Members of the State-Funded Pension Scheme;*
- the impact of the new commission calculation principles on the performance of investment plans was assessed;
- the monitoring of the capital increase process of the asset managers of the SFPS was carried out, in order to verify compliance with the new capital requirements.

In 2016, one on-site inspection of the asset managers of SFPS was carried out, in the course of which special attention was paid to the internal control system of the asset manager, the appropriateness of the segregation of functions of the asset manager to the established organisational structure, decision-making and fulfilment of management decisions, conformity to and application of the internal regulatory base and the established reporting system. Particular attention was paid to the engagement and use of outsourced services, assessing the control systems established by the asset manager to assess the outsourced services. The activities of asset holders were also assessed. The deficiencies and inconsistencies identified during the inspection were discussed with the management of the pension fund and action plans for making the necessary adjustments were agreed upon to ensure the successful functioning of the pension fund. Follow-up monitoring was carried out within the scope of off-site supervision by controlling the implementation of the action plan and, where necessary, recommending the necessary adjustments.

Private pension funds and pension plans

Performance indicators of private pension funds

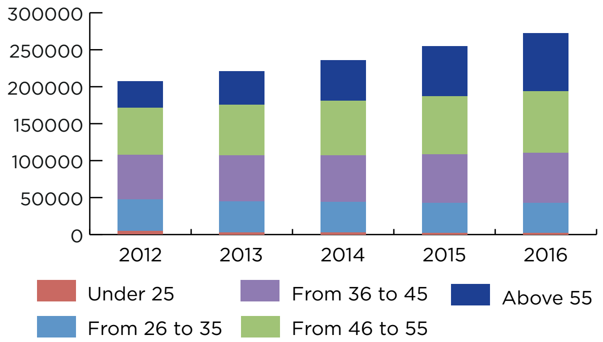
At the end of 2016, there were five open-end pension funds and one closed-end pension fund in Latvia, administering 17 pension plans in total.

> As in the previous year, in 2016, the population was very interested in saving for pensions, and some trends continued, such as an increase in the number of participants and the new historical maximum of contributions paid by participants.

According to the age structure of third-level pensioners, those who are approaching retirement age are more actively involved in making pension savings.

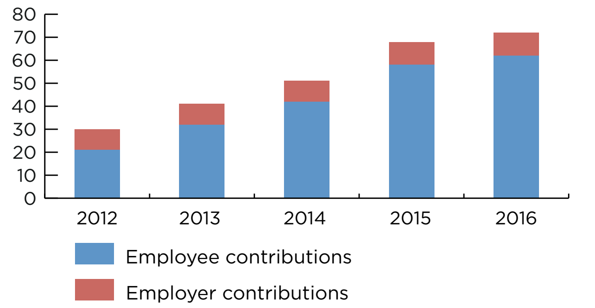
During the year, the number of participants who joined private pension plans increased by 17.2 thous. (7%), amounting to 272,209 participants, representing 27.7% of economically active Latvian residents at the end of the year.

Figure 16.
Breakdown of the number of pension plan participants by the age of the participant



In 2016, a total of EUR 71.8 million were paid in pension plans, i.e., 6.3% more than in the previous year. Compared to 2015, the contributions of participants increased by 7.2%, whereas employer contributions slightly lagged behind the previous year level (by 0.8%).

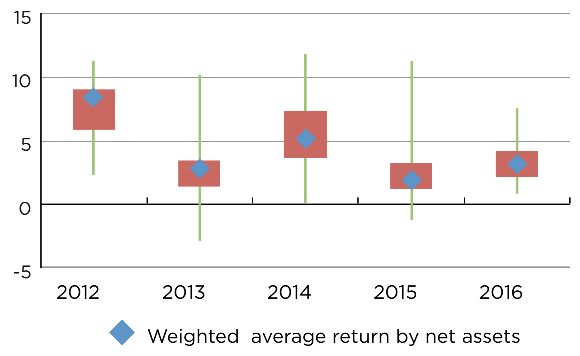
Figure 17.
Contributions into third-pillar pension plans (in million EUR)



At the end of 2016, the capital accumulated by third-tier pension plans amounted to EUR 380.6 million, having increased by 15.2% during the year. The accumulated pension capital growth was mainly ensured by the growing contributions of the members of pension plans, and a profit of EUR 11.2 million was also earned during the year, i.e. 86% more than in the previous year.

Compared to 2015, return indicators have increased. During the reporting year, the average return of pension plans was 3.2%, whereas for individual plans it ranged from 0.75% to 7.5%. For some plans an increase in return was driven by the significant rise in the value of the USD against the EUR.

Figure 18.
Average weighted annual return of pension plans (%)



Fund certificates accounted for the major share in the structure of portfolio of pension plans (46%), of which 48% had a focus on stocks or the indices thereof, while 44% had a focus on investments in fixed income instruments. During the year, the share of fund certificates grew and the share of claims on demand dropped, indicating that managers saw opportunities in investing in potentially more profitable financial instruments. The share of term deposits remained low due to the low interest rate environment. Over the year, the share of debt securities grew slightly, and 70% thereof was comprised of government securities. 85% of the debt securities had the investment credit rating (data source: *Bloomberg*). Investments in alternative investment funds slightly increased, accounting for 1% of total investments at the end of the reporting year (0.4% at the end of 2015).

During the year, investments in Latvia dropped by EUR 18.1 million, amounting to EUR 109 million at the end of December, and the share of these investments in the total portfolio had also dropped to 28.5% at the end of the year. Investments in other EEA Member States accounted for 69.5% of all investments.

As the number of the participants who have reached the retirement age increases, EUR 30.8 million were disbursed from pension plan capital during the year (i.e., 42% more than in 2015).

Supervisory measures applied to private pension funds and pension plans

In 2016, the off-site supervision of private pension funds was carried out by assessing the financial standing of private pension funds, quality of assets of pension plans, the income and costs structure and compliance of their activities with the requirements of the laws of the Republic of Latvia, FCMC regulations and guidelines, as well as other laws and regulations.

As part of off-site supervisory measures, in 2016, 544 regular reports were received from private pension funds and pension plans for analysis.

In 2016, one on-site inspection of a private pension fund was carried out aimed at assessing the activity of the pension fund, in discharging the functions prescribed in the Law on Private Pension Funds. During the inspection, particular attention was paid to the appropriateness and sustainability of the internal control system established by the pension fund as well as to the identification and management of significant risks.. Segregation of functions and appropriateness to the established organisational structure were analysed as well as the capacity of information exchange and the reporting system established by the pension fund to ensure sufficient and easily traceable information to internal and external users. Particular attention was paid to the selection and use of outsourced services, assessing the control systems established by the pension fund to assess the outsourced services. The activities of asset managers and asset holders were also assessed. During the inspection, the FCMC also assessed the risk trends associated with the products offered by the pension funds.

The deficiencies and inconsistencies identified during the inspection were discussed with the management of the pension fund, and action plans for making the necessary adjustments were agreed upon to ensure the successful functioning of the pension fund. Follow-up monitoring was carried out within the scope of off-site supervision by controlling the implementation of the action plan and, where necessary, recommending the necessary adjustments.

Within the scope of off-site supervision, the FCMC also assessed the critical situation analysis submitted by private pension funds for the investment portfolio of each pension plan. The specified risk factors, the likely scenarios and anticipated activities to be carried out in the event of the occurrence of adverse scenarios were assessed.

Within the scope of off-site supervision, in the reporting year, the functioning of the internal audit of the private pension funds was also assessed, evaluating the internal audit plans and prepared opinions.

> During the reporting year, one inspection was also carried out employing the mystery shopping method to ascertain that the information required under the Law on Private Pension Funds is appropriately explained to potential participants.

An extensive assessment of the risk profile of private pension funds was carried out.

Also, meetings were held with the management of private pension funds to monitor the key events in the activities of market participants and the fulfilment of business strategies in between on-site inspections.

In 2016, active work was also carried out in the area of pension fund supervision in committees at the European level. The FCMC representatives actively participated in the work of the European Insurance and Occupational Pensions Authority in the area of pension fund supervision and also in the work of its Occupational Pensions Committee that dealt with topical pension fund supervision issues at the European level. The FCMC also took an active part in the EIOPA *Task Force on Personal Pensions* and *Review Panel*. The project coordination work of *Peer Review on Prudent Person Rule for IORPs* has been started. Representatives of the FCMC also participated in the work of the committees set up by the OECD in the field of pensions.

In order to strengthen the supervisory framework, during the reporting year, internal regulatory documents in the area of on-site inspections and the application of sanctions and corrective measures were updated.

Providers of investment services

Performance indicators of investment firms

At the end of the reporting year, out of the four investment firms, two operated with profits, earning a total of EUR 3.1 million. Income from commission fees and other similar income for the services rendered to customers accounted for 99% of all revenue of investment firms, whereas administrative expenses was the highest expense item, comprising 66% of total expenses.

In 2016, three investment firms were engaged in the holding of financial instruments for customers, under the licences issued to them for the performance of non-core investment services, whereas no customer assets were transferred for management to the three firms holding licences for the individual management of the financial instruments of investors.

During the reporting year, the amount of cash owned by customers held by investment firms for the performance of transactions in financial instruments, dropped by 3.4% to EUR 11.6 million.

The capital adequacy ratio of investment brokerage companies did not change significantly during the reporting year, and at the end of December it amounted to 15.7%. Whereas for individual brokerage firms, this indicator ranged from 10.2% to 157.3% (the minimum capital adequacy requirement was 8%).

Supervisory measures applied to investment service providers

In 2016, in the area of the provision of investment services one full-scale on-site inspection and two target inspections were completed, and one scheduled inspection was started at the end of the year. During the inspections, the FCMC, in the same way as in previous years, assessed the compliance of the provided investment services with the requirements of the laws and regulations; for example, the process of granting customer status, disclosing information to the customer about financial instruments and the risks pertaining thereto, ensuring the customers with the best outcome of the transaction, the determination of the suitability and appropriateness of an investment service to the customer in terms of his knowledge, experience, investment objective and financial ability to assume a particular risk. The FCMC also assessed whether the internal processes and documents of investment service providers are current as well as their compliance with the requirements of the laws and regulations.

During the year, a number of extra-curricular activities were carried out, which were mainly related to the evaluation of reports submitted by market participants.

> In 2016, a new supervisory practice was launched, namely, meetings with the heads of the structural units of market participants providing investment services, during which market participants presented their activity in the services sector, as well as informed of the already implemented and planned internal control measures in providing investment services.

Overall, nine such meetings have been held.

Sanctions and corrective measures

No sanctions or corrective measures of other kinds have been imposed for the breaches and deficiencies in providing investment services identified in the inspections carried out in 2016. At the end of the year, the assessment of the breaches and deficiencies identified in one of the inspections carried out in 2016 was not completed. Accordingly, no final decision had been adopted regarding the need to impose sanctions or corrective measures.

In order to mitigate any inconsistencies in the area of provision of investment services by market participants and to promote investor protection and a common understanding among investment service providers of compliance with the statutory requirements in practice, the FCMC continued its work on complementing the document *Guidelines on the Application of the Provisions of the Financial Instruments Markets Law Applicable to the Provision of Certain Investment Services.* At the end of the reporting year, it sent a letter to all market participants regarding the deficiencies identified in the course of supervision in providing investment services, indicating to market participants the need to review the compliance of their activities with the statutory requirements regarding the provision of investment services and investment ancillary services.

Financial instruments market

The activities of issuers of financial instruments listed in the regulated market and supervisory measures applied thereto

At the end of 2016, *AS Nasdaq Riga* (Stock Exchange) operated in Latvia as the only regulated market. In 2016, after quite a long time, the stocks of a new issuer were listed on the Stock Exchange. At the end of the year, the stocks of 26 joint stock companies (issuers) were listed on the Stock Exchange. The bonds of two new issuers were included in the securities listing in 2016, and, at the end of the year, it included 59 various debt securities issues in a total of 17 issuers, whereof 11 issues were Latvian government debt securities and 48 issues were corporate debt securities.

The FCMC continuously monitored whether the issuers were disclosing information in a timely manner and in compliance with the requirements of the *Financial Instrument Market Law* (FIML).

In 2016, having identified the violations and assessed the duration and significance of the commenced violation, in seven cases the FCMC required issuers to take measures to eliminate the deficiencies in disclosing mandatory information in the future (i.e., applied corrective measures), and passed five decisions in the administrative case initiated against the issuer for violations in disclosing mandatory information (administrative acts were issued, applying the following sanctions: in three cases a warning was given to the issuer and in two cases a fine in an amount of EUR 3,000 and EUR 5,000, respectively, was imposed).

In 2016, seven off-site due diligence inspections of the annual reports of the issuers and six off-site due diligence inspections of the interim statements were carried out.

> During the performance of the off-site due diligence inspections of the reports of the issuers, deficiencies were identified in the preparation of the reports and individual measures were taken aimed at preventing the identified deficiencies in the respective reports, ensuring that the users of the report have available financial information of the issuers prepared in accordance with the requirements of the legal acts.

In one case, in 2016, a decision was taken to issue a warning to the issuer against whom administrative proceedings had been instigated regarding the non-compliance of the audit committee with the requirements of FIML.

In 2016, with a view to promoting the protection of investors' interests, the FCMC also sent several letters to issuers with a view to informing them about the coming into force of new requirements as well as clarifying the application of certain statutory requirements.

Trading in financial instruments

In 2016, in the Latvian regulated market, the Stock Exchange, there was a significant drop in stock market trading activity compared to 2015, which was explained by the fact that a higher trading activity in 2015 was driven by the compulsory stock redemption offer of AS Ventspils Nafta. In 2016, compared to 2015, the total number of transactions in the stock market increased by 10.8%, whereas the number of traded stocks dropped by 71.2%, and the total turnover in the stock market in 2016 was EUR 13.8 million, which was 69.6% lower than in 2015. At the end of 2016, the stock market capitalisation of the Stock Exchange, compared to the end of 2015, had dropped by 36.9% to EUR 802.7 million. The decline in stock market capitalization is related to the exclusion of the stocks of AS Ventspils Nafta from being traded on the Stock Exchange.

In 2016, the stocks of only one company were traded on the Baltic alternative market First North, and the trading activity was very low, with the total turnover amounting to EUR 2.2 thous. in 2016.

> " To promote the stability of the financial instruments market and transparency of the operations thereof, the FCMC continuously carried out supervision of trading in financial instruments by following the transactions closed by the shareholders and analysing the orders submitted to the Stock Exchange, as well as to the alternative market, and the transactions carried out therein to identify and prevent market manipulation and insider dealing.

Upon identifying the features of market manipulation or insider dealing, enhanced due diligence inspections were carried out – four in total. In one case, the FCMC indicated to the investor that signs of market manipulation had been observed in a closed transaction, and required it to immediately cease the actions that might mislead other investors regarding stock price, demand and supply (i.e., applied corrective measures). At the end of the year, two inspections had not been fully completed.

Regular supervision is being carried out to establish whether information on changes in significant holdings (5% or more) have been identified and whether the persons carrying out the management duties of an issuer have reported their transactions performed. In 2016, in verifying whether the persons carrying out the management duties have notified their transactions performed and whether the persons have notified, as required under the FIML, the acquiring or losing of a significant shareholding, the FCMC passed decisions in two administrative proceedings which had been instigated in 2015, against the persons for the failure to report on the transactions of a person included in the list of inside information holders in a timely manner, i.e., in one case, a warning was issued to the relevant person and, in the other case, a fine of EUR 1,000 imposed.

Supervision of compliance

In the AML/CTF area, in 2016, work started in the previous year was continued in terms of the improvement of the regulatory framework as well as the supervisory processes of compliance with AML/CTF requirements for banks, and in the strengthening of the supervisory function carried out by the FCMC in the area of AML/CTF.

In 2016, the FCMC particularly strengthened its capacity in the field of AML/CTF, i.e., in April it established the Compliance Control Department which monitors the compliance of activities as well as statutory compliance of the participants of the financial market in the AML/CTF field in the banking as well as non-banking sectors, and the analysis of customer information and transactions conducted by financial market participants, develops laws and regulations as well as ensures the compliance with the national and international sanctions in the AML/cTF area. In the department, there are currently 18 employees, which is a significant increase compared with the previous year, when five employees carried out the supervision of the relevant area.

In 2016, the inspections of the Latvian banks focusing their services on foreign customers, and the AML/CTF compliance inspections carried out by professional US consultancy companies with considerable experience in the AML/CTF field which were started in 2015 were completed.

> " An independent audit to assess compliance with the AML/CTF requirements is generally accepted international practice and is an essential step in improving the cooperation of Latvian banks providing services to foreign customers with US-based correspondent banks that provide direct US dollar payments.

During the inspections, the consultants assessed the internal control systems of banks in the area of AML/CTF and made recommendations for the improvement and development thereof. The inspections carried out by the FCMC have also previously highlighted the areas to be improved. At the same time, the audit results will help to fine-tune the identified areas concurrently in the entire non-resident banking sector. As a result of the completed inspections, the relevant bank has developed plans for improving AML/CTF prevention control systems, and the FCMC has been strictly following the execution thereof.

The Compliance Control Department, in carrying out the supervision over the compliance of financial market participants, has assessed the principles of the customer risk-based numerical assessment systems developed by banks and the strategies for managing the AML/CTF as well as the conformity of the large risk exposure limits of the AML/CTF to the capacity of the internal control system of the relevant bank, by identifying the required improvements and monitoring the dynamics of the AML/CTF large exposure indicators on a regular basis. The Compliance Control Department monitors the results of AML/CTF risk stress tests carried out by banks and decisions regarding AML/CTF risk at the credit institution based on the results.

The amendments carried out in 2016 to the *Law on the Prevention of Money Laundering and Terrorism Financing* are to be mentioned as significant, including, on the basis of the requirements of the EU AML/CTF Directive IV as regards the extended definition of the politically exposed persons (PEPs), not only local officials, but also seven new PEP categories (judges, heads of municipalities, etc.). Also the circle of the family members of the PEP was extended to include grandchildren, grandparents, and adopted children, as well as close associates thereof, including not only counterparties, but also the persons with whom PEP has established close relations. In accordance with the requirements of the *Law on Prevention of Money Laundering and Terrorism Financing,* banks are required to conduct an enhanced due diligence and continuous monitoring of such persons. In order to ensure that happened, banks had to identify such persons, and they therefore asked their customers to complete a questionnaire.

At the same time, the FCMC continued its regular monitoring in the AML/CTF prevention area, and

> " in 2016, a fine was imposed on four banks for the failure to comply with the requirements laid down in the AML/CTF prevention law, to a total of EUR 5,933,636, as well as a set of duties was imposed to be carried out in order to fine-tune and improve the internal control systems of the banks.

In addition, in one case, a fine of EUR 25,000 was imposed on a board member of the bank, whereas in another case a warning was issued to the board member responsible for AML/CTF prevention. For one bank, restrictions were imposed on the performance of the rights, activities, and obligations thereof. In 2016, at the initiative of the FCMC, the European Central Bank approved the decision to withdraw the licence from one credit institution. The Compliance Control Department carries out strict monitoring of compliance with the corrective measures and obligations in the field of AML/CTF prevention by credit institutions.

The FCMC has also strengthened its supervisory function over the AML/CTF prevention of non-bank monetary financial institutions, by creating the Non-Bank Supervision Division in 2016. Concurrently, work has been started on improving the regulatory framework of AML/CTF prevention for the non-banking sector as well. For example, the regulatory requirements for high-risk customer enhanced due diligence have been improved, which set out detailed requirements for assessing the risk of segmented customers, which are currently binding on licensed payment institutions and electronic money institutions. Similarly, the "Regulatory Provisions for Cooperation with Third Parties and Requirements for Business Relations with Customers for the Identification or Due Diligence of which Third-Party Services" have been Used, developed and approved by the FCMC, are also binding on payment and electronic money institutions.

Carrying on regular monitoring in the AML/CTF area in the non-banking sector, in 2016, the provision of payment services was suspended in one payment institution because significant deficiencies had been identified in the company's AML/CTF internal control system as well as other violations of laws and regulations.

Security of financial services and information systems

In 2016, the FCMC carried out scheduled on-site information system security audits in six banks (out of which one was within the scope of the SSM), in one insurance company and one payment institution. Increased attention was paid to the security of the provision of remote services, supervision and ensuring business continuity of automated transactions.

Considerable effort was made in assessing the conformity of the applications of market participants for the registration or licensing of new services or new market participants to the requirements of statutory regulations on information systems.

> In 2016, the FCMC advised market participants on the new requirements for the security of Internet payments and evaluated the solutions selected by market participants to comply with these requirements.

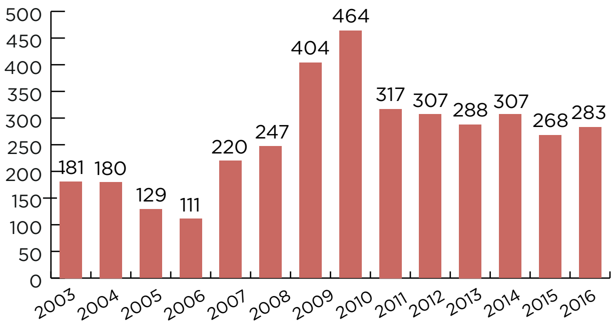
During the reporting year, the FCMC maintained close cooperation with the authority for the prevention of security incidents of information technologies CERT.LV and took part in the meetings of the working groups of the Information Technologies and Information Systems Security Expert Group (SEG), sharing experience regarding topical information systems security hazards and methods for the prevention thereof.

Reviewing of customer complaints relating to the activities of market participants

The protection of the rights of the customers of market participants and the reviewing of complaints of the actions of market participants remained a part of the FCMC supervision carried out in 2016.

In 2016, the FCMC received and reviewed 283 applications regarding the acts of various participants of the financial and capital market: 161 complaints about credit institutions, 42 complaints about insurance companies, 17 complaints about the participants of the financial instruments market, 14 complaints about payment institutions and electronic money institutions (12 of them for the payment institution SIA AirPay, regarding which, in 2016, the FCMC passed a decision to cancel its entry in the payment institution register) and four complaints about investment management companies. Two complaints were received about the activities of leasing companies, whereas one complaint was about a cooperative credit union. Similarly, in 2016, the FCMC received and reviewed 11 complaints about already liquidated market participants, as well as seven complaints about market participants undergoing liquidation. Whereas 23 submissions were received from the customers of AS TRASTA KOMERCBANKA in 2016, mainly regarding matters concerning the payment of guaranteed compensation. In 2016, one complaint was received from the customer of AS Latvijas Krājbanka regarding the disbursement of the guaranteed compensation.

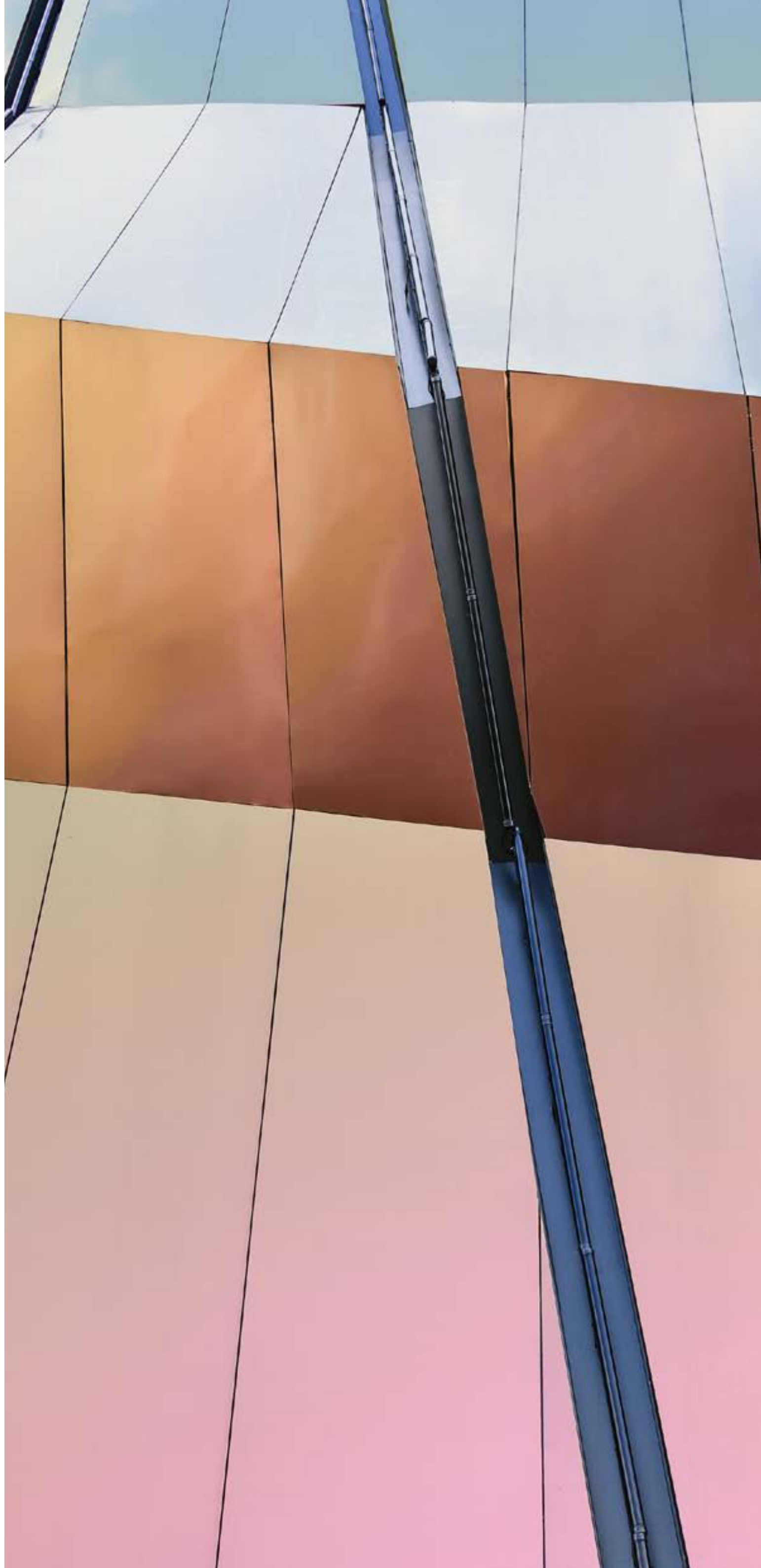
Figure 19.
Number of complaints received by year



In all cases, the FCMC asked the market participants to provide explanations, after the assessment whereof, the FCMC provided answers or advice on its merits to the customers, within the scope of FCMC competence.

Taking into account that within the process of supervision of credit institutions it is being controlled, whether the credit institutions meet the requirements of the *Credit Institution Law* and the laws and regulations subordinated thereto, FCMC experts verified whether the actions of the credit institutions have the features of violations of these laws and regulations. Having reviewed 144 complaints, the FCMC did not identify any violations of the Credit Institutions Law and the laws and regulations subordinated thereto in the actions of the credit institutions, but the FCMC will use the findings mentioned in 12 complaints for supervisory purposes. Having reviewed what was mentioned in five complaints, the FCMC identified deficiencies in the management of operational risk at the relevant credit institution.

Whereas, having reviewed customer complaints about the activity of insurance companies, the FCMC did not identify any violations of laws and regulations for which the sanctions provided for in the *Law on Insurance Companies and the Supervision Thereof* should be imposed in any of the cases mentioned in the complaints. In 24 cases the customer and the insurer proceeded with resolving their mutual disagreements in civil proceedings.



6 LICENSING

In 2016, minor changes could be observed in all segments of the financial market. As for bank licensing, improving of the SSM was carried out, and the key event to be mentioned was the decision passed by the ECB regarding the withdrawing of the licence from AS TRASTA KOMERCBANKA. In 2016, the ECB also passed a number of decisions regarding the granting of qualifying holding permission and the approval of the appointment of significant officials to credit institutions. The FCMC has continued to be actively involved in this process, still being the authority responsible for examining the submitted documents and for preparing a draft decision, which is subsequently submitted to the ECB for final decision-making. In 2016, there were changes in the field of insurance: licences were withdrawn from: AAS "Gjensidige Baltic" and from the Latvian branch GT BALTICS of GROUPAMA SA which discontinued its activity in Latvia, and from the branch of *Compensa Towarzystwo Ubezpieczen S.A Vienna Insurance Group*. These changes were mainly related to the streamlining of the activity of the companies.

> "There has also been a change in the number of registered payment institutions and electronic money institutions, i.e., registration has been cancelled for seven payment institutions, and these changes were mainly related to the willingness of the companies to restructure their activity, whereas in some case the cancellation was related to identified continuous breaches of laws and regulations.

In 2016, the FCMC registered one alternative investment fund manager – SIA SG Capital Partners AIFP.

Table 1.

Changes in the number of licensed market participants in 2016

	AT THE BEGINNING OF 2016	AT THE END OF 2016	NEW MARKET ENTRANTS IN 2016
Banks	17	16 (one bank less)	0[3]
Branches of EU Member State banks	9	7 (two branches less)	0[4]
Cooperative credit unions	34	34	0
EEA-based providers of banking services	312	327 (seven companies less)	+22
Insurance companies	8	7 (one company less)	0[5]
Branches of EU Member State-based insurers	14	12 (two companies less)	0[6]
EEA-based providers of insurance services	501	526 (16 companies less)	+41
Investment management companies	12	12	0
EEA-based providers of investment management services	23	20 (three companies less)	0
Investment firms	4	4	0
EU Member State-based investment firms	2	2	0
EEA-based providers of investment firm services	1857	1960 (42 companies less)	+145

3 On 3 March 2016, the licence of AS TRASTA KOMERCBANKA was withdrawn.
4 The branches of EU Member State-based banks:
On 1 March 2016, the Latvian branch of *AS LHV Pank discontinued its activity*.
On 21 June 2016, it was confirmed that AS DNB Bank's Latvian branch does not provide financial services in the Republic of Latvia but only provides the functions of a technical branch in the Republic of Latvia.
4 April 2016. The branch of Pohjola Bank plc in Latvia changed its name to OP Corporate Bank Plc branch in Latvia.
5 Insurance companies:
On 2 September 2016, the licence of AAS Gjensidige Baltic was withdrawn.
6 the branches of EU Member State-based insurance companies:
On 8 November 2016, the Latvian branch GT BALTICS of GROUPAMA SA discontinued its activity.
On 14 September 2016, Compensa Towarzystwo Ubezpieczen S.A Vienna Insurance Group branch in Latvia discontinued its activity.

	AT THE BEGINNING OF 2016	AT THE END OF 2016	NEW MARKET ENTRANTS IN 2016
Agents engaged by the EEA-based providers of investment services	26	30	+4
Private pension funds	6	6	0
Insurance brokerage firms	89	84 (eight companies fewer)	+3[7]
Insurance agents	512	490 (42 agents fewer)	+20
EEA-based providers of payment services	291	331 (ten companies fewer)	+50
Payment institutions (registered)	33	26 (seven companies fewer)[8]	0
Payment institutions (licensed)	3	3	0
Electronic money institutions (registered)	12	12	0
Electronic money institutions (licensed)	3	3	0
EEA-based electronic money institutions	70	104 (two companies fewer)	+36
Licensed alternative investment fund managers	5	5	0
Registered alternative investment fund managers	7	8	+1[9]

7 Insurance brokerage firms:
On 8 November 2016, SIA AKA *Insurance* was registered.
On 27 October 2016, SIA FortsUno was registered.
On 16 November 2016, SIA Norde Apdrošināšana was registered.
In 2016, the entries relating to the following insurance brokerage firms were deleted from the Register of Insurance Brokerage Firms: SIA Savour, SIA Cinko Baltic, SIA Apdrošināšanas brokers Areāls, SIA HIIT , SIA RL Grupa, SIA Boreas Brokers, SIA Apdrošināšana un risku pārvalde, SIA Investment Broker.

8 Payment institutions:
In 2016, the entries related to the following payment institutions were deleted from the Register of Payment Institutions: AS Madonas ūdens, SIA Madonas siltums, SIA AirPay, SIA RFM TRANSFER LATVIA, SIA Post Service Kurzeme, SIA Digimoney, SIA VENIPAK LATVIJA.

9 Alternative investment fund managers:
In 16 November 2016, the FCMC registered one alternative investment fund manager, i.e., SIA SG Capital Partners AIFP.

RESOLUTION MECHANISM

The principles of the resolution mechanism

Pursuant to the EU directive (*Bank Recovery and Resolution Directive* (BRRD)) regarding the framework for the recovery and resolution of credit institutions and investment firms, establishing one of the three stability pillars of the financial system, i.e., the resolution mechanism.

The main objectives of the implementation of the resolution mechanism are as follows:

- To set a uniform approach and effective instruments throughout the entire EU, to prevent the consequences related to the banking crisis in a timely manner;
- To protect the stability of the financial system and ensure the continuity of critically important functions;
- To considerably minimise the possibility of tax payers incurring losses, by requiring that the expenses for rescuing a bank that is important to the national economy are covered by the shareholders and creditors of the bank;
- To establish an effective cross-border banking group resolution mechanism.

> " The institution in charge of the resolutions in Latvia is the FCMC, and it is responsible for the preparation of resolution plans, as well as for carrying out resolution activities or the rescuing of such institutions, the resolution whereof is required in the interests of the general public, or for decision-making on non-application of the resolution.

The resolution mechanism is also applicable to investment firms, subject to the minimum equity requirement in the amount of EUR 750,000. For the time being, there is no such investment firms in Latvia.

The Regulation of the European Parliament and of the Council establishing the Single Resolution Mechanism came into force on 1 January 2016.

Single Resolution Mechanism

Taking into account that Latvia is a Eurozone country, it automatically obtains the status of a member state of the single resolution mechanism. A SRB has been established, which, in cooperation with the involved national resolution authorities of the EU member States (including the FCMC), implements an efficient and coordinated functioning of the single resolution mechanism, and is responsible for the management and use of the funds of the Single Resolution Fund, as well as for the performance of the functions of the resolution authority with respect to banks falling under the direct competence of the SRB.

> The objective of the SRB is to ensure financial resources which, in the case of crisis, may be used to finance the resolution of the bank. The SRB is financed from the contributions of the Member States' banks (including Latvian banks), aimed at gradually achieving (by 2024) an amount comprising 1% of the covered deposits in all credit institutions in all involved Member States, which amounts to approximately EUR 55 billion.

The SRB carries out the functions of a resolution authority over Latvian banks which are subject to the direct supervision by the ECB within the scope of the SSMV, whereas the FCMC ensures the preparation of the SRB decisions and the implementation of the passed decisions, Decision-making regarding the application or non-application of the resolution to other Latvian banks falls within the competence of the FCMC.

To ensure an effective resolution of such banking groups, which are engaged in cross-border operations, resolution colleges have been set up within the EU, engaging experts of the FCMC in the activities thereof.

Planning of the resolution

The objective of the resolution plan of the credit institution is to prepare for action in the case of crisis in a timely manner:

- To define the critically important functions of the institution and describe how the continuity thereof will be ensured;
- To assess the possibility and commensurability of applying resolution activities to the institution;
- To select the resolution strategy and suitable resolution instruments (segregation of assets, selling of the undertaking, a temporary institution, internal recapitalisation);
- to determine the minimum requirements for own funds and eligible liabilities (MREL requirement) for the credit institution, to be constantly ensured by the institution so that, in the case of internal recapitalisation, bank capital is restored at the expense of the creditors.

In 2016, four bank resolution plans were developed.

CHANGES TO REGULATORY REQUIREMENTS

In 2016, the FCMC continued to improve the regulatory framework governing the activities of the participants of the financial and capital market. Changes to the framework of the regulatory requirements are based not only on the experience gained during the financial crisis, but also on the trends observed in financial and capital markets and the principles of best international practice.

> With a view to ensuring the stable development of the Latvian financial and capital market, the FCMC, based on the laws and regulations issued by the EU institutions and having considered the nature and the dynamic environment of the Latvian financial sector, and within the scope of the powers conferred on it, refined national laws and regulations, which would not only regulate the activities of Latvian market participants, but also promote the protection of the interests of investors, depositors and the insured.

In the AML/CTF area, work previously started on the refining of the regulatory framework was continued in 2016.

National laws and regulations

In continuing the transposition of the requirements of the AML/CTF directive and the FATF *(Financial Action Task Force)*, the FCMC developed **amendments to the Law on Anti-Money Laundering and Combating Terrorist Financing**, imposing a duty on banks to carry out an assessment of the aptness of the person or the board member responsible for compliance with the requirements of the AMT/CTF law, as well as provide for the powers and the breakdown of the duties of the persons in charge of the AMT/CTF, as well as the procedure under which the supervision of the responsible persons is ensured. These requirements were provided for to ensure that the person responsible for AML/CTF has appropriate professional experience and education in order to fulfil their responsibilities and to ensure that the institution is compliant with the requirements of the AML/CTF law. Furthermore, a clearly defined list of competencies facilitates the possibility of identifying the responsible person at the bank to which sanctions are to be applied for the identified non-compliance. Also, the right of the FCMC to issue regulatory provisions on the provision of information for monitoring and controlling AML/CTF has been provided for. Concurrently, with a view to ensuring the implementation of uniform standards in credit institutions and financial institutions regarding the measures to be taken to comply with the requirements of the AML/CTF law, and to enable the FCMC to impose sanctions and corrective measures in cases where the relevant credit institution or financial institution fails to fulfil the specified requirements, a number of areas has been provided for entitling the FCMC with the right to issue laws and regulations. The FCMC also drafted necessary amendments to the *Credit Institution Law*, according to which the penalties applicable to banks for violations of the AML/CTF compliance have been increased.

Amendments to the Law on Payment Services and Electronic Money, which came into force on 28 March 2017, have been made to implement the requirements of the Payment Accounts Directive (2014/92/EU) regarding the comparability, exchange, and disclosure of information and access to accounts for consumer payment accounts.

Additional amendments provide for a change in the calculation of the fees chargeable for the supervision of payment and electronic money institutions.

Within the scope of its competence, the FCMC got involved in the drafting of the bills of the Ministry of Finance in order to implement new regulations in the field of mutual crowdfunding services as well as in the field of audit services. At the same time, the FCMC identified the new responsibilities thereof arising from the European Parliament and Council Regulation (EU) No. 537/2014 on specific requirements for statutory audits of public-interest entities and repealing Commission Decision 2005/909/EC. Following the introduction of new regulations in the field of audit services (the Law on Sworn Auditors and amendments to the Financial Instruments Market Law), informing of all public-interest entities under the supervision of the FCMC has been insured in the form of presentations on the new requirements and their nature thereof.

At the European Union level, the year 2016 has not been a particularly active year in terms of the entry into force of new first-level EU directly applicable legislation. Although the implementation of important financial sector regulations, such as the EU Regulation on Markets in Financial Instruments *(MiFIR)*, providing for the establishment of a new and extensive infrastructure for the collection and exchange of financial instrument trading data, and the EU regulation on packaged retail investment and insurance and *(PRIIP)* background documents providing for the key elements, which should be presented in the background document, as well as of a single format to promote the comparability of products should have been started at the end of 2016, the implementation deadlines thereof have been postponed until the end of 2017/the beginning of 2018. The deferral of the implementation deadline is related to the complexity of the technical standards and delays in the development thereof, which has resulted in insufficient time for market participants to prepare for ensuring compliance with the new requirements.

Concurrently, a number of delegated and implementation regulations of the European Commission were adopted and came into force in 2016, laying down the technical standards for the application of certain previously adopted EU first-level legislation, including *CRR/CRD IV, Solvency II* and other legislation. The relevant legislation has been published on the FCMC website http://www.fktk.lv/lv/tiesibu-akti/jaunumi.html by market segment.

> The key changes to the framework of the regulatory requirements related to the areas of information disclosure and supervisory reports, especially for insurance market participants.

Whereas, in the field of credit institutions, changes related to the disclosure of additional information and supervisory reporting also apply to capital adequacy and liquidity adequacy and the assessment process thereof, within the scope of which new requirements are being applied to credit institutions in determining the amount of capital required to cover business and potential risks inherent in the activity thereof.

Solvency II

On 1 January 2016, the requirements of the *Solvency II* came into force laying down significant changes in the EU insurance and reinsurance sector in relation to the solvency and supervisory regimes. In order to transpose the requirements of this Directive into national law, the **Insurance and Reinsurance** which comprised a number of the requirements laid down in the *Law On Insurance Companies and Supervision Thereof* and in the *Reinsurance Law*, thus not only incorporating the principles of the *Solvency II* Directive, but also establishing a single regulatory framework for the Latvian insurance and reinsurance sector. This law will significantly improve the protection of the interests of policyholders.

> Unlike the Solvency I regime, the new requirements lay down the procedure for determining the capital requirements based not only on the amount of premiums or indemnities, but also on market risks, credit risk and operational risk, thereby covering all investment-related risks, to which an insurer or a reinsurer is exposed.

The changes introduced by *Solvency II* also apply to areas such as the calculation of technical provisions, valuation of assets and liabilities, governance systems, own funds, disclosures, supervision of cross-border groups, as well as monitoring reports, in regard to which the FCMC has developed a number of laws and regulations which are necessary to enable the FCMC to ensure the supervision of the insurance and reinsurance sectors in accordance with the new requirements.

Regulations for the preparation of reports by insurers and reinsurers are aimed at obtaining information for carrying out supervision, preparation of financial accounts, balance of payments and Eurostat statistical report, as well as for obtaining statistical information for the Latvian insurance market outlook. The regulatory regulations lay down the content, form, submission procedures, and deadlines for the annual, quarterly and monthly activity reports to be submitted, as well as for the transition to a single electronic reporting format (Extended Business Reporting Language (XBRL)). For format implementation purposes, insurance market participants must invest in improving their information systems. The regulatory framework is binding on insurers and reinsurers upon submitting individual reports, as well as on insurance and reinsurance participating companies, insurance holding companies, and mixed financial holding companies that submit the information necessary for group supervision.

"Regulatory Provisions on the Preparation of the Annual and Consolidated Financial Statements Annual Report of Insurance and Reinsurance Companies and the Branches of Non-Member State Insurers" and amendments to **"The Regulatory Provisions for the Preparation of the Annual and Consolidated Financial Statements of Credit Institutions, Investment Firms, and Investment Management Companies".** The International Accounting Standards approved by the European Commission lay down the principles for the preparation of the consolidated financial statements of insurers, reinsurers, credit institutions, investment firms, and investment management companies; however, EU legislation provides for additional requirements related to the information to be included in the management report, calculation of the technical reserves by insurers, and for the preparation of the non-financial statements of companies, which contain information on environmental, social, human rights, and anti-corruption-related issues. The regulatory provisions have been developed in order to successfully implement the above requirements into Latvian national legislation, thereby promoting responsible and transparent business practices.

Regulatory Provisions on the Preparation of the Public Quarterly Reports of Insurers. In connection with the Insurance and Reinsurance Act, which came into force on 1 January 2016, there was a need to issue a new version of the "Regulatory Provisions on the Preparation of Public Quarterly Reports of Insurers", in which, in addition to the clarifications made, a requirement to submit information according to the prescribed reporting forms established by the FCMC has been introduced, so that it (in the same way as in the credit institutions sector) could publish information on the activities of insurers on its website, thus ensuring the possibility for stakeholders to familiarise themselves with the key performance indicators of the insurance sector and the participants thereof in a single place.

Regulatory Provisions for Establishing the Capital and Liquidity Adequacy Assessment Process refine the existing requirements as well as introduce new requirements that credit institutions must comply with in defining the amount of capital required to cover the risks inherent in the activity thereof as well as potential risks, as well as requirements for the assessment of liquidity adequacy. The key changes are related to the requirements regarding the need to carry out a regular assessment of the identification of liquidity risk, and the assessment of the identification and management processes, and the determination of the amount of the liquidity buffer. Based on the new regulatory provisions, credit institutions need to focus on measuring the viability of their business model when determining the amount of capital needed, which is a particularly important consideration in the case of extremely low market rates. In addition to the above, the new requirements also change the general procedure for calculating the amount of necessary capital, lays down the capital structure for addressing Tier 2 risks, which corresponds to the covering of the capital structure for addressing Tier 1 risks, and provides for covering the recommended capital buffer with Tier 1 base capital, thus promoting the ability of credit institutions to absorb the potential losses under stress conditions. During the on-site meeting, the FCMC specialists presented the new requirements to the market participants, thus ensuring a uniform and clear compliance with the requirements.

The Regulatory Provisions on the Importance of Information, Proprietary and Confidential Information, and the Periodicity of Disclosure specify how credit institutions and investment brokerage firms to which the requirements set out in Paragraph eight of by the EU Regulation No. 575/2013 (within the scope of Pillar III) are binding, apply the exemption from certain disclosure requirements and assess the periodicity of disclosures. The assessment of information disclosure requirements specified in the regulatory provisions shall also be applied by credit institution in regard of the disclosures to be made in public quarterly reports.

The Regulatory Provisions for the Preparation of Supervisory Financial Statements. In accordance with Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down implementing technical standards for the prudential oversight of the institutions pursuant to Regulation (EU) No 575 / 2013 of the European Parliament and of the Council, the FCMC receives financial reports of credit institutions (FINREP) at a consolidated level. However, FCMC experience suggests that for carrying out the supervisory functions, information is also required at the individual level. Therefore, regulatory provisions have been developed, laying down a requirement for credit institutions and the branches of the credit institutions registered in other Member States and the branches of foreign credit institutions to also provide financial information at an individual level. Additional information is necessary not only for carrying out supervision, the preparation of statistical reports and the calculation of indicators (for example, for the ECB's *Consolidated Banking Data Report*), but also for the assessment of the impact of new regulatory provisions, which can provide a more accurate and comparable data set of Latvian credit institutions sector in the external accounts (ECB, EBA) as well as inform market participants about the potential impact of the new regulatory requirements.

The Regulatory provisions for Receiving the Permission to Use Internal Models, Approaches and Methods for the Calculation of Capital Requirements in Accordance with the Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation No 648/2012. The regulatory provisions set out the requirements for documents to be submitted to the FCMC for using the internal models, methods, and approaches for the calculation of own funds requirements, thereby promoting a single approach to the application of the regulatory requirements. The regulatory provisions have been supplemented with a section which extends the scope of the provisions by providing for the documents to be submitted for all internal models, methods, and approaches developed by credit institutions that need to be approved by the Commission before they can be used for the calculation of the own funds requirement.

In the form of FCMC provisions, the previously developed **recommendations regarding the use of agent services for the identification of clients, as well as the information technology and staffing necessary for AML/CTF risk management,** which should be sufficient to manage the existing and expected AML/CTF exposure of the bank, thus conferring the status of compulsory enforceable requirement to the above requirements.

The FCMC developed and issued **regulatory provisions for the aggregation and provision of information on the customers of a credit institution and the transactions carried out by them to the FCMC**, which lays down the requirements as to how a credit institution should collect information about its customers and their transactions and the procedure by which this information is to be submitted to the FCMC. Receiving timely and accurate information is a key condition to enable the FCMC to ensure continuous supervision of credit institutions and to react promptly where necessary, if the information indicates the need for an in-depth examination of the circumstances or due diligence, thus ensuring that supervisory and control measures taken by the FCMC are timely and effective.

Recommendations (guidelines) for imposing sanctions on financial and capital market participants and on the natural persons and legal entities responsible for the violations of financial and capital market regulation were issued pursuant to the delegation specified in Section 17.1 of the *Law on the Financial and Capital Market*, and these recommendations set forth the procedure and principles that the FCMC shall follow when considering the issue on imposing a penalty on the financial and capital market participant or the natural person or legal entity responsible for the violation.

Macro-prudential instruments

The global financial crisis demonstrated that micro-prudential supervision, which mostly focused on ensuring stability at the level of an individual financial institution, was not sufficient to ensure the stability of the financial system as a whole. . Therefore, in addition to the previous supervisory approach, macro-prudential supervision was introduced, which requires taking appropriate measures if cyclical (e.g. an excessive increase in lending) or structural (for example, in relation to systemically important credit institutions) systemic risks increase. In such cases, appropriate instruments may be applied, i.e., specified capital buffer requirements, increased minimum capital and liquidity requirements, and more stringent restrictions on large exposures.

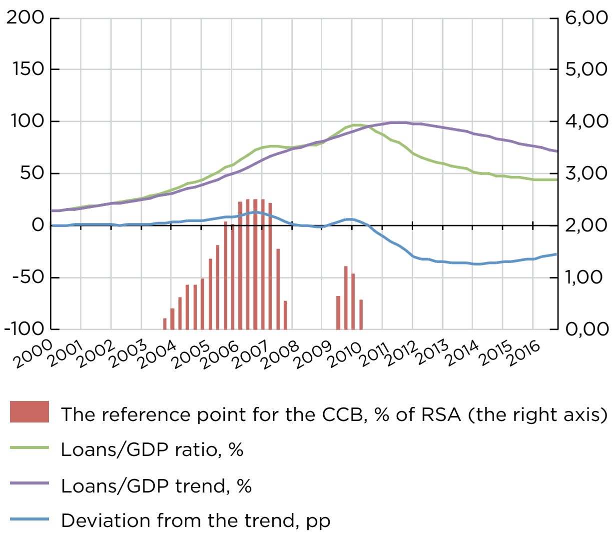
In regard to cyclical risks under Section 35[5] of the *Credit Institution Law,* the FCMC, starting from 2015, has been determining and publishing, once a quarter, the **countercyclical capital buffer requirement** for transactions with domestic customers.

> The counter-cyclical capital buffer is intended to ensure that a credit institution builds up a sufficient capital base during the period of economic growth so that it could absorb losses during an economic slowdown or stagnation.

The counter-cyclical capital buffer is intended as a kind of a buffer for credit institutions to enable them to continue lending also under adverse economic circumstances. For the assessment of cyclical risks in the Latvian national economy, the FCMC applies a counter-cyclical capital reference point, which takes account of lending trends as well as GDP trends. During 2016, as well as at the beginning of 2017, due to weak lending and economic growth, the FCMC maintained the counter-cyclical capital buffer rate for transactions with Latvian domestic customers at 0%.

Figure 20.

Reference point for the counter-cyclical capital buffer (calculated using data for the 3rd quarter of 2016)[10]



There are systemically important credit institutions in the financial sector, the encountering of financial difficulties by which affect not only other financial market participants, but also the real economy.

> "The criteria for a credit institution to be considered systemically important are related to the size, substitutability, and importance thereof to the financial infrastructure, the complexity of its activities, and the cross-border activities thereof, and its interconnection with other institutions. Given the activity of systemically important institutions and the important role they play in the financial sector, additional requirements, such as higher capital buffers, corresponding to the importance of the relevant institution need to be introduced

The use of macro-prudential instruments will enable major credit institutions to become significantly more resilient in unpredicted circumstances. Under Section 35[9] of the *Credit Institution Law,* the FCMC identifies credit institutions which qualify as O-SII (other systemically important institutions)[11] once a year, and can set an O-SII capital buffer requirement for them of up to 2% of the exposure amount. In 2016, the FCMC identified and published a list of six systemically important credit institutions in the domestic financial sector, for which a systemic capital buffer rate and more stringent corporate governance requirements have been defined. Compared to 2015, the list of other systemically important institutions remained unchanged in 2016. A transitional period ending 30 June 2018 has been set to give time for the identified institutions to be able to get prepared for compliance with the capital buffer rate.

10 The reference point for the CCB is calculated using loans/GDP deviation from the long-term trend (based on the "narrow" loan definition).

11 The FCMC carries out the identification of O-SII in accordance with the European Banking Authority Guidelines (EBA/PN/2014/10). The Basel Committee on Banking Supervision (BCBS) has identified, in co-operation with the Financial Stability Board (FSB), and has published the list of globally systemically important credit institutions (21 November 2016), which does not include any of the credit institutions licensed in Latvia, except the Nordea Group, operating *Nordea Bank AB Latvian* branch.

Table 2.
Transitional provisions for the capital buffer of other systemically important institutions

CREDIT INSTITUTION	THE C-SIIB RATE TO BE MAINTAINED, IN % OF THE WEIGHTED RISK ASSETS (AS OF 30 JUNE 2017)	THE C-SIIB RATE TO BE MAINTAINED, IN % OF THE WEIGHTED RISK ASSETS (AS OF 30 JUNE 2018)
ABLV Bank AS	1%	2%
Swedbank AS	1%	2%
AS SEB banka	1%	2%
Joint stock company Rietumu Banka	0.75%	1.75%
Joint stock company Citadele banka	0.75%	1.50%
AS DNB banka	0.75%	1.50%

European Commission initiatives in 2016

In 2016, the European Commission announced a number of new legislative initiatives, which were also discussed and analysed by FCMC experts as part of the EU Council's Financial Services Task Force.

A proposal was made for amending Directive (EU) 2015/849 of the European Parliament and of the Council on the prevention of the use of the financial system for the purpose of money laundering or terrorist financing. The amendments aim to extend the scope of the directive to virtual currency exchange platforms, strengthen the functions of controlling services, harmonize rules for conducting enhanced customer due diligence measures for clients from high-risk third countries as well as other issues. Also, at the end of 2016, the discussion of the proposals in regard to the EU regulation on the establishment of a regime for the renewal and settlement regime of central counterparties was started.

Carrying on the work of implementing ***Basel III***, as well as eliminating the identified deficiencies, the European Commission has announced a set of reforms aimed at further strengthening the resilience of the EU financial system by making changes to the capital requirements of credit institutions and to the activity recovery and resolution regimes.

The reforms provide for the carrying out of significant amendments:

- EUROPEAN PARLIAMENT AND COUNCIL DIRECTIVE 2013/36/EU of 26 June 2013 on access to credit institutions for the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC **(CRD)**;
- REGULATION (EU) OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 **(CRR)**;
- DIRECTIVE 2014/59/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 15 May 2014 establishing a regime for the reinstatement and settlement of credit institutions and investment firms and amending Council Directive 82/891 / EEC and Directives 2001/24 of the European Parliament and of the Council / EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2005/56/EC, 2007/36/EC, 2011/35/ EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012 of the European Parliament and of the Council **(BRRD)**;
- REGULATION (EU) OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL No 806/2014 of 15 July 2014 establishing a common framework and a single procedure for the settlement of credit institutions and investment firms with a resolution mechanism and a single resolution fund and amending Regulation (EU) No 1093/2010 **(SRMR)**.

In order to enhance the stability of the EU institutions, the proposals include:

- Defining of capital requirements through risk-sensitive approaches, in particular in areas such as market risks, counterparty credit risk and exposures to central counterparties (CCP);

- A binding leverage ratio (LR) to prevent credit institutions from using excessive leverage;
- A binding net stable funding ratio (NSFR) to prevent excessive reliance by credit institutions on short-term inter-bank financing for long-term investments and reduce the risk of long-term financing;
- Delegating the developing of methodological updates aimed at complementing the new approaches to risk-sensitivity to the EBA.

In addition to the above-mentioned prudential requirements, the proposal proposes measures that might enhance the ability of credit institutions to finance the EU economy:

- Increasing the ability of credit institutions to issue loans for the financing of SMEs and infrastructure projects;
- Alleviating requirements in the remuneration area and reducing administrative burdens for small institutions carrying out simple operations;
- Making the CRD/CRR rules more proportionate and less burdensome for small and simple institutions, for which certain existing rules related to disclosure, reporting and complex trading portfolio activities are unfounded.

The proposal also provides for the measures aimed at promoting the creation of a capital market union, which would enable institutions to provide a deeper and more liquid EU capital market. The following is proposed to achieve the goals:

- To provide proportional capital requirements for trading portfolio positions, including those which are related to market-making activities;
- To reduce the cost of issuing and holding individual instruments (covered bonds, high-quality securitisation instruments, government debt instruments, instruments held for hedging);
- To reduce the factors that prevent the CCP from clearing transactions for institutions that act as the intermediaries of customers.

GUARANTEE SYSTEM

The structure of financial stability in Latvia is composed of:

1. The Deposit Guarantee Fund;
2. The Fund for the Protection of the Insured;
3. The protection system of the customers of the financial instruments market (investors);

The Deposit Guarantee Fund

The guaranteed compensation for depositors of Latvian banks and credit unions (deposit-takers) (with certain exceptions provided for in Section 23 of the *Deposit Guarantee Law*) has been set at EUR 100,000 per deposit-taker. In the cases specified in Section 4 of the *Deposit Guarantee Law*, the guaranteed compensation has been set at EUR 300,000.

> The State guarantees compensation specified in the Deposit Guarantee Law to each deposit-taker irrespective of whether there are sufficient funds in the Deposit Guarantee Fund (DGF) at the particular time.

Under the *Deposit Guarantee Law*, in cases when the funds are not sufficient, they would be provided by the FCMC borrowing them from a bank registered in Latvia or the Latvian branch of a foreign bank, however, if the funds are still not sufficient, by borrowing from the Treasury.

> At the end of 2016, the share of depositors whose deposits did not exceed EUR 100,000 accounted for 70%[12] of all depositors in Latvian banks, therefore the DGF guaranteed a 100% repayment of deposits for 2.19 million depositors.

Under the *Deposit Guarantee Law* deposit-takers (banks and credit unions) are required to make a quarterly payment to the DGF amounting to 0.05% of the average balance of guaranteed deposits with the deposit taker in the previous quarter. In addition, the FCMC also determines the adjustment ratio applicable to the payment by each particular deposit-taker. When establishing the adjustment ratio applicable to the payment, the FCMC considers each deposit-taker's capital adequacy ratio, liquidity and large exposure indicators, the quality of the loan portfolio of the deposit taker in the previous calendar year, as well as the business plan and strategy of the deposit-taker. Deposit-takers paid EUR 16,308 million into the DGF for 2016.

In 2016, the FCMC ensured the accumulation and management of the funds of the DGF, and at the end of the year, the amount held in the NGF account with the Bank of Latvia was EUR 133,251 million.

The FCMC ensures the accounting for the DGF, which comprises the description of the most significant FCMC financial accounting principles applied in the preparation of the financial statements, which conform to the fundamentals of the International Public Sector Accounting Standards regarding the provision of accounting and financial statements by public sector entities. The financial statements of the DGF for 2016 and the independent auditor's report thereon are available on the FCMC website at: http://www.fktk.lv/lv/statistika/valsts-garantiju-fondi.html

The DGF has the priority right to claim amounts from the bank which is being liquidated (up to the amount of the guaranteed compensation), but in regard to the cooperative credit unions that are under liquidation or insolvent, the DGF has the right of an unsecured creditor to claim receivables in the amount of the disbursed guaranteed compensation.

Disbursements of guaranteed compensations to the depositors of AS TRASTA KOMERCBANKA

In March 2016, the FCMC identified the inaccessibility of deposits at AS TRASTA KOMERCBANKA (TKB). The entitlement to receive the guaranteed compensation extended to **5,958** depositors of TKB for a total of EUR 62.7 million. The disbursements of guaranteed compensations were started on the 8th working day of the occurrence of the inaccessibility of deposits, without waiting the maximum amount of days specified in law (30 working days). Subsequent to the withdrawing of the licence from TKB, the bank had sufficient liquid assets to disburse guaranteed compensations to the customers.

> For 95.4% of the depositors of TKB, the depositor guarantee scheme covered their deposits in the amount of 100%.

The FCMC made the decision to charge TKB to pay guaranteed compensations from the bank's own assets, considering that:

a) the provision of Section 25 of the *Deposit Guarantee Law* that the guaranteed compensation from the deposit-taker and from the assets of the guarantee deposit fund may be disbursed through the deposit-taker to whom the inaccessibility of deposits has occurred;

b) upon the occurrence of the inaccessibility of deposits, TKB had sufficient funds to disburse the full guaranteed compensation to all depositors of TKB which were entitled to the guaranteed compensation.

Therefore no assets of the Deposit Guarantee Fund had been used to disburse guaranteed compensations to the depositors of TKB.

Table 3.
Ensuring the disbursement of guaranteed compensations (GC) to TKB depositors at 31 December 2016

	NUMBER OF DEPOSITORS	AMOUNT OF GC (IN EUR)	NUMBER OF GC RECIPIENTS	GC DISBURSEMENTS (IN EUR)	SHARE OF GC NOT RECEIVED, %
TKB	5658	62 717 728	2745	53 505 279	14.7

Fund for the Protection of the Insured

The assets of the Fund for the Protection of the Insured (FPI) are made up of deductions of 0.1% by insurance companies from their total gross insurance premiums received from natural persons for the types of insurance specified in the law. Since the beginning of the operation of the FPI, the assets thereof have been allocated in an amount of 12.3 thousand EUR for the disbursement of guaranteed compensation.

> As at the end of 2016, the amount of the assets of the FPI had exceeded the amount specified in Section 288 of the Insurance and Reinsurance Law, the FCMC suspended contributions to the FPI in 2016. At the end of 2016, EUR 18,322 million were accumulated in the FPI.

The payment of insurance indemnity in case of defaulting on the liabilities by insurer may only be received by a policyholder who is a natural person:

1) for life insurance – 100% of the insurance indemnity, capped at EUR 14,230 per policyholder, excluding insurance in respect of the market-linked life insurance contract;

2) for other types of insurance set out in the law – 50% of the insurance indemnity, capped at EUR 2,850 per policyholder.

Where the FPI does not have sufficient assets for the disbursement of insurance indemnity under the *Insurance and Reinsurance Law*, the FCMC may enter into a loan agreement on lending the missing amount from one or several banks or insurers.

Protection of the customers (investors) of the financial instruments market

The investor protection scheme is based on the Investor Protection Law. The compensation per investor is calculated for non-recoverable financial instruments or losses resulting from investment services that have not been executed.

> The compensation per investor is 90% of the value of the irrecoverable financial instruments or of the loss caused by a non-executed investment service, capped at EUR 20,000.

The FCMC ensures the disbursement of compensation, whereas the Consultative Financial and Capital Market Council of the FCMC monitors the payment of compensation

The funds for the payment of compensation are provided by the participants of the scheme that are legal entities to whom the FCMC, under the set procedures, has issued a permit (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 the participants of the scheme. The payment of each participant of the scheme for ensuring compensation is established in proportion to the participant's share in the joint financial instruments portfolio of the participants of the scheme. Where the payments of the participants of the scheme are not sufficient to pay compensation under the *Investor Protection Law*, the FCMC is entitled to get a loan for the disbursement of compensation.

Administration of the financial stability fee

The financial stability fee is paid by banks registered in the Republic of Latvia and their branches in the Member States and foreign states, as well as by the branches of the banks registered in foreign states and Member States in the Republic of Latvia. Under Section 6, Paragraph one of the *Financial Stability Fee Law*, the financial stability fee is administered by the FCMC.

In fulfilling this duty, in 2016, the FCMC not only monitored the payment of this fee, but also prepared, in co-operation with the Ministry of Finance, special rules for taxpayers regarding the calculation of the financial stability fee for 2015, which were necessary to ensure the transition from the procedure for calculating the duty, which was effective until 30 June 2015 to the procedure which came into force on 1 July 2015, following the amendments to the *Deposit Guarantee Law*, which affected the procedure for calculating the financial stability fee.

Taking into account the above mentioned changes in legislation, the collected financial stability fee for 2016 amounted to EUR 8.9 million, which was by 118% higher than in 2014.

10 COOPERATION

International cooperation

In the area of international cooperation, the FCMC's priority is to continue to take part in the events held in the European region. Considering that participation in the work carried out by the SSM and the European financial supervisory authorities is gaining importance, the FCMC got actively involved in the committees of the EU Council and the European Commission only in regard of the projects with significance to the Latvian financial market. Just as in previous years, the FCMC continued to cooperate successfully with supervisory authorities in those countries which have engaged in cross-border cooperation with Latvia.

> " The year 2016 was marked with the completion of the negotiations regarding the joining of the OECD by Latvia. In 2016, final negotiations took place in the Investment Committee, the Corporate Governance Committee, and the OECD Working Group on Combating Bribery in International Business Transactions, in which the FCMC played a key role in completing negotiations with the work done and the obligations assumed.

Participation in the work of the Council of the European Union and of the European Commission in the area of financial services

During the reporting year, the experts of the FCMC got actively involved in developing national positions on financial sector regulation issues that were reviewed by the EU Council's Financial Services and Commercial Law Working Groups. Although in face-to-face meetings, it mainly participated in the EU Council and European Commission working groups to discuss the proposals, which are essential for Latvia's financial sector, such as the revision of the Credit Institutions' Capital Requirement Regulation and Directive, the revision of the Anti-Money Laundering Directive, and the development of the European deposit insurance system, etc.

In 2016, an agreement was reached at the EU level on a directive on the activity and supervision of institutions for occupational pension capital accumulation institutions as well as on the amendments to the Shareholders' Directive. Whereas, the European Commission presented, as new initiatives, proposals for amendments to the capital requirements of credit institutions and business recovery and resolution of credit institutions, amendments to the directive on anti-money laundering or combating terrorist financing, and amendments to the regulation on European venture capital funds, the regulation on European Social Entrepreneurship Funds, as well as Proposals for the regulation on the treatment and resolution regime of central counterparties.

As regards the EU proposals in the area of financial services that were not concluded in 2016, it is expected that by the end of 2017, the EU Council, the European Parliament, and the European Commission might agree on legislative proposals, such as the proposal for the regulation on the European deposit insurance system, the proposal for amendments to the Anti-Money Laundering or Combating of Terrorist Financing Directive, the proposal for the regulation on the prospectus to be published when securities are offered to the public or admitted to trading, and the proposal for the regulation of money market funds. Approving the proposal published at the end of 2016 regarding the amendments in the framework of the capital requirements for credit institutions will be a priority.

Just like every year, in 2017, the European Commission, in cooperation with the European Supervisory Authorities, will continue its extensive work on developing the delegated and implementing measures https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-reforms-and-their-progress/regulatory-process-financial-services/regulatory-process-financial-services_en).

Participating in the work of European supervisory authorities

Several institutions are involved in establishing the European Union's financial and capital market supervision and regulatory environment, each commissioned with its own specific tasks and objectives. The European supervisory authorities (European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), the European Securities and Markets Authority (ESMA) and the European Systemic Risk Board (ESRB)) develop technical standards, guidelines and recommendations to define common regulatory requirements across Europe.

> "Because Latvia is a member of the European Union and part of the European financial and capital market, the FCMC also actively participates in the work of all European supervisory authorities. Only by actively participating and expressing an opinion that is in line with Latvia's interests can it be possible to ensure that Latvia's opinion is heard. Moreover, an opportunity arises to influence the shaping of European supervisory policies and practices.

For Latvia, being a small country, it is key to express its opinion on the impact of the legislation under development on small financial markets and seek to achieve that it is balanced so that it would benefit and develop not only large but also small countries. In regard to various new initiatives, market development trends and new products, the European financial supervisory authorities have a considerable scope of work.

In 2016, the **EBA** carried on its work at developing the Single Rulebook for the *European banking sector*. The EBA focused on the development of projects in the payment services area, the anti-money laundering and combating terrorism financing area, as well as on improving the framework of credit risk. The EBA also got involved in promoting a common understanding and application of the International Financial Reporting Standard 9. With a view to promoting the convergence of supervision, work was carried on improving the supervision testing and assessment processes, as well as on the improvement of the implementation of the new European crisis management framework. For more information on the activities of the EBA, visit the website www.eba.europa.eu.

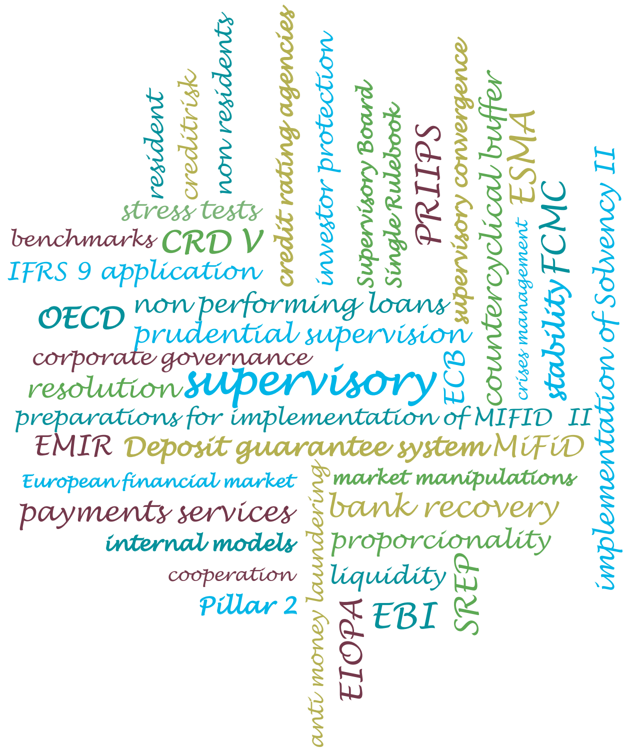
EIOPA.

In 2016, the regulatory framework, which was set up by implementing the *Insolvency II* directive came into force. During the first year of *Solvency II*, EIOPA focused mainly on monitoring the implementation, as well as on establishing of the system for verifying the quality of the report data and the aggregation thereof, and on data exchange systems with national supervisory authorities. Work was carried out on the development of the technical standards necessary for implementing *PRIIPS* and the insurance distribution directive. The EIOPA also continuously monitored and assessed the risks to the insurance and pension sector, the vulnerability of the industry with a view to facilitating or coordinating supervisory activities, if necessary. Relevant reports were prepared for the ESRB. For more information on the activities of the EIOPA, visit the website https://eiopa.europa.eu.

In 2016, **ESMA** continued to be actively involved in the development of the Single Rulebook of the European financial instrument market. The priorities of ESMA included supervisory convergence, risk assessment, the development of the Single Rulebook and direct supervision of credit rating agencies and trade repositories. During the financial year, work continued on implementing the new EU directives and regulations (e.g., financial instrument markets, market abuse, credit rating agencies, central securities depositories, etc.), by developing a number of draft technical standards or providing proposals for the European Commission delegated acts. In 2016, work continued in regard to two extensive information technology projects aimed to create a database for centralised collection and maintenance of information on over-the-counter transactions with financial derivatives, as well as a financial instrument reference database. For more information on the activities of the ESMA, visit the website www.esma.europa.eu.

During the reporting year, the **ESRB** continued the work focussed on building a stable macro-prudential system across the EU, identifying systemic risks that pose threats to the EU financial system, and took measures to remove them. The ESRB also analysed and collected information about the macro-prudential instruments by the Member States. The statements of Member States on these instruments, as well as more information on the activities of the ESRB, is available on the website www.esrb.europa.eu.

Figure 21.
The most commonly used terms in 2016, in cooperating with European institutions



Cooperation with supervisory authorities of other countries

In ensuring the supervision and stability of the financial sector, cooperating with the supervisory authorities of the financial sector of other countries plays an important role. In carrying out day-to-day duties, cooperation with the supervisory authorities of such countries takes place, whose financial institutions are involved in providing cross-border services. To promote bilateral cooperation and exchange of information, information exchange and cooperation agreements are entered into with the supervisory authorities, whereas cooperation and information exchange with the supervisory authorities of the financial sector in EEA Member States can take place without entering into cooperation agreements. All concluded bilateral and multilateral cooperation agreements are available on the FCMC website.

To exchange information on the development trends in the financial sector and latest developments in supervisory matters, FCMC management continued the practice of previous years – arranging a meeting with the US public administration and financial supervisory authorities during the annual meeting of the International Monetary Fund.

11 COMMUNICATION WITH THE GENERAL PUBLIC AND EDUCATING CUSTOMERS

In continuing the pursued strategic direction aimed at providing an open and proactive approach to informing the public about the activities, functions, and role of the FCMC, as well as promoting customer awareness of financial services and the risks thereof, the FCMC provided extensive information on current issues. In 2016, the FCMC has been mentioned 4,269 times in various Latvian media, which is 27% higher than in the previous year (3,360 mentions in 2015). FCMC experts have provided over 100 interviews to Latvian and international media, as well as distributed 132 communications to the media regarding the decisions passed by the FCMC Board, the developments of regulatory requirements, the activity of the financial market participants and other matters.

> "During the year, the Communications Division held three events for the media: the developments in banking activity in 2015; the withdrawing of the licence of AS TRASTA KOMERCBANKA; the completion of an independent testing carried out by the US specialists in 12 Latvian banks, the activities of which are focused on providing services to international customers.

In 2016, the FCMC also organized a broad media campaign, i.e., the fourth Financial Education Week.

The outcome of the annual study carried out by SKDS on the confidence of the Latvian population in financial institutions, suggests that in 2016, the level of awareness of the activity of the FCMC as a financial supervisor had slightly increased among the population. In 2016, the population was more aware about the guaranteed compensation of EUR 100,000 to which the customers of Latvian credit institutions and credit unions are entitled in the event of inaccessibility of deposits. At the beginning of 2016, 48.6% of the population admitted that they were aware of the guaranteed compensation, whereas in 2016 the number those who are aware had risen by 13% (55% of the respondents). It should be emphasized that people with higher education and higher income are somewhat more aware of the guaranteed compensation, i.e., more than 65% of the respondents. An increase in confidence and knowledge about the state guarantees was most likely facilitated by experience, i.e., after the withdrawing of the license from AS TRASTA KOMERCBANKA in March 2016, the TKB depositor guarantee scheme fully covered the payables owed to 95.4% depositors.

The FCMC continued its ongoing two-way communication on social networks, i.e., by maintaining the official account @FKTK_LV on the Twitter, as well as via Youtube and Slideshare. In 2016, during the hosting of the fourth Financial education week, the FCMC also created a Facebook page "The FCMC Customer School" on Facebook aimed at informing and engaging in a dialogue with the public on the current topics of financial literacy.

People can benefit from an interactive tool BANKU KOMPASS available on the website of the FCMC, where anyone can compare the key quarterly performance indicators of Latvian commercial banks.

In 2016, the most significant topics for the explanation of which the Communications Division has spent most resources and/or which has gained publicity in the media were as follows:

- The change in the management of the FCMC at the beginning of 2016;
- Withdrawing of the licence from AS TRASTA KOMERCBANKA on 3 March 2016, and the procedure for disbursing the state-guaranteed compensation to the depositors of the bank;
- Joining the Organisation for Economic Cooperation and Development , i.e., OECD and ensuring a positive opinion in the area ofanti-money laundering and combating terrorist financing;
- Establishing the Compliance Control Department of the FCMC in April 2016;
- The completing of questionnaires by the customers of banks aimed at identifying politically exposed persons, taking into account the amendments to the Law on Anti-Money Laundering and Prevention of Terrorist Financing;
- Sanctions applied by the FCMC, i.e., a penalty or a warning (have been applied to seven credit institutions).

Financial literacy-related activities

One of the priority directions of the strategic activity of the FCMC is to gradually promote the financial literacy of the population, by ensuring the coordination of activities at the national level, representation in the OECD working group International Network on Financial Education (INFE) and research activity in this field.

Implementing the Financial Literacy Strategy

In 2016, the second year of the implementation of "The Financial Literacy Strategy of the Latvian Population for 2014-2020" (i.e., the year 2015) was assessed.

> "The analysis of the performance indicators of the Strategy showed that work was being carried out to achieve all strategic objectives, continuing the previously commenced positive direction, i.e., household savings had grown, though not as rapidly as before, totalling EUR 8.6 billion; over 9 thousand new life insurance contracts with accumulation of funds had been concluded; an increase in the number of participants of the private pension plans in 2015 was the steepest in the last five years, and the volume of the risk insurance premiums per resident had also grown.

This year, the optimum (0.9) balance was achieved in terms of the household loans vs. deposits ratio, i.e., 99% in monetary terms – total loans to households' total deposits (100%).

Financial Education Week 2016

In 2016, concurrently with the fifth Global Money Week organised by the *Child and Youth Finance International,* the FCMC together with partners hosted the fourth *Financial Education Week (FIN 2016)* in Latvia aimed at popularising financial literacy. The motto of FIN 2016 was "A Trip into Financial Literacy 2016", during which the financial talisman, i.e., the outdoor object, i.e., the money box *Smarty* travelled, for the first time, to two regions of Latvia (Jelgava and Talsi), where the FCMC and its partners organized *Inspirational lectures* about financial literacy by well-known local people, as well as a debate between local experts and municipal discussions to promote joint activities. Talsi County Municipality, Jelgava City Council and the Zemgale Region Competence Development Centre became the financial literacy partners this year. In addition to the activities of the partners, the FIN 2016 lectures and practical workshops were held in Latvian primary schools, high schools and universities throughout the year.

Development of the CLIENT SCHOOL and lifelong learning activities

Since 2014, the FCMC educational website *CLIENT SCHOOL* is being developed by preparing and deploying additional training materials in the section *Client ABC*, which explains all the current topics and concepts related to financial performance. In 2016, approx. 20 new explanatory material packs were added to the section. This year, the CLIENT SCHOOL delivered 25 (in 2015 – 36) extended consultations by email. Furthermore, the CLIENT SCHOOL had also been popularised in the FCMC column in the newspaper Latvijas Avize, covering, in six articles, the topics of the negative interest rate, the impact of Brexit on finances, the account register, the strengthening of the control of transaction compliance, e-security, and others. At the end of 2016, a new activity was launched at the CUSTOMER SCHOOL, i.e., regular lectures at the National Library (Financial Literacy at the "Castle of Light").

As a significant event in promoting lifelong learning regarding financial literacy, the draft document "Basic Competence Standard for Adult Learners", prepared by the FCMC and its Partners Task Force, which is based on the approach of developed countries in terms of matters of improving the financial literacy of the population, i.e., the OECD INFE core competencies framework on financial literacy (2016). The standard is to be approved and published in the first quarter of 2017. This year, too, FCMC experts contributed to further educating teachers on topical issues both at the annual seminar at the BA School of Business and Finance, as well as at the seminar organised by the Bank of Latvia for the teachers of economics and social sciences.

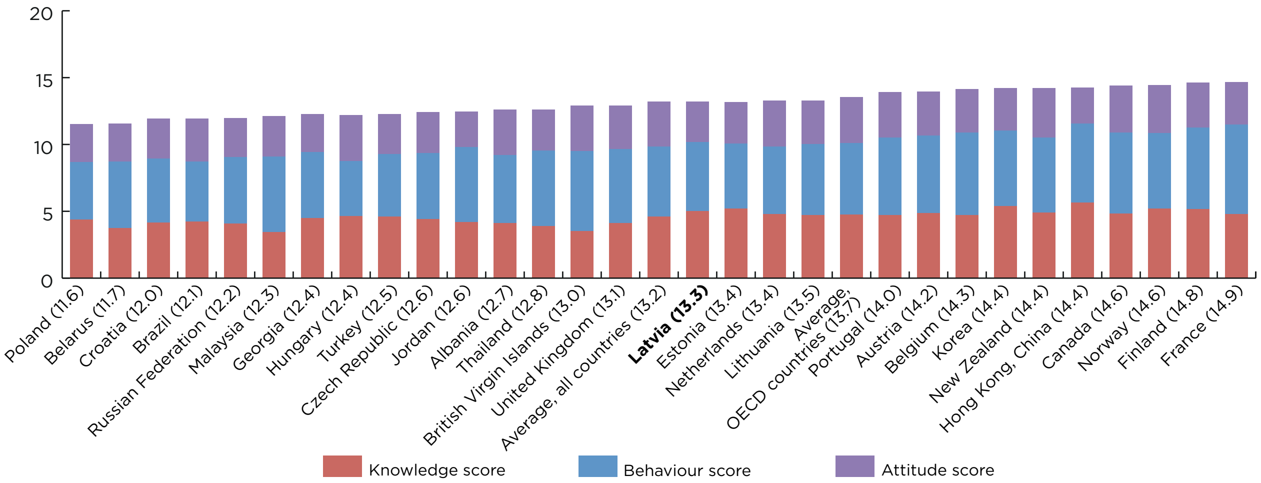
OECD INFE financial literacy survey

Financial literacy surveys in Latvia (2014, 2015) have been carried out in accordance with the OECD methodology. Therefore the data thereof were included in the OECD first international financial literacy survey of populations (30 countries, whereof 17 are the OECD countries) in 2016. The overall rating of the financial literacy of the Latvian population is close to the OECD average, along with that of the Netherlands, Lithuania and Estonia.

Figure 22.

Financial knowledge, attitudes and behaviour

Stacked points (weighted data): all respondents, sorted by overall score out of 21 (reported in parenthesis)



Notes: Average, all countries and Average, OECD countries report the mean of the country/economy percentages Each country/economy is therefore given equal weight.

The financial knowledge, practical behaviour and attitudes of the population were assessed separately. The Latvian population ranked highest in terms of financial knowledge, outperforming the OECD average ranking in the total rating group with the Netherlands, Estonia, Finland, Hong Kong, Korea, Austria, Norway and New Zealand, whereas in the category Attitude and practical action, its rating was relatively low. The recommendation of the OECD INFE to Latvian and Estonia: *"In some OECD countries with the highest financial knowledge, such as in Latvia and Estonia, there is a relatively lower overall level of financial literacy due to the lack of practical action. These countries need to seek solutions to change financial behaviour in order to strengthen people's financial literacy."*

The Permanent Task Force, which ensures the implementation of the national strategy, should continue to seek solutions of how to gradually change the behavioural models hindering society's development and sustainability in the financial area.

Twitter: @FKTK_LV

Youtube: @FKTKLatvija

Slideshare: @FKTK_LV

Facebook: @Klientuskola

Website: www.fktk.lv

Educational website: www.klientuskola.lv

KEY TASKS IN 2017

The key SUPERVISION-RELATED TASKS set for carrying out the supervision of the participants of the financial market in 2017 are as follows.

SUPERVISING CREDIT INSTITUTIONS:

- the assessment of the strategies, business models, and the earning capacity of banks, with a focus on risk-taking, sustainability and the balancing of the earning capacity;
- consolidating the compliance and risk management functions by paying attention to the processes and effectiveness of the carrying out of the stress tests of banks, improvement of the ORP and the application thereof in practice, the quality of reports;
- assess credit risk and the adequacy of provisions, mainly focusing on problem (overdue, restructured) loans, and the credit recovery process. At the same time, supervision will keep track of the implementation measures of IFRS 9 (International Financial Reporting Standard) and the preparedness for it on the part of banks.

SUPERVISING THE FINANCIAL INSTRUMENTS MARKET:

- Improving the monitoring process of the providers of investment services pursuant to the new requirements of the EU Financial Instruments Market Directive (MiFID II) and the Financial Instruments Regulation (MiFIR).
- Rolling out of new information systems (TREM2, FIRDS, TRACE, etc.) and the upgrading of existing systems (e.g., **The Central Storage of Regulated Information** – ORICGS) aimed at meeting the current requirements of EU legislation and integrate into a single EU financial market supervision and transparency infrastructure;
- Ensuring the re-licensing process of the central securities depository pursuant to the requirements of the EU Regulation. The FCMC has received an application for obtaining a central securities depository licence, which provides for establishing in Latvia, by way of reorganisation, the company *Nasdaq CSD SE*, by merging the joint stock company *AS Latvian Central Depository, AS Eesti Väärtpaberikeskus,* and *Akcinė bendrovė* LIETUVOS CENTRINIS VERTYBINIŲ POPIERIŲ DEPOZITORIUMAS.

SUPERVISING PENSIONS AND INVESTMENTS:

- Continuing the analysis of the impact of the activity of the asset managers of the State-Funded Pension Scheme (changes to how the commission fee is calculated), as well as the analysis of the application of the provisions of the Directive on the Undertakings for the Collective Investment of Transferable Securities (UCITS V). In 2017, the impact analysis will also be carried out in the IMJSC area in regard to the activity of investment funds related to transposing the provisions of the UCITS V directive into the laws and regulations.

SUPERVISING COMPLIANCE:

- The specialists of the Compliance Control Department will monitor how successfully the credit institutions that focus on providing services to foreign customers carry out the corrective measures set by the FCMC and how the necessary measures are being taken to eliminate the deficiencies identified by the specialists of the US consultancy companies in 2016;
- Participation in the national MONEYVAL (the Financial Action Task Force (FATF)) assessment process regarding the fulfilment of the FATF recommendations;

Improving the regulatory framework of the financial sectors one of the strategic priorities of the FCMC. Therefore the action plan of the FCMC includes a number of projects related to virtually all existing financial market segments falling under the supervision of the FCMC. In 2017, in regard to the envisaged developments in the area of regulatory requirements, the FCMC will:

- get actively involved in the examination of the proposals for amendments to the European Commission Capital Requirement Directive (CRD) and the Capital Requirement Regulation (CRR), preparing position documents for the meetings of the Council working group, comments and proposals for the Presidency materials to promote the adoption of such a framework, which provides for an opportunity to take into account the nature of the Latvian financial sector;
- carry out the preparatory measures for the implementation of IFRS 9 (International Financial Reporting Standard), by gaining awareness of problem issues, and based on the assessment of

the impact, seeking solutions, including amending laws and regulations;

- submit proposals to the Macro-prudential Board (MPB) for the application of macro-prudential instruments in accordance with the identified trends in structural and cyclical risks;
- carry on the work of transposing the requirements of the Directive on the distribution of insurance into the laws and regulations of the Republic of Latvia;
- carry on the work of transposing the requirements of the Directive on the activity and supervision of institutions for occupational retirement provision (ICRP) into the laws and regulations of the Republic of Latvia;
- carry on the work of transposing the requirements of the Financial instruments market directive (MiFID II) into the laws and regulations of the Republic of Latvia;
- take part in the development of regulation of the activity of mutual loan-based crowdfunding platforms;
- carry on the transposing of the Directive on payments services in the domestic market (PSD2) into the laws and regulations of the Republic of Latvia;
- take part in the development of the regulatory sandbox solution to provide for the development of innovative financial services and international competitiveness of the FinTech sector;
- Work will continue on 4. Transposing the requirements of the anti-money laundering and prevention of terrorist financing directive into the laws and regulations of the Republic of Latvia;
- Work will continue to improve the regulatory framework and raise the monitoring effectiveness in the AML/CTF non-bank financial institutions, taking into account the nature of their activity and the risks of AML/CTF.

In regard to the RISK REDUCTION MEASURES contemplated by the EU, in 2017, the FCMC specialists will:

- get actively involved in the examination of the proposals for amendments to the European Commission Bank Recovery and the Resolution Directive (BRRD) and the examination of the proposals for amending the Single Resolution Mechanism Regulation (SRMR);
- get actively involved in the examination of the drafts of the accompanying documents of the proposal for amendments to the European Commission proposal to establish the European Deposit Insurance Scheme (EDIS),
- prepare position documents for the meetings of the Council working group, comments and proposals for the Presidency materials to promote the adoption of such a framework, which provides for an opportunity to take into account the nature of the Latvian financial sector.

GOVERNANCE AND STRUCTURE OF THE FCMC

12 STAFF POLICY

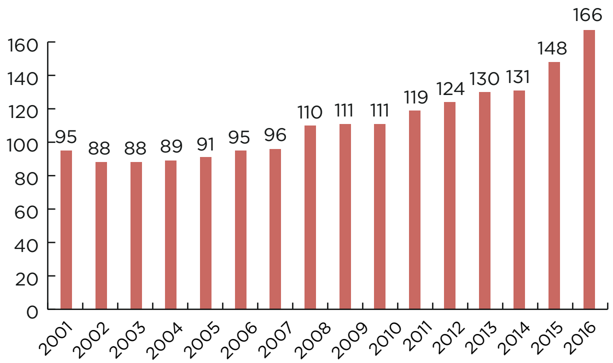
Highly educated and professional staff is the key resource of the FCMC, ensuring the achievement of FCMC goals and the further development of the institution.

Staff breakdown by number and the changes thereof

In 2016, the number of posts at the FCMC increased to 166. During the reporting year, there have been changes to the structure of the FCMC, i.e., with a view to strengthening the anti-money laundering and prevention of terrorist financing area, and as a result of the reorganisation of the Financial Integrity Division, the Compliance Control Department composed of the following five divisions has been established: Banking Supervision Division, Non-Banking Supervision Division, Transaction Supervision Division, Sanctions and Compliance Control Division and Regulatory Division. In turn, with a view to strengthening the internal audit, strategic and annual planning, risk management, project management and internal control functions, and as a result of the reorganization of the Internal Audit and Quality Management Division, the Internal Audit Division and the Strategic Planning and Risk Management Division have been established.

Figure 23.

Staff number dynamics (2001 - 2016)



In 2016, the average number of employees, including those on long-term leave, was 155. At 31 December 2016, the FCMC employed 160 employees, whereof:

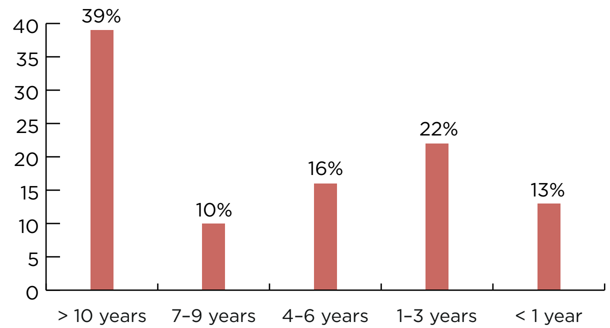
- 131 (82%) were engaged in performing principal activities and 29 (18%) were engaged in performing support functions;
- 111 (69%) were civil servants and 49 (31%) were employees;
- all employees were engaged in performing intellectual work.

In 2016, the staff turnover rate was 3%. During the reporting year, 24 employees were hired by the FCMC, including 20 employees who were hired for performing principal activities and four employees who were hired for performing support functions, whereof one employee was hired by the FCMC for a definite term, i.e., for the term required to replace an employee on extended leave of absence (childcare leave). After the expiry of the probation period, in accordance with the established adaptation period plan, all the new employees received a positive assessment and continue to be employed by the FCMC. During the reporting year, the FCMC terminated its employment relationship with ten employees, including one employee who had been hired by the FCMC to replace an employee on an extended leave of absence (childcare leave). Of the nine permanent employees who terminated their employment relationship with the FCMC, three employees retired, five chose to pursue a career in the private sector, and one employee is working abroad.

In 2016, 87% (139) of the employees of the FCMC had been employed by the FCMC for more than one year, those in an employment relationship with the FCMC for 15 years, i.e. from the moment the authority was established (in 2001) numbered 31% (50) employees, and 13% (21) employees have been employed for less than a year.

Figure 24.

Breakdown of staff by length of service at the FCMC (%)



Job-related business trips

In 2016, 94 (57.3%) employees were assigned on 440 business trips, including:

- 73 (44.5%) employees were involved, on a regular basis, in the work of the task forces established by the European Union and the European financial supervisory authorities (EBA, EIOPA, and ESMA);
- Nine (5.5%) employees were regularly involved in the events of the task forces of the European Council;
- The Chairman of the FCMC, as the representative of the Republic of Latvia, participated in the Spring session of the International Monetary Fund and the World Bank;
- Two employees as subject-matter experts met, within the scope of the Spring and Autumn sessions of the International Monetary Fund and the World Bank, with the US financial supervisory authorities in Washington and New York.

Breakdown of FCMC staff by gender and age

In 2016, 72% (115) of all FCMC employees were women, whereas 28% (45) were men. In 2016, the age profile of the staff was characterised by the following indicators: 6% (10) of employees were aged up to 29 years, 40% (63) were aged from 30 to 39 years, 35% (56) were aged from 40 to 49 years, and 19% (31) were aged over 50 years.

In 2016, the average age of FCMC staff did not change compared to the previous year, i.e., 42 years.

Figure 25.
Breakdown of FCMC staff by age group (%)

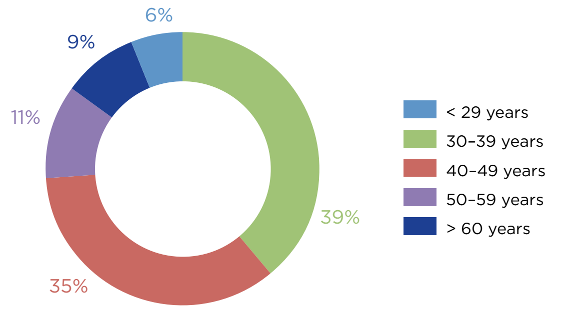
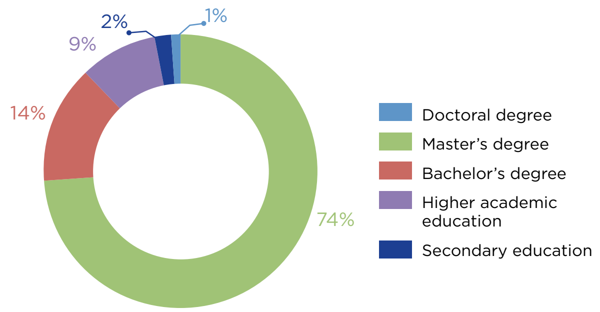


Figure 26.
Breakdown of FCMC staff by educational attainment level (%)



Staff qualifications

In 2016%, 98% (157) of FCMC employees had a university degree (whereof 74% held a Master's degree), whereas 2% (3) of the employees had secondary or professional secondary education.

Improving staff qualifications

In accordance with FCMC strategy, and with a view to continuously improving FCMC activity processes whilst thereby raising the effectiveness and efficiency of performance, as well as to carrying out the supervision of the financial sector, especially of the banking sector, 86.3% (138) of FCMC staff improved their qualifications by attending job-related training held in Latvia and abroad. In Latvia, staff attended seminars aimed at improving their knowledge of legislation, financial analysis, risk management, electronic payments, procurement management, anti-money laundering and prevention of terrorist financing, personal data protection, record keeping, information technology, presentation and management skills. To supplement knowledge of banking risk management, stress testing methodology and practice, the capital requirements of the insurance sector *Solvency II*, the bank capital requirement, i.e. *Basel Capital Accord II*, and on other matters related to financial supervision, 52 (32.5%) of FCMC employees attended seminars held abroad.

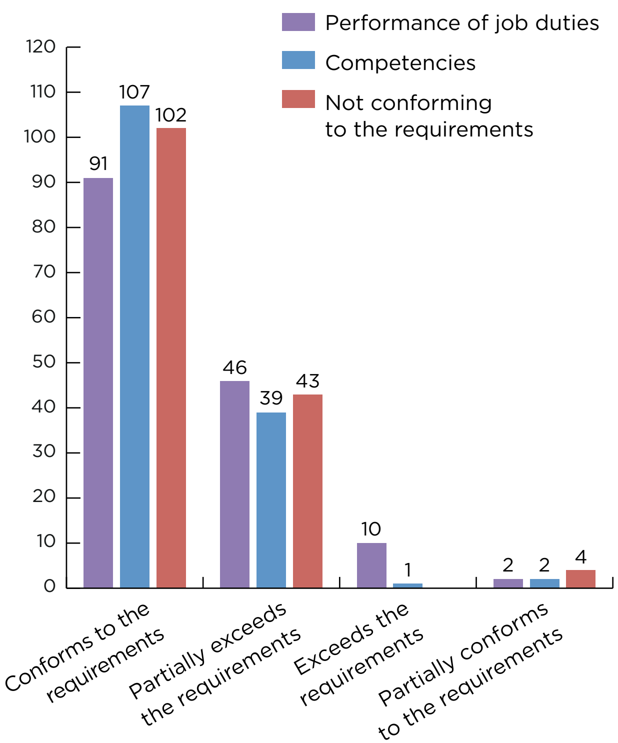
Staff performance appraisals

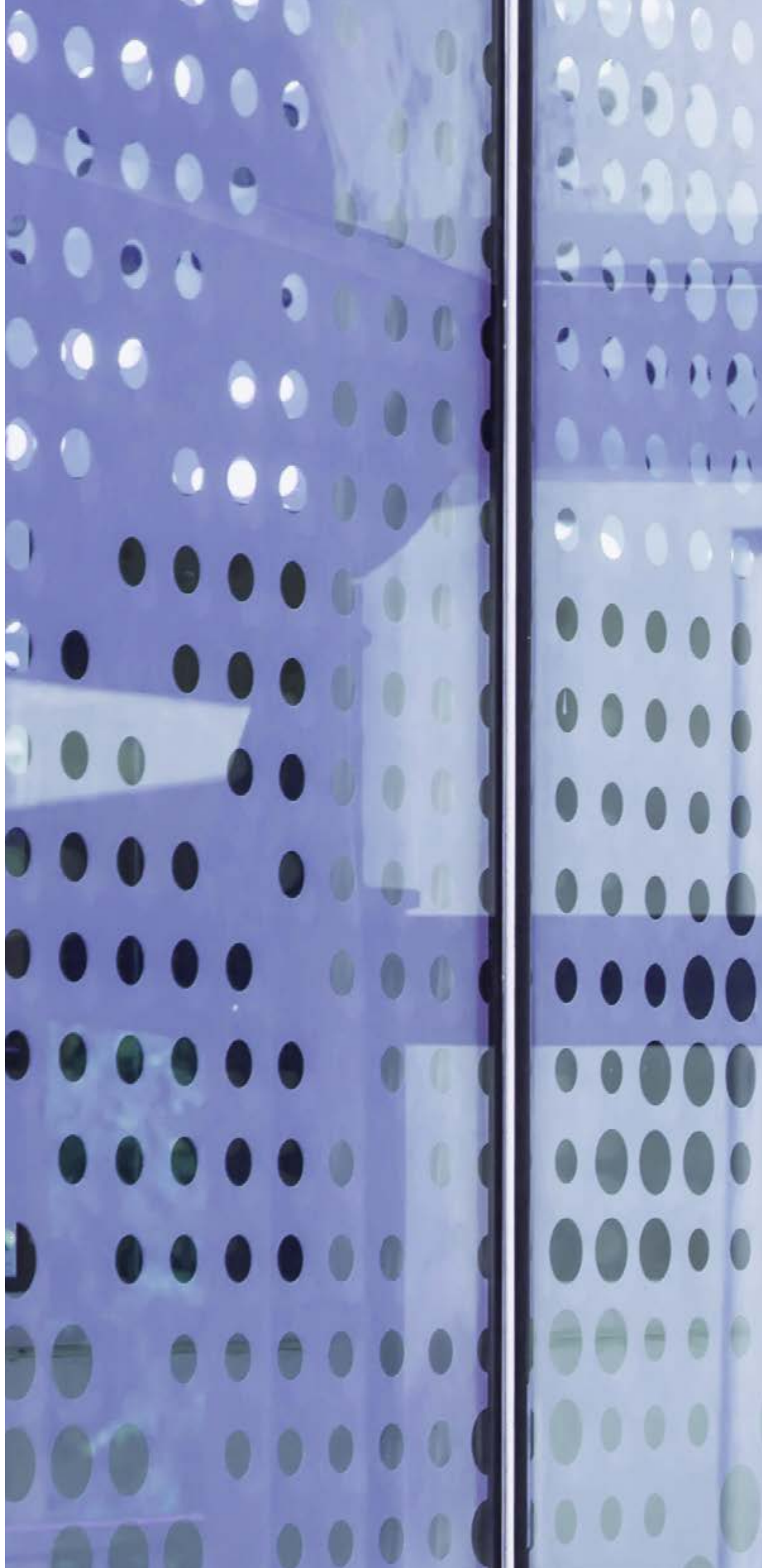
In 2016, under the procedure set forth by the FCMC, 149 employees underwent staff performance appraisals (SPA), including 27 heads of structural units (including three members of the board) and 122 subject-matter experts. Three criteria were set for assessing performance: attainment of established goals, performing of job duties, and the required job-related competencies.

Seventy per cent (104) of employees received the overall assessment of all criteria as *'Conforms to the requirements',* 29% (43) of the employees received the assessment *'Partially exceeds the requirements'* and 1% (2) received the assessment *'Partially conforms to the requirements'*. In 2016, none of the employees received the overall assessment of all criteria as 'Fails to conform to the requirements'.

The majority of employees also received the assessment *'Conforms to the requirements'*, including regarding each individual criterion — for attaining established goals — 61% (91) employees, for the performance of job duties — 72% (107) employees, and for the required job-related competencies — 68% (102) employees.

Figure 27.
Breakdown of the SPA assessment by criteria (number)





13

FCMC STRUCTURE

* Member of the Board

14

FINANCING OF THE ACTIVITY OF THE FCMC

In 2016, the activity of the FCMC was fully financed from the payments of participants of the financial and capital market. During the reporting year, within the scope of the budget for ensuring FCMC activity, the FCMC also managed the DGF and the FPI, as well as administered the FSF and contributions to the single resolution fund. The assets of the DGF and FPI are only used for the purposes thereof. No deductions are made from the assets of the DGF and the FPI for the administration thereof or for the benefit of the FCMC.

Table 4.
Financing of the activities of the FCMC in 2015-2016, in EUR

	ACTUAL PERFORMANCE IN 2015	ACTUAL PERFORMANCE IN 2016[13]	BUDGET FOR THE REPORTING YEAR	BUDGET PERFORMANCE FOR THE REPORTING YEAR,%	SHARE OF THE ACTUAL PERFORMANCE IN TOTAL, %
REVENUE (+)	**8 077 784**	**8 883 432**	**9 442 435**	**94**	**100**
PAYMENTS BY THE PARTICIPANTS OF THE FINANCIAL AND CAPITAL MARKET	8 057 039	8 866 355	9 432 435	94	100
REVENUE RELATED TO THE SUPERVISION OF MONETARY FINANCIAL INSTITUTIONS	6 078 714	6 655 792	7 151 545	93	75
Payments by credit institutions	5 860 609	6 369 514	6 974 410		
Payments by credit unions	31 889	34 515	33 810		
Payments by payment institutions	42 231	66 508	40 390		
Payments by electronic money institutions	143 985	185 255	102 935		
REVENUE RELATED TO THE SUPERVISION OF THE FINANCIAL INSTRUMENTS MARKET AND PRIVATE PENSION FUNDS	762 161	803 460	813 150	98	9
Payments by participants of the financial instruments market	491 997	528 619	565 250		
Payments by private pension funds	270 164	274 841	247 900		
REVENUE RELATED TO THE SUPERVISION OF INSURANCE	1 216 164	1 407 103	1 467 740	95	16
Payments by life insurance companies	260 602	276 168	260 340		

13 Audited data 25.04.2017

	ACTUAL PERFORMANCE IN 2015	ACTUAL PERFORMANCE IN 2016[13]	BUDGET FOR THE REPORTING YEAR	BUDGET PERFORMANCE FOR THE REPORTING YEAR,%	SHARE OF THE ACTUAL PERFORMANCE IN TOTAL, %
Payments by other insurance companies	955 562	1 073 680	1 150 425		
Payments by insurance brokerage firms[14]		57 255	56 975		
OTHER REVENUE	20 745	17 077	10 000	170	
EXPENSES (-)	**7 438 131**	**8 615 893**	**10 157 895**	**85**	**100**
Salary for work, other payments to employees, and national social insurance mandatory contributions	5 366 083	6 198 352	7 289 760	85	71.9
Employee insurance	36 857	55 040	54 990	100	0.6
Improving professional qualifications of the staff	94 024	103 871	159 935	63	1.2
Telecommunications, communications, and information	153 077	160 106	167 675	95	1.9
Information to the general public, internal and external communication	68 339	51 788	109 220	47	0.6
Maintenance and operational expenses	676 535	770 706	788 380	98	9
Services for the provision of supervision	11 312	111 758	56 360	187	1.2
International cooperation	891 929	1 003 316	1 306 485	77	11.8
Amortisation/depreciation of capital investments	139 975	160 956	225 090	72	1.8
RESULT	**639 653**	**267 539**	**-715 460**		

14 Insurance brokerage firms began paying deductions for the financing of the FCMC from 2016.

In 2016, the financing budget of the FCMC increased by 20% compared to 2015. This was because 17 new employees were hired by the FCMC in 2017, whereof nine were employed in the Compliance Control Department which is in charge of the control over anti-money laundering and combating terrorist financing, which was set as a national-level priority task in order to ensure the supervision of the Latvian financial markets in line with the standards of the most developed countries, which contributed to the acceptance of Latvia as a member state of the OECD. The said task was completed, and Latvia became a member state of the prestigious global organisation. In order to cover the increased budget, there was a rise in the contributions payable by the market participants for the financing of the FCMC, by making changes to the Regulation of the FCMC financing in April 2016, concurrently maintaining the share of contribution rates between the key market participants, as well as providing for the self-financing of the FCMC of 7%.

In 2016, it was intended to cover 93% of the FCMC budget revenue from the payments made by market participants. In turn, 76% of the payments by all market participants are sourced from the monetary financial institutions, 9% from the financial instruments market participants together with pension fund managers, and 15% of payments are sourced from insurance market participants. The highest share of FCMC financing is made up by credit institutions, (i.e., 72%) according to 2016 actual data.

In 2016, the total expenditure incurred by the FCMC was EUR 8,615.9 thous., 15% lower than budgeted (EUR 10,157.9 thous.). The main reasons for the difference between the budgeted vs actual expenditure were: a later than intended new employee hiring process as well as lower international cooperation expenditure. In 2016, revenue exceeded expenditure by EUR 267.5 thous., which was used for the financing of the 2017 year budget, in accordance with which the share of self-financing by the FCMC accounts for 5% of the expenditure or EUR 544 thous. At the time of preparation of this report neither the amount of expenditure nor the structure thereof has been audited. Therefore these numbers are not final yet, and, the audited budget performance results might change insignificantly.

In 2016, the higher financing of the activity of the FCMC was due to the expenses of the remuneration of FCMC staff (72%), which in terms of the share of expenditure were the same as in 2015.

> The activity of the FCMC is ensured by the top intellectual and highly qualified work of financial services specialists. Therefore in 2016, there was an increased focus on the competitiveness of the remuneration of the staff thereof, and reforms in this area will be continued in the future, concurrently seeking ways of reducing expenditure for such items, which are less significant for the quality of the activity of the FCMC.

Table 5.

Breakdown of FCMC staff remuneration in 2016, in EUR

REMUNERATION	6 198 352
Salaries and similar payments	**5 030 627**
including bonuses	196 019
including additional payments	57 608
including remuneration to the FCMC Board	308 574
National social insurance mandatory contributions	**1 167 724**
including the national social insurance mandatory contributions on the remuneration of the FCMC Board	73 062
Employee health insurance	**55 040**

As the number of FCMC staff increased in 2016, there was a need for more leased office premises; thus, a new lease agreement for the lease of additional premises of 189.6 m2 was entered into, which resulted in higher maintenance and facility management costs.

During the reporting year, the FCMC represented Latvia in eight European and global level financial markets supervision and the coordination thereof organisations, the membership of which cost 10% more than in 2015.

Table 6.
Membership fees paid by the FCMC to the EU and global organisations in 2015-2016, in EUR

	2015	2016	CHANGES IN 2016/2015
Payments to EU organisations	462 611	502 784	8%
Payments to global organisations	35 534	46 967	32%
Total	**498 145**	**549 751**	**10%**

In 2016, the intensity of the participation of FCMC staff in the activities of the European Central Bank, the European Commission and other bodies and organizations, the training organized by them, as well as in the working groups for improvement and coordination of supervision processes remained unchanged. Furthermore, at the end of 2016, a single resolution mechanism became operational, as represented by the Board thereof, co-ordinating the functioning of the Eurozone Deposit Guarantee Schemes and in the organizational structures of which the representatives of the FCMC have been actively involved. Therefore the number of business trips during the reporting year exceeded 600 (the same as in 2015), whereas the costs thereof amounted to EUR 388.5 thous.

The FCMC has been continuously improving the technical resources of the activity support thereof, in particular in the field of information technology. Therefore EUR 231.4 thous. were spent on capital expenditure during the reporting year (in terms of cash flow), whereof 73% consisted of direct investments in computer hardware and software.

The 2016 financial statements of the FCMC and of the DGF and FPI, which are subordinated to the FCMC, as well as independent auditor reports on them being available on the FCMC website www.fktk.lv after the approval thereof by the Board of the FCMC.

15

INTERNAL AUDIT

Internal audit is conducted by the Internal Audit Division of the FCMC, which, following the assessment of FCMC governance, internal control, risk management processes, and the operational efficiency, provides an objective and independent opinion about the control environment at the FCMC to the Board thereof. In order to increase the effectiveness of FCMC governance, internal control, and risk management as well as the operational effectiveness of FCMC processes, the Internal Audit Division provides recommendations for the improvement thereof.

> "In 2016, the Internal Audit Division conducted scheduled internal audits of the FCMC as well as internal audits in accordance with the audit plan approved by the Internal Audit Committee of the Eurosystem/ European Central Banking System.

Internal audits were planned and conducted based on a risk-based approach and considering the strategy of the FCMC. The findings of the results of internal auditing have been reported to the Board of the FCMC with a view to excluding the exertion of any influence on the results of the audit. The Internal Audit Division monitors the progress of the implementation of the provided recommendations in order to ensure that the most significant recommendations are completed and the control environment is improved accordingly.

With a view to ensuring the quality of audits, in carrying out its activity, the Internal Audit Division complies with the general principles of the International Standards for the Professional Practice of Internal Auditing, the Code of Ethics, and the guidelines. In 2016, self-assessment was carried out to determine whether internal auditing conforms to the framework of the Professional Practice of Internal Auditing. The Internal Audit Division has developed and maintains and current quality assurance and improvement programme. The quality and results of internal auditing are reported to the Board of the FCMC.

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