Annual Report and Activity Report
OF THE FINANCIAL AND CAPITAL MARKET COMMISSION
for 2017

FINANŠU UN
KAPITĀLA
TIRGUS
KOMISIJA

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INTRODUCTION

1. 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 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

Changes as a logical course of events

Continuing integration into the Western political and financial space, in 2016 Latvia joined the Organisation for Economic Cooperation and Development (OECD), and since then it was apparent that we have to perform at a new level of accountability. The membership in the organisation of the world's most developed countries means that the bar of financial sector supervision standards is set very high. Before the accession of Latvia to the OECD a thorough assessment of the Latvian financial system was carried out from a new perspective. At that time we developed the necessary improvements jointly with our cooperation partners, and in summer this year we will find out the assessment regarding the implementation of recommendations. Historical changes were underway and intense work was continued in 2017, reflected in this Annual Report and the Activity Report of the FCMC.

Commercial banks constitute a key element of the Latvian financial sector. Since the very inception of the banking system, there has been always a certain disproportion in the structure of deposits attracted by the banks, as the funds of foreign customers have always prevailed over the deposits of domestic customers. Of course, such imbalance is not a characteristic only of the Latvian banking sector; an extensive foreign customer base is also typical of other countries of the European Economic Area, developing the financial services exports. However, a certain share of the customer base in the Latvian banks has been associated with insufficiently managed risks, thus raising suspicions of attempted money laundering or an inability to address such activities. From time to time, the name of Latvia is publicly mentioned referring to dubious financial transactions and throwing it into the information flow that deteriorates the international reputation of our country. If we are unable to prevent it, we must do without the high risk customers and their transactions at all. One may take only the risk that its control system is capable of managing.

The critical reassessment of the customer base, gradually terminating business relations with foreign customers exposed to high risk, has been a priority task for Latvian banks over the last two years.

> The result is evident – overall in 2016 and 2017, the deposits held by foreign customers in the Latvian banks declined by 30%; namely, about 4 billion euros of unwelcome high exposure funds moved out of the Latvian financial sector. We ended the year 2017 with only a 39% foreign customer percentage.

In 2017, the FCMC in cooperation with the US Federal Bureau of Investigation detected breaches of statutory requirements in five Latvian banks that had enabled the circumvention of the sanctions imposed against the North Korea by using the Latvian banks along with a number of foreign banks. The banks were involved in the violations indirectly, they all confessed to the wrongdoing and later cooperated with the investigators; nevertheless, a fine, in the total amount of 3.5 million euros, was applied to the banks.

Having implemented the new procedures in the industry, the Latvian banking sector shrank in 2017, having an impact on the profit indices; at the same time, our banks managed to retain high levels of capitalisation and liquidity. The rigorous stability ratios set by the FCMC for the foreign segment banks have proven themselves in action as a feasible tool during a period when the customer base has to be changed radically. I would say that there are definitely not so many countries where the banks would be able to ensure radical changes in such a peaceful and controlled manner – billions of euros are leaving the Latvian financial sector within a limited period of time and this process is still ongoing. This is unlikely an evaluation of economic influence; however, it is a significant contribution to the mitigating country and sector risks. The quality of the loan portfolio also continued to improve during the reporting year, and the domestic deposits grew visibly, compensating the decrease in the foreign deposit segment. Thus, already in 2017, Latvia reached the lowest threshold in terms of foreign deposits, releasing the country and the banks from unnecessary reputational risk, while the exit of certain customer categories from the customer base of the banks still remained a topical issue on the agenda.

The development and competition environment, we are now involved in, hardly ever faces stagnation. At the present stage, there is an apparent confrontation of values between the Western world, which Latvia belongs to, and the different mind-set to the east of us, where the high risk funds mostly have originated and come from into our financial sector. In the light of these geopolitical indications, it is logical that the test the Latvian banks should currently pass is much more refined than we had ever imagined, and the errors of the past still resonate. In February this year, the US Financial Crimes Enforcement Network expressed its concerns about the activities of the largest domestic capital bank in Latvia, focused on the foreign customer service, with respect to sustainable money laundering, and proposing to henceforth apply special measures to the said bank, publicly disclosing this information. The proposal merely isolated the bank from the financial markets due to reputational risk, even though its financial situation was stable, and the stockholders had to promptly adopt the decision on the winding-up of the bank. Currently, under the supervision of the FCMC, voluntary liquidation of a bank is being implemented for the first time in Latvia, by ensuring, through a special control mechanism, that no circulation and laundering of the proceeds from criminal activity would be possible during this process. This is a new experience for both the supervisor and the participants of the sector.

In light of the changes in the global financial system and national safety aspects, the government has set the task to also henceforth audit the high risk customer segment, by reducing the exposure to CIS customers to a controllable level (5-6%), also assessing the deposits of so-called other countries hidden behind them to clarify what they actually consist of, and focussing on the attraction of the wider scope of the European Union customers. Thus, the very foundation of our banking system, existing over the last 25 years, would be changed. In the future a different customer profile will be established. This transformation will, most likely, be followed by the merger of the two former Latvian banking groups, and there would be no longer any specific foreign customers' banks. The stage of fundamental changes in the Latvian banking sector will consistently continue under the management of the FCMC and in cooperation with our strategic allies. The changes will be introduced also to other market segments in line with the latest legal framework and practice of developed countries.

The task of the financial supervisor in this transformation process is to be able to timely foresee potential flaws in the new business plans and strategies that have been developed anew. Our technologically advanced financial institutions, most probably, well equipped also in the field of FinTech, should be used to kick-off a new start. In terms of clientele, the current changes are actually to be viewed as returning to the natural geopolitical environment of Latvia, observing the self-determined boundaries. Our largest reputational risks continue departing, and a new ground with new players is now being formed, with policing the developments in our hands. The FCMC's change management team has my confidence, because at this historical stage, full of regular and unexpected events, through our intense work we have ensured that, on the whole, stability and soundness still prevail in the Latvian financial sector. I extend my gratitude to the colleagues and partners for their contribution up to now.

Pēters Putniņš
Chairman of the FCMC

3. REPORT OF THE BOARD

The FCMC has been operating as an autonomous public institution since 1 July 2001, regulating and monitoring 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 activity of the FCMC is managed by the Board, consisting of five members of the Board: Chairman of the FCMC, his deputy and three members of the Board, who concurrently are the directors of the departments.

In 2017, changes occurred in the composition of the FCMC Board – on 6 June, the previous Deputy Director of the Supervision Department Nora Dambure was appointed as Director of the Supervision Department and Board Member. In turn, Jeļena Ļebedeva, who had been working in the composition of the FCMC Board since March 2012, continued working in the FCMC and managed the Resolution and Guarantee Funds Division. The rest of the composition of the Board remained unchanged in 2017 – Chairman of the FCMC Pēters Putniņš, Deputy Chairwoman Gunta Razāne, Director of the Legal and Licensing Department Gvido Romeiko and Director of the Regulations and Statistics Department Ludmila Vojevoda.

FOTO: Board of the FCMC at the beginning of 2018

Pēters Putniņš

Gunta Razāne

Nora Dambure

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 decision-making. In 2017, 55 meetings of the FCMC Board were held, during which 218 decisions were adopted (in 2016 – 45 meetings with 223 decisions adopted, 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, meetings of the Consultative Council of the Financial and Capital Market Commission are also convened on a regular basis. In 2017, fourteen such meetings were held during which 40 draft laws and regulations binding on the financial and capital market were reviewed (in 2016 – 33 draft laws, respectively).

On 4 November, 2017, three years had passed since the establishing of the Single Supervisory Mechanism, and in the area of the supervision of the banks that are significant for Latvia, the staff of the FCMC continued to actively involve the joint supervision task forces of the European Central Bank in the work of the SSM, as well as in the development of supervisory practice. Three systemically significant Latvian banks, i.e., *Swedbank*, *SEB banka*, and *ABLV Bank* are subject to supervision in cooperation with the staff of the ECB and the FCMC, and it forms a significant basis for the everyday supervision of banks. The FCMC also supervises less important banks, whereas the ECB continued to prescribe a uniform framework and guidelines for the supervision of such banks.

The FCMC, ensuring continuous monitoring of market participants, carried out the monitoring of the performance results of market participants, the analysis of the financial statements and activity inspections thereof, *inter alia*, on-site inspections.

Overall, in 2017, the FCMC carried out on-site inspections of 43 market participants, including 17 inspections of banks, four inspections in insurance companies, three inspections in electronic money institutions, two inspections in the field of the provision of investment services, four inspections in savings and loan companies and one inspection in an investment management company; one on-site inspection of one state-funded pension scheme asset manager was also carried out, as well as two private pension fund inspections. In 2017, the FCMC carried out on-site information system inspections in three banks, one insurance company, two branches of insurance companies and three payment institutions.

In 2017, the FCMC, in cooperation with the US Federal Bureau of Investigations, detected that five Latvian banks – AS *Baltikums Bank*, AS Privatbank, AS Reģionālā investīciju banka (Regional Investment Bank), AS *NORVIK BANKA* and AS *Rietumu Banka* – had failed to observe the requirements of the regulatory legal framework in the field of anti-money laundering and counter-terrorism financing (AML/CTF). All of the involved banks cooperated with the FCMC and recognised the detected flaws. The FCMC had entered into administrative agreements with the referred to banks, enabling them to most effectively ensure the fulfilment of urgent measures – to timely detect the transactions leading to the evasion of international sanctions, and to act in accordance with the procedure prescribed by the legal framework. The fine was imposed on these five credit institutions in the sum total of EUR 3,532,785 and a number of duties were stated for the arrangement and enhancement of the internal control system of the banks. In addition thereto, in three cases a warning was expressed to five officials of the credit institutions in charge of the AML/CTF.

In 2017, the FCMC Board also imposed a fine on AS *Meridian Trade Bank* in the amount of EUR 889,651, because it detected that the bank had failed to ensure due internal control system operation in the field of credit risk management.

In 2017, the FCMC Board adopted an important decision to address the court with a petition on the revocation of the administrator of the liquidated AS *TRASTA KOMERCBANKA* from the fulfilment of the duties of the administrator. The FCMC detected that the administrator of the liquidated AS *TRASTA KOMERCBANKA* did not meet the requirements laid down in the Credit Institutions Law and its actions were to be considered to contain bad faith.

In 2017, the FCMC issued a warning to AS *SEB banka*, because it had failed to fully comply with the requirements of the Statutory Regulations of Safety of Information Systems of the Financial and Capital Market Participants, namely, had failed to ensure, within the set term (1 April), the set limits for a simplified internet banking authorisation tool – code card.

In 2017, taking into account the decision of the FCMC Board to allow *Nordea Bank AB* to transfer the assets and liabilities of *Nordea Bank AB* Branch in Latvia into the ownership of AS *DNB banka*, two mutually competing banks were merged, further on operating under the name *Luminor Bank* AS.

ABBREVIATIONS USED IN THE ANNUAL REPORT

AIFM – Alternative Investment Fund Manager

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

CCB – Counter-cyclical Capital Buffer

CET1 – Common Equity Tier 1 Capital Ratio

DGF – Deposit Guarantee Fund

EBA – European Banking Authority

ECB – European Central Bank

EEA – European Economic Area

EIOPA – European Insurance and Occupational Pensions Authority

ESMA – European Securities and Markets Authority

ESRB – European Systemic Risk Board

EU – European Union

FATF – Financial Action Task Force

FCMC – Financial and Capital Market Commission

FinTech – information technology based financial services innovations

FPI – Fund for the Protection of the Insured

FSF – Financial Stability Fee

GC – Guaranteed Compensation

GDP – Gross Domestic Product

IFRS – International Financial Reporting Standards

IT – Information Technology

LCR – Liquidity Cover Ratio

MFI – Monetary Financial Institution

MLTF – Money Laundering and Terrorism Financing

OECD – Organisation for Economic Cooperation and Development

OPCAI – Occupational Pension Capital Accumulation Institution

PIE – Public Interest Entity

PRIIP – Packaged Retail and Insurance-based Investment Product

ROE – Return On Equity

SFPS – State-Funded Pension Scheme

SPA – Staff Performance Appraisals

SRB – Single Resolution Board

SRB –Single Resolution Board

SREP – Supervisory Review and Evaluation Process

SSM– Single Supervisory Mechanism

TKB – AS TRASTA KOMERCBANKA

FCMC ACTIVITIES IN 2017

SUPERVISION

Credit institutions

Supervisory principles

The FCMC regulates and oversees the sector of the Latvian commercial banks in close cooperation with the European Central Bank within the scope of the SSM 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 undertakes continuous and comprehensive supervision of 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 focussing 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 and horizontal off-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 is continuously improving the methods applied in the supervision of all market participants.

In 2017, 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 2017, based on the assessment of the operational risks of credit institutions and of the trends of the financial system, the FCMC set the supervisory priorities.

Credit institution supervisory priorities set in 2017:

- the assessment of the strategies, business models, and the earning capacity of the credit institutions, with a focus on sustainability and balancing of the earning capacity;
- strengthening the compliance and risk management functions, focussing on the process of the performance and effectiveness of the stress test of the bank, enhancement and practical application of the recovery activity plans, as well as the reporting quality;
- credit risk and assessment of adequacy of provisions, focussing on problematic loans and the recovery process; in parallel, the supervisors also focussed on the measures for the introduction of IFRS 9 and the readiness of the banks thereto.

Based on the priorities, the minimum amount of supervisory measures was identified and, taking into account the existing resources, the supervisory measure plan was drawn up for 2017, which comprised on-site as well as off-site supervisory measures.

Supervision of banks in 2017 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.

A number of off-site measures were taken for the assessment of the **business model and earning capacity** in accordance with the approved plan of supervisory measures, *inter alia*, the reports submitted by the banks, performance indicators and other information at the disposal of the supervisor was analysed, as well as the material risks inherent to the banking business have been assessed. Within the scope of assessment of the business model and earning capacity, indicators such as return on equity (ROE), cost-income ratio, income stability, changes in number of payments and number of customers, interest and tariff policy, etc. were assessed.

The focus of the priority of **strengthening the compliance and risk management functions** was on the strengthening of the internal capital and liquidity adequacy assessment process in the banks, enhancement and practical application of recovery plans, as well as the quality of reports prepared by the bank (COREP, FINREP).

In the field of **credit risk and assessment of adequacy of provisions**, the main focus was on the work of the bank with problematic loans and the process of recovery thereof, as well as the impact of the introduction of IFRS 9 on the identification of the non-performing assets, revaluation thereof and the formation of provisions.

Off-site monitoring of bank performance

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, is constantly assessing 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, plans the necessary supervisory measures, including on-site inspections.

In 2017, 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, thus promoting a mutual dialogue between the FCMC and the banks.

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

> In 2016 and 2017, the supervisory review and evaluation process (SREP) carried out by the FCMC was considerably enhanced, taking into account the EBA guidelines for the supervisory review and evaluation process, as well as the ECB framework with respect to the SREP of less significant banks.

Risk assessment, within the scope of the SREP, is being carried out biannually, and it takes into account both the risk level characterising quantitative indices and their thresholds in accordance with the ECB methodology[1], as well as information on risk management arising out of the on-site inspections, thematic and horizontal inspections, information at the disposal of the FCMC on the observance of the regulatory requirements in the credit institutions, detected internal control system flaws, quality of the capital and liquidity adequacy assessment processes and the recovery plan assessment.

Risk assessment within the scope of the SREP of the significant banks under direct supervision of the ECB is carried out annually, by means of the methodology prescribed by the ECB.

Risk assessment, within the scope of the SREP, is set out in the rating scale from "1" to "4", and, in 2017, the following risk ratings were assigned to banks in Latvia:

Risk level	1.0–1.7 (low risk)	1.8–2.5 (moderately low risk)	2.6–3.3 (moderately high risk)	3.4–4.0 (high risk)
Number of banks[2]:	0	6	8	1

The planning of the supervision of an institution is performed based on the risk rating assigned to it — the required supervisory measures applied to an institution that has been assigned the lowest rating (the institution's activities have a low inherent risk and its risk management is sufficient) are minimal, whereas an institution with the highest risk rating (the institution's activities have a high inherent risk and its risk management is weak) attracts continuous and enhanced supervision.

The SREP results were taken into account, when determining the common equity capital requirements for covering the risks inherent to the banking activity or potential risks.

1 Available only to the supervisory authorities within the scope of the SSM.
2 Including the banks under the direct supervision of the ECB.

Sanctions and corrective measures

In carrying out the supervision of banking activity, in 2017, the FCMC imposed a fine on one bank regarding the deficiencies in the internal control system in the field of credit risk and internal governance, and issued a warning to one bank regarding the violations of the FCMC regulations.

The FCMC also carried out corrective measures, setting additional requirements to 10 banks in the field of credit risk.

Group supervision

In 2017, 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 2017, 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.

In 2017, 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

During the reporting year, the FCMC carried out 17 inspections in banks, paying particular attention to assessing the capital adequacy ratio, the lending process as well as risk management functions — management of credit risk, operational risk, liquidity risk, market risk, strategy, and business risk, as well as the control function over operational compliance. The deficiencies and irregularities identified

Horizontal off-site inspections in credit institutions

One of the objectives of horizontal inspections is to get a comprehensive and comparative insight into the assessment of a single risk or particular activity area. In 2017, the FCMC carried out two horizontal off-site inspections. In 2017, horizontal inspections comprised matters such as:

- asset recovery process and the management of the assets taken over;
- calculation of the weighted values of the exposure risk for the credit risk.

In addition to the above mentioned, in light of changes in assessing financial instruments, which took effect on 1 January 2018, along with the introduction of the International Financial Reporting Standard 9 "Financial Instruments" (SFRS 9), the FCMC assessed the readiness of the banks to apply the requirements of the referred to standard.

The results of horizontal inspections and assessment regarding the readiness of the banks to introduce IFRS 9 enabled the FCMC to gain a comprehensive view on the issues to be inspected, identifying overall trends and practices in the activities of banks and specifying the general requirements, comprising the best practices. On the basis of the results of inspections, the FCMC developed the best practice recommendations to the banks, as well as will apply the results of inspections and assessment regarding the readiness of the banks to introduce IFRS 9 in further everyday banking supervision.

Capital adequacy

The level of the capitalisation in the banking sector remained high, and at the end of 2017, the combined capital adequacy ratio of the banking sector reached 21.4%, whereas the Common Equity Tier 1 capital (hereinafter referred to as CET1) – 19.0%. 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 Tier 1 capital in the case of Latvian banks.

In 2017, 11 banks used the opportunity to consolidate their capital base, including therein the audited (interim) profit for the current year. The increase in the capitalisation level was also driven by the improvement in the quality of the bank loan portfolio and decrease of large exposures. In 2017, one bank increased the paid-up share capital by EUR 4.08 million, whereas, two banks, by disbursing the dividend from the retained profit of the previous years (Interim), decreased the equity capital by EUR 26 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.

Each year the banks assess 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.

Some areas for improvement 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 certain cases, the FCMC requested updating of the results of the process of assessment of the internal capital adequacy and submitting them repeatedly. Concurrently, the FCMC continued to maintain dialogue with the banks about their business model, strategy and capital planning process.

During the assessment of bank capital adequacy ratio, 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.

Within the scope of the SREP, in 2017, the FCMC evaluated the level and management of banking risks mentioned in Article 92 of EU Regulation No. 575/2013 (Tier 1 risks), and other risks inherent to the activities of the credit institutions and probable risks (Tier 2 risks) and in accordance with the rights provided for by the Credit Institutions Law set the requirements to all banks to maintain the highest own funds level for covering such risks inherent to the activities of the credit institutions and probable risks, which are not covered by the own funds requirements set by EU Regulation No. 575/2013.

Liquidity

Sufficient liquidity of the credit institutions ensures the ability to withstand the potential reduction in the deposit base under the influence of external macroeconomic environment risks, and, for the purposes of ensuring adequate liquidity, the FCMC is entitled to set special liquidity requirements to the credit institutions. The FCMC assesses the risks inherent to the activities of the credit institution and probable risks, taking into account the business model thereof, risk management principles and possible systemic liquidity risk that might endanger the stability of the financial market of the Republic of Latvia.

Also in 2017, the FCMC evaluated whether the strategy, procedures and measures taken by the credit institutions ensure sufficient risk management, whether the amount of liquidity reserves of the credit institutions is sufficient for covering the liquidity and financing risks inherent to its activities and corresponds to the business models. The FCMC, evaluated the reports of the credit institutions regarding the process of the liquidity adequacy assessment, and, in 2017, had prescribed the special liquidity requirement to 13 banks, the activities whereof were mainly focussed on servicing foreign customers.

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 their activities. In 2017, in 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 activity of each bank were assessed. If necessary, the banks were requested to carry out improvements.

Single Supervisory Mechanism

On 4 November 2017, it was three years since establishing the Single Supervisory Mechanism or the SSM. 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 2017, EUR 21 trillion of the assets of the Eurozone banking sector were under the direct or indirect supervision of the SSM. Within a short time, the SSM has become the largest bank supervisor globally. Except for 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 2017, there were 114 significant 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 3500 less significant banks (18% of the assets of the Eurozone banking sector).

In 2017, three Latvian banks – *Swedbank*, SEB banka and *ABLV Bank* – were supervised by the ECB, and from 10 February 2018, following the merger of *DNB banka* and *Nordea Bank* Branch in Latvia, *Luminor Bank* also became subject to direct ECB supervision. These banks are supervised, with the ECB and FCMC staff participating in the joint supervisory work teams, which form the basis of the everyday supervision of significant banks.

The FCMC continued to supervise less significant banks and, at the same time, in cooperation with the ECB and other national competent authorities, to enhance and adjust the single framework and guidelines for the supervision of such banks. The FCMC took an active part in the processes managed by the ECB, namely, with respect to the bank earning capacity analysis, introduction of IFRS 9, the matter of non-performing loans, by developing appropriate guidelines for banks. Various measures were taken to improve the solvency of the Eurozone banking sector, as well as the FCMC took an active part in the development of common supervisory standards by improving one of the key banking supervisory tools – the supervisory review and evaluation process.

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 of the significant 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 2017, the ECB Supervisory Board adopted 2308 decisions (the decisions were mainly adopted on the following issues: 1057 licensing decisions, 188 decisions on own capital matters and 342 decisions in regard to SREP), 32 board meetings and draft decisions were coordinated and approved in 1888 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 and enhancement of the ECB's single supervision methodology, as well as further coordination of the statutory regulation in the European Banking Union space.

Insurers

In 2017, the priority of the supervisory process of insurance companies was to ensure supervision pursuant to the requirements laid down in the Insurance and Reinsurance Law, namely, the compliance of the submitted documents with the statutory requirements and the on-site inspections of the activity of insurance companies.

In 2017, the FCMC carried out the full-scale on-site inspections of the activities of two insurance companies and thematic on-site inspections of the activities of two insurance companies, evaluating the conformity of the formation of technical reserves to the requirements set by the legal framework. The FCMC carried out off-site supervision and monitoring, based on the analysis of the reports and other information submitted by insurance companies, as well as the insurance companies were invited to present the FCMC their approved operational strategies, thus facilitating 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 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 process, which is based on an assessment of the impact of risks. 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 and tools applied by them in terms of the nature, volume, and complexity of the operations thereof. In 2017, as a result of the risk assessment carried out by the FCMC and determining of the risk grade, the following risk grades were assigned to insurance companies:

Risk grade	1 (low level of risk and the applied risk management methods are sufficient	2 (moderate level of risk and/or while the risk management methods applied by the insurance company are satisfactory, there is room for improvement)	3 (increased level of risk and/or the risk management methods applied by the insurance company are not satisfactory, because there are considerable deficiencies)	4 (high level of risks and the risk management methods applied by the insurance company are not sufficient, i.e., inconsistent with the risks, scale of activity, and complexity inherent to its activity)
Number of insurance companies	0	3	4	0

In 2017, the FCMC carried out the thematic off-site inspection of the activities of all insurance companies with respect to their risks and solvency assessment performance process and assessed the received risks and solvency evaluation reports. A discussion was organised regarding the results of the off-site inspection with the responsible employees of insurance companies.

In the supervisory process carried out in 2017, material violations of the requirements prescribed by the Insurance and Reinsurance Law were identified, for which a warning was expressed to one insurance company.

In 2017, the FCMC cooperated with the supervisory authorities of insurance and reinsurance companies of EU Member States, which are supervising the insurance groups and reinsurance groups whose members were insurance companies licensed in Latvia. In 2017, FCMC staff participated in the colleges of insurance and reinsurance supervisors of three EU Member States and prepared and provided information in accordance with the requests of group supervisory authorities.

In 2017, the FCMC also cooperated with the insurance supervisory authorities in Estonia and Lithuania, took part in the joint meeting of the insurance supervisors of the Baltic State organised by the Lithuanian supervisory authority, as well as in the work of the European Insurance and Occupational Pensions Authority (EIOPA) in the field of insurance supervisions and provided information in accordance with the requirements of the International Association of Insurance Supervisors and the OECD.

Insurance and reinsurance intermediaries

In 2017, the FCMC carried out 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 it, which is based on the analysis of the submitted reports and other submitted information.

In the reporting year, the FCMC conducted a thematic on-site inspection of the activity of six insurance brokers, assessing their compliance with the requirements laid down in the Law of the Activity of Insurance and Reinsurance Intermediaries.

In the supervisory process carried out in 2017, material violations of the requirements laid down in the Law of the Activity of Insurance and Reinsurance Intermediaries were identified, for which the record of one insurance broker was withdrawn from the Register of Insurance and Reinsurance Intermediaries maintained by the FCMC.

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

In 2017, the FCMC carried out an inspection of the observance of procedure for the establishment, accruing and administration of the guarantee fund of compulsory third party liability insurance of the owners of motor vehicles administered by the association Motor Insurers' Bureau of Latvia and informed the Ministry of Finance and the association Motor Insurers' Bureau of Latvia about the results of the performed inspection.

Cooperative credit unions

In 2017, 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. During the reporting year, the FCMC experts carried out four on-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 initiated against credit unions in 2017. In 2017, a licence was withdrawn for one union.

Payment institutions and electronic money institutions

At the end of 2017, there were 22 payment institutions operating in Latvia. Along with the growth of market competition in the provision of payment services via electronic payment means and reduction in the number of payment institutions and electronic money institutions offering payment services by more than 20%, the total volume of the payment performed by the payment institutions and electronic money institutions was also considerably reduced.

In 2017, 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 2017, the supervision of payment institutions and electronic money institutions was carried out, also taking into account 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 2017, special focus was placed on the analysis of the client base of the payment institutions and electronic money institutions, planning to continue it also in 2018.

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 2017, there was a focus on the financial stability of payment institutions and electronic money institutions: The FCMC requested information regarding the amount of equity capital of the institutions and the balance sheet statements not only from the licensed institutions, but also from the registered institutions.

In 2017, on-site inspections were carried out in three electronic money institutions. These inspections were aimed at assessing the compliance of the operational model and the performance of the management of 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.

In carrying out the supervision of activity of payment institutions and electronic money institutions, in 2017, the FCMC initiated four administrative cases. The registration in the FCMC's payment institution register was cancelled for seven payment institutions and three electronic money institutions (discontinuation of the provision of payment services).

Investment management companies and investment funds

In 2017, the off-site supervision of investment management companies and investment funds was carried out to assess their financial standing, quality of assets, income and costs structure and compliance of their activities with the requirements of the laws and regulations.

Conformity assessment of key information aimed at investors was carried out, as well as an 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 also 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 inherent to the company, 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.

In 2017, a risk profile assessment of all investment management companies and investment funds was carried out.

During the reporting year, one on-site inspection of the investment management company was also carried out. The inspection was aimed at assessing the key field of activity of the companies and the conformity thereof to the requirements of the laws and regulations. Special focus in the course of inspection was placed on the control system developed by the company and to risk management, by assessing the compliance and usability of the internal legal framework basis. During the inspection, the transparency of the company's activity and compliance with best practice principles were assessed, as well as how the interests of the clients were observed.

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

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.

Managers of alternative investment funds and alternative investment funds

In 2017, the FCMC conducted 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 laws and regulations.

Special focus was placed on the use of asset evaluation methods for determining the value of the assets. 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.

Managers of the assets of the state-funded pension scheme and investment plans

In 2017, the off-site supervision of the asset managers of the state-funded pension scheme (SFPS) was carried out 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 laws and regulations.

In 2017, the taxonomy of off-site reports changed, therefore special focus was placed on the conformity of the received reports to the new taxonomy. During the reporting year, within the scope of off-site supervision, the FCMC also assessed the critical situation analysis provided by 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 the occurrence of adverse scenarios were assessed.

Within the scope of 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 2017, 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 was received and reviewed in accordance with the 10 December 2014 FCMC Regulation No. 295 Regulations on the Preparation of Key Information to the Members of the State-Funded Pension Scheme;
- investment plan expenses were assessed by in-depth analysis of the structure thereof;
- 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 2017, the on-site inspection of the activity of one SFPS assets manager was carried out. In the course thereof 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 and applicability 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 introduction of the action plan and, where required, recommending the necessary adjustments.

Private pension funds and pension plans

In 2017, the off-site supervision of private pension funds was performed 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 and regulations. In 2017, the taxonomy of off-site reports changed, therefore special focus was placed on the conformity of the received reports to the new taxonomy.

In the reporting year, two on-site inspections of private pension funds were also carried out to assess the activity of the pension fund when carrying out the functions specified in the Law on Private Pension Funds. During the inspections, particular attention was paid to the appropriateness and sustainability of the internal control system established by the pension fund and the identification and management of material risks. The segregation of functions and appropriateness to its 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 of the pension fund to assess the outsourced services. Within the scope of inspection of each pension fund, the activity of the manager of the funds thereof and the holder of the funds thereof was also assessed. During the inspection, the FCMC also assessed the risk trends of the products offered by the pension funds.

The deficiencies and inconsistencies identified during the inspections were discussed with the management of the pension fund, and action plans for making the necessary adjustments were agreed upon to successfully ensure the functioning of the pension fund. Follow-up monitoring has been 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 mystery shopping inspection was also carried out, applying the mystery shopping technique 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. Meetings were also 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.

During the reporting year, 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 EIOPA in the area of pension fund supervision, by providing answers to surveys and self-assessments, as well as taking part in the work of the 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 the Review Panel. The project coordination work of Peer Review on the Prudent Person Rule for IORPs was commenced.

During the reporting year, the representatives of the FCMC 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.

Investment service providers

In 2017, in the field of the provision of investment services, two full-scale on-site inspections were carried out, one mystery shopping visit and six meetings with the management of the structural units of market participants providing investment services were organised, during which the market participants presented their activities in the sector of investment services, as well as the taken measures and plans with respect to the internal control measures in the field of the provision of investment services. During the inspections, the FCMC, in the same manner 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 their knowledge, experience, investment objective and financial ability to assume a particular risk. The FCMC also assessed the topicality of internal processes and documents of investment service providers and their compliance with the requirements of the laws and regulations.

During the reporting year, several off-site measures were taken, mainly related to the assessment of the reports submitted by the market participants and the statement provided by certified auditors, as well as the review of complaints and applications of the customers of investment service providers and provision of advice.

As in the second half of 2017 the FCMC and all investment service providers were actively getting prepared for the introduction of the new directive in the field of the provision of investment services (MiFID II) and the number of directly applicable regulations related thereto, the FCMC experts provided support to the Ministry of Finance in preparing the corresponding amendments to the Law on the Financial Instruments Market, developed and coordinated several new statutory regulations related to the introduction of the requirements of MiFID II with the industry, provided advice and informative support to market participants, *inter alia*, by posting questions and answers on the website of the FCMC.

In 2017, no sanctions or corrective measures of another kind were imposed for the breaches and deficiencies in providing investment services identified in the inspections. At the beginning of 2017, the FCMC supplemented the Guidelines on the Application of Separate provisions of the Law on the Financial Instruments Market Governing the Provision of Investment Services, in order to demonstrate the typical deficiencies detected during the course of supervision to market participants, strengthen investor protection and promote compliance of the provision of investment service with the requirements laid down in the laws and regulations.

Financial instruments market

Supervision of the points of sale of financial instruments and the Central Securities Depository

At the end of the reporting year, there was one regulated market – *Nasdaq Riga* (Stock Exchange) and one multilateral trading system or alternative market – First North Latvia operating in Latvia. Both of these markets are operated by *Nasdaq Riga* AS.

In 2017, in carrying out the supervision of the activities of the points of sale of financial instruments, the FCMC regularly followed-up on whether the points of sale comply with the requirements of legal acts governing their activities, *inter alia*, disclose information on submitted orders and closed transactions, and assessed the documents submitted by them, by evaluating the compliance of the operation of the systems of internal control and information technologies.

As 2017 closed in re-licensing of the Latvian Central Depository in accordance with the requirements of Regulation No. 09/2014 – on 22 August 2017, *Nasdaq CSD* received the authorisation to provide the services of the central securities depository in Latvia, Estonia and Lithuania, and, starting from 15 September 2017, Estonian and Lithuanian central securities depositories have been joined to *Nasdaq CSD*. Therewith, the FCMC became the main supervisory authority for market infrastructure, now playing a significant role in not only the activities of the Latvian securities market, but also the securities market of the neighbouring countries. The FCMC established and is managing the *Nasdaq CSD* SE supervisory college, in close cooperation with the supervisory authorities and central banks in Lithuania, Estonia and Latvia. In December 2017, a cooperation and information agreement was signed between the FCMC, the Bank of Latvia, the Estonian Supervisory Authority, the Bank of Estonia and the Bank of Lithuania, setting the operational principles of the *Nasdaq CSD* SE supervisory college.

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

At the end of 2017, the stocks of 24 joint stock companies (issuers) in total were admitted to the trading on the regulated market (Stock Exchange), out of which the stocks issued by five issuers were listed on the Official Listing and the stocks of 19 issuers – on the Second Listing. The bonds of two new issuers were included in the securities listing in 2017, and, at the end of the year, in total it included 48 various debt securities' issues in a total of 16 issuers, whereof 10 issues were Latvian government debt securities and 38 issues were corporate debt securities.

In carrying out the supervisory function, the FCMC controlled whether the issuers were disclosing the regulated information in due time and in accordance with the requirements of the Law on the Financial Instruments Market and Regulation No. 596/2014. The FCMC followed-up on whether all of the issuers had timely published their financial statements (both the annual audited and the interim ones) in accordance with the requirements of the legal acts, and acted without delay, if it concluded that the issuer had failed to comply with the corresponding requirements (by imposing six corrective measures in total), and afterwards the issuers immediately prevented the respective irregularities. At the beginning of 2017, one of the issuers received a letter of reprimand from the FCMC for the failure to timely disclose such regulated information that is considered to be inside information in 2016.

Administrative proceedings were initiated against the issuers, whose infringements with respect to publishing financial statements were material, protracted or repeated; in four administrative proceedings decisions were adopted on the infringements of the Law on the Financial Instruments Market, imposing a fine on the relevant companies in the sum total of EUR 19,650 (the amount of the fine ranged from EUR 500 to EUR 10,650).

In 2017, the FCMC carried out the off-site due diligence inspections of the financial information (statements) prepared by the issuers, by controlling whether the issuers observe the reporting requirements. No material deficiencies or infringements were detected in the reporting procedures.

Since 1 January 2017, when the new regulation took effect stipulating the establishment of the audit committees and the operation thereof, the FCMC carried out both the explanatory work to facilitate the correct application of the new norms of law and the controlling work, by verifying whether all of the capital companies had acted in accordance with the new norms of law.

To facilitate the protection of investor interests and promote the actions of the market participants in accordance with the norms of law, in 2017 the FCMC also continued the practice launched in previous years – to take informative measures (seminars and informative letters), by informing the issuers on the coming into effect of the new requirements, explaining the application of requirements of separate legal acts, as well as directing the attention of the issuers to the most frequent mistakes.

At the end of 2017, the stocks of two companies were listed in the multilateral trading system – First North Latvia, *inter alia*, one of these companies was listed as the new issuer in 2017.

The alternative market does not have the status of the EU regulated securities market. The enterprises listed on First North Latvia market are bound by the regulations of First North Latvia, and they are not subject to the requirements prescribed for the enterprises listed on the regulated market (*inter alia*, requirements of disclosure of regulated information), which are usually stricter.

Trading in financial instruments (on the regulated and alternative market) and the supervision of investor activities

In 2017, a significant increase in the activity of trading in stock was observed on the Latvian regulated market (Stock Exchange) as compared to the year before, largely attributable to the mandatory stock redemption offer expressed by the majority stockholder of AS *Latvijas Kuģniecība* with respect to the stock of AS *Latvijas Kuģniecība*. In 2017, compared to 2016, the total number of transactions in the stock market increased by 10.3%, and the number of traded shares increased by 706.3%, as well as the total turnover in the stock market in 2017 was EUR 49.4 million, – 257.8% higher than in 2016. 58.2% of the total turnover of 2017 on the Stock Exchange was ensured by the transactions in the stock of AS *Latvijas Kuģniecība* – the turnover of the company stock last year comprised EUR 28.8 million. At the end of 2017, the stock market capitalisation of the Stock Exchange, compared to the end of 2016, had increased by 54.6% and comprised EUR 1,240.8 million.

In 2017, the activity also grew in the alternative market First North Latvia, because in November 2017 the trading in the stocks of one new issuer was commenced. In 2017, the total turnover of stocks in First North Latvia reached EUR 241.4 thousand.

To promote the stability of the financial instruments market and transparency of the operations thereof, the FCMC ensured continuous supervision of trading in financial instruments by following the transactions closed by the shareholders and bondholders, analysing the purchase and sales orders submitted to the Stock Exchange, as well as to First North Latvia, and the transactions carried out therein to detect and prevent market manipulation and insider dealing. Upon identifying the features of market manipulation or insider dealing, enhanced due diligence inspections were carried out – there were four such carried out in total. In two cases, the FCMC carried out the corrective measures and indicated to the investor that signs of market manipulation had been observed in its transaction, and required it to immediately cease the actions that might mislead other investors regarding a stock price, demand and supply. In one instance, the administrative proceedings on market manipulations were initiated against the persons involved in the transactions, but there was still no decision adopted in the said administrative proceedings by the end of 2017. Additionally, regular supervision was also carried out as to whether the information had been disclosed on changes in major holding (5% and more) and whether the persons performing the duties of the management of the issuer, or the persons closely associated thereto, had given notification of the transactions closed by them with the securities of the issuer in accordance with the requirements of the legal acts. In 2017, the FCMC initiated administrative proceedings against one of the investors regarding the infringement of Regulation No. 596/2014 (by adding the fact of the infringement of Regulation No. 596/2014 to the administrative proceeding initiated against the person at the end of 2016 with respect to the infringement of another type) and in the second half of the year adopted the decision in these administrative proceedings, by imposing a fine on the person for the infringement committed by them in the amount of EUR 1,500.00. In cases where the infringement of the person was less significant, for example, it was detected that persons who were obliged to disclose information on the transaction of the manager of the person closely associated thereto, had not done it in due time, the FCMC applied corrective measures in two cases – sent letters of reprimand to the persons, inviting them to henceforth act in accordance with the legal regulation.

Supervision of compliance in the AML/CTF field

In 2017, work started in the previous years was actively continued for the improvement of the regulatory framework, as well as the supervisory processes of compliance with AML/CTF requirements for banks and non-bank financial institutions, as well as in the strengthening of the supervisory function carried out by the FCMC in the field of AML/CTF.

By way of continuing the transposition of the requirements of the AML/CTF IV Directive, as well as ensuring the introduction of the recommendations of the Financial Action Task Force (FATF) and *Moneyval* experts, the FCMC took part in the development of amendments to the Law on the Prevention of Money Laundering and Terrorism Financing. The said amendments define the duty of the subject of the law to regularly review and update the policies and procedures and carry out the revision and updating of the ML/TF risk assessment, as well as the duty to ensure the storage, assessment and updating of documents and information obtained during customer due diligence at least once per five years. The amendments prescribe the requirements for the identification of the legal arrangement in accordance with the FATF recommendations, as well as define the term "occasional transaction", supplementing the customer due diligence and transaction monitoring requirements for such type of transaction. For example, in situations when enhanced customer due diligence shall be carried out, the requirement is set to also perform it with respect to the occasional transactions. A duty is imposed on the subject of the law to also carry out enhanced due diligence in cases not stipulated by law, if an increased ML/TF risk is present. In accordance with the FATF requirements, there is a requirement set for the subject of the law belonging to a certain group, to ensure, at the group level, that the structural units in charge of the compliance, audit and the fulfilment of the AML/CTF functions have access to the information necessary for the fulfilment of such functions from the branches and subsidiaries. The cash circulation thresholds have been lowered (from EUR 15,000 to EUR 10,000), taking into account that the persons trading in goods and receiving or performing payments in the amount of EUR 10,000 or more in cash have risk elevating circumstances, under which customer due diligence is to be carried out. The amendments also set the requirement for the subjects of the law, in establishing the internal control system, to provide for the procedure for ensuring independent anonymous internal reporting regarding the violations of the requirements of the referred to law and the assessment of such reports. The amendments put the definition of the ultimate beneficial owner in more detail in accordance with international standards, prescribing that the ultimate beneficial owners of all legal entities are to be identified – natural persons, implementing the title or control with respect thereto. The law contains the definition of the shell arrangement. Furthermore, the Law on the Prevention of Money Laundering and Terrorism Financing is supplemented with the new Chapter, stating the liability for violations in the AML/CTF field and the competence in the imposition of sanctions. In implementing the requirements of the AML/CTF IV Directive, fines and measures are prescribed with respect to serious, repeated or systematic violations of requirements regarding customer due diligence measures, information storage, reporting suspicious transactions and internal control of the subjects in charge.

In line with the delegation set by the Law on the Prevention of Money Laundering and Terrorism

Financing, the FCMC issued the statutory regulations, setting the minimum requirements for the credit institutions, licensed payment institutions and electronic money institutions for ensuring due diligence of service providers and monitoring of transactions, as well as the regulations binding on credit institutions with respect to the due diligence of their customers – loro correspondents and monitoring of the transactions during the business relationship. To manage the ML/TF risks, *inter alia*, the risks related to the provision of payment services, fund placement and interbank financial flow management, the FCMC issued the statutory regulations on the preparation of reports on the payments performed by the customers of credit institutions via correspondent bank networks.

Taking into account that the applicable legal regulation does not prescribe the features of suspicious transactions, but merely lays down a general definition of a suspicious transaction, the FCMC, having aggregated the deficiencies detected during the process of the supervision of credit institutions and the best practice examples in detecting suspicious transactions, as well as the recommendations, guidelines and best practice of international organisations, developed the recommendations for the credit institutions for detecting the features of suspicious transactions. In turn, in order to facilitate a uniform understanding of the credit institutions as to the measures to be taken within the customer due diligence, as far as possible, preventing the involvement of the credit institutions in the AML/CTF, having aggregated the deficiencies detected during the process of supervision of credit institutions and the best practice examples in customer due diligence, developed the recommendations for the credit institutions for the customer due diligence prior to establishing a business relationship and during the business relationship.

At the same time, the FCMC continued regular monitoring in the field of AML/CTF, and in 2017, a fine was imposed on five credit institutions for the failure to comply with the requirements laid down in the AML/CTF prevention law, in the sum total of EUR 3,532,785, as well as imposed a set of duties to be carried out in order to fine-tune and improve the internal control systems of the banks. The FCMC carried out the follow-up supervision of the fulfilment of these duties. In addition thereto, in three cases a warning was expressed to five officials of the credit institutions in charge of the AML/CTF.

The FCMC also continued the regular supervision in the AML/CTF field in the non-bank sector and, in 2017, the record was cancelled in the Register of the Electronic Money Institutions and Payment Institutions for one electronic money institution and one payment institution, a warning was expressed to one payment institution, as well as the activities of one credit union were suspended and a legal obligations were imposed thereto to convene the general meeting of members and resolve upon the continuation of the activities and considerable improvement of the internal control system in the AML/CTF field.

In 2017, the representatives of the FCMC took part in the work of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism Moneyval, where the issues regarding anti-money laundering were discussed.

In accordance with the FCMC's register of unusual and suspicious financial transactions, in 2017, 22 reports were sent to the Office for the Prevention of Laundering of Proceeds Derived from Criminal Activity.

Security of financial services and information systems

In 2017, the FCMC carried out on-site information systems inspections in three banks, one insurance company, two branches of insurance companies and three payment institutions. Increased attention was paid to the security of the provision of remote services, cybersecurity and ensuring business continuity.

Considerable effort was made for registration or licensing of the applications of new services of market participants or applications of new market participants, by assessing the conformity thereof to the requirements of statutory regulations on information systems. In 2017, the FCMC advised market participants on the new requirements for the security of 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 technology CERT.LV and took part in the meetings of the working groups of the Information Technology and Information Systems Security Expert Group (SEG), sharing experience regarding topical information systems, security hazards and methods for the prevention thereof.

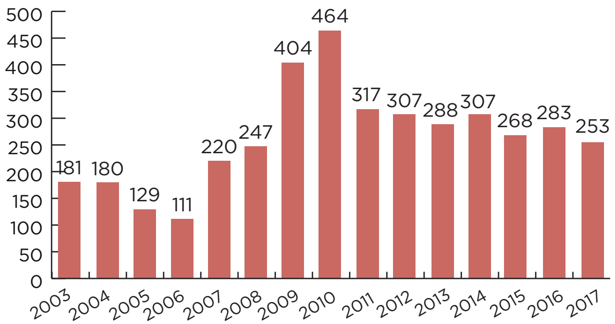
Review of customer complaints about the activities of market participants

The protection of the rights of the customers of market participants and the reviewing of complaints of the actions of market participants were also part of the FCMC supervision in 2017.

In 2017, the FCMC received and reviewed 253 applications regarding the actions of various financial and capital market participants – 189 complaints on credit institutions, 42 – on insurance companies, 12 – on payment institutions and electronic money institutions, out of which 9 complaints were about the electronic money institution SIA FSC EU. In 2017, the FCMC adopted the decision to remove the record of this institution from the Register of Electronic Money Institutions. In 2017, the FCMC also received and reviewed three complaints regarding investment service providers, customer complaints regarding the issuers and one complaint on the activities of the investment management joint stock company. There were also three complaints received with respect to the operation of the stockholder in the financial instruments market.

Figure 1

Number of complaints received by years



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 163 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 would use the findings mentioned in 54 complaints for supervisory purposes. In turn, having reviewed content of five complaints, the FCMC identified deficiencies in the management of operational risk at the relevant credit institution.

In 2017, the FCMC received and reviewed 45 applications on the actions of insurance market participants in total – 27 applications on insurance companies, 15 – on the branches of EU Member State insurers in Latvia and three – on the insurance and reinsurance intermediaries.

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

Having reviewed 45 complaints of the customers of insurers and insurance and reinsurance intermediaries, the FCMC did not detect any violations of the laws and regulations, which would be subject to the imposition of sanctions prescribed by the Insurance and Reinsurance Law or the Law on the Activities of Insurance and Reinsurance Intermediaries. In 27 cases, the customer and the insurer continued resolving the mutual issues under a civil dispute, and the FCMC forwarded eight applications for review to the Motor Insurers' Bureau of Latvia.

6. ACTIVITIES OF MARKET PARTICIPANTS IN 2017

Banking sector

General information

At the end of 2017, 16 banks and five branches of banks of the EU Member States were operating in the Republic of Latvia. In spring of the reporting year, along with the change of the strategy and focussing on the provision of banking services in the local market only, the branch of the Estonian bank *Eesti Kreediidipank* in Latvia was closed. In turn, in autumn of the reporting year, several Latvian banks announced the name change, including, AS *Baltikums Bank*, demonstrating the expansion of the business model, continues its activities under the brand AS *BlueOrange Bank*, which is more easily perceived in international markets. Along with the changes in the composition of the stockholders, *Bank M2M Europe* changed its name to *Signet Bank*, thereby reflecting the commitment of the largest stockholder *Signet Global Investors* to promote the international development of the bank. At the end of the year, the change of the name of AS *Latvijas pasta banka* to AS *LPB Bank* was also registered in the Commercial Register of the Republic of Latvia. In autumn of 2017, the merger project of *DNB Bank ASA* and *Nordea Bank AB* was implemented in the Baltic states (hereinafter – the bank merger process) – and the merged bank continued to operate as *Luminor Bank* AB.

Latvian banking sector is narrowing down

In 2017, the gradual narrowing down of the scope of the banking sector was observed, mainly affected by the decrease in the scope of the business related to servicing foreign customers, leaving an adverse effect on the profit indices of the banking sector.

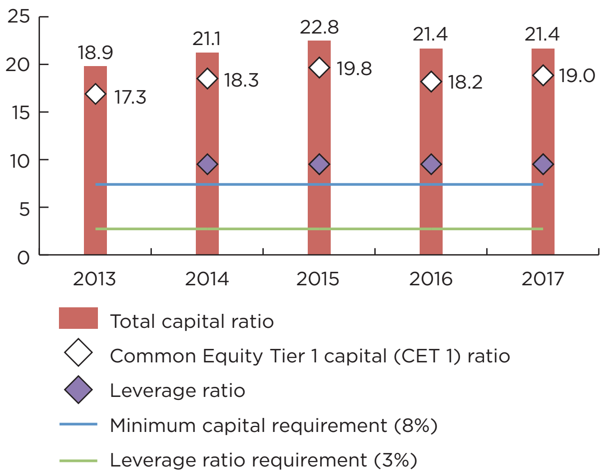
Banks with a considerable share of foreign customers continued to review their customer base, gradually terminating cooperation with high risk foreign customers. In light of the above, in 2017, the volume of foreign deposits in Latvian banks continued to reduce and the amount of assets of the banks decreased, as well. Notwithstanding the reduction in the foreign customer deposits and scope of the banking business, the banks still preserved a high capitalisation and liquidity level.

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 households continued to grow, and, alongside this, also the quality of the loan portfolio. A stable growth of domestic household deposits was preserved, compensating for the fall in deposits in other customer segments, thus the total volume of the domestic customer deposit remained almost unchanged, but the share thereof in the banking deposits reached 60%.

Banking sector performance indicators

The level of capitalisation of the banks remained constantly high, as the total capital ratio (TCR) at the end of 2017 reached 21.4%, but the Common Equity Tier 1 (CET 1) capital ratio – 19.0%. At the end of 2017, the TCR ratio of individual banks ranged from 12.5% to 38.1%, whereas CET1 ranged from 10.9% to 38.1%.

Figure 2
Bank capital ratios (%)



The banks also ensure that the leverage ratio[3] is at a high level, and, at the end of the reporting year, it reached 9.8%, whereas for individual banks it ranged from 5.1% to 20.3% (the minimum threshold set by the Basel Committee on Banking Supervision is 3%).

Liquidity of banks. The decrease of the foreign deposit balance has not affected the ability of the banks to maintain a sufficient amount of the liquid assets, in order to meet the FCMC's liquidity requirement[4]. The liquidity ratio still remained at a high level – in the banking sector, on the whole, at the end of the year, it comprised 59.4% (for individual banks it ranged from 35.7% to 117.9%).

Since 1 October 2015, the single liquidity coverage ratio (LCR) for banks came into force in the EU, i.e., the ratio of a bank's liquid assets to the "net liquidity outgoing cash flows" within a 30-calendar day stress period, and the banks had to ensure LCR fulfilment in the amount of at least 80% by the end of 2017. At the end of December, the average size of the LCR of the Latvian banking sector amounted to 313%, whereas for individual banks it ranged from 158% to 917%, thus significantly exceeding the minimum requirements. The high fulfilment of requirements will not cause any difficulties for the banks to also fulfil the LCR requirements after 1 January 2018, when the LCR will have to be fulfilled in the amount of 100%.

The total banking sector loans to deposits ratio practically remained unchanged and at the end of the year it comprised 71%. With the domestic loan portfolio decreasing, the domestic loans to deposits ratio dropped to 102% (at the end of 2016 – 105%), meaning that, in total, only a small share of the domestic loan portfolio is financed by foreign resources (primarily loans issued by parent banks).

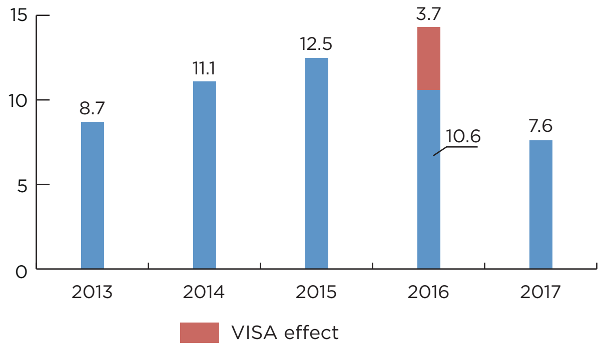
Earning capacity. In 2017, the earnings of banks[5] amounted to EUR 236.1 million (in 2016 approx. EUR 453.8 million), moreover, the performance of all

3 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.
4 By 31 December 2017, the minimum liquidity ratio requirements are in force - 30%. Liquidity ratio - Liquid assets/current liabilities (with remaining maturity up to 30 days), where Liquid assets = cash on hand = claims against central banks and other credit institutions = central government debt securities and other liquid securities, while the Current liabilities = liabilities on demand and liabilities with remaining maturity not exceeding 30 days.
5 Unaudited.

10 Latvian banks and four branches of foreign banks, (the market share whereof made up 92% of the total assets of the banking sector) involved a profit.

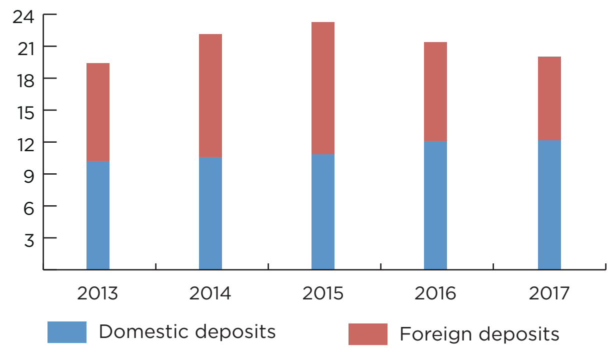
During the reporting year several factors adversely affected the profit, *inter alia*, the one-off income of the banks obtained in the previous year from the redemption of the stocks of *VISA EUROPE* owned by Latvian banks (which ensure a high profit base level in 2016), as well as the decrease in the scopes of business of the banks servicing foreign customers (which considerably reduced the amount of obtained income) and the bank merger process. The said factors adversely affected the total net amount operating income of the banking sector – compared to the previous year, it decreased by ~22%, while the main item of expenses of the banks – administrative costs – slightly increased (~1%). At the end of 2017, the return on equity (ROE) ratio of the banking sector achieved 7.6% (at the end of 2016 – 14.3%; 10.4%[6]), *inter alia*, in the banks, where a considerable share of business is comprised of servicing foreign customers, as the business volume reduced, the earning capacity continued to decrease and their ROE, at the end of December, comprised 5.7% (at the end of 2016 – 17.7%; 11.6%[6]), in turn, the earning capacity of the banks focussed on domestic customers remained stable, as their ROE, at the end of December, reached 9.5% (at the end of 2016 – 11%; 9.2%[6]).

Figure 3
Return on equity ratio (ROE), %



Amount of deposits. During the reporting year, the amount of deposits in total decreased by EUR 1.1 billion or 5.1%. Stricter AML/CTF requirements introduced in 2016 and the work of the banks for mitigating the risk pertaining to the foreign customer banks, continued to affect the reduction in the amount of foreign deposits in Latvian banks in 2017 as well. Though at a slower rate than the year before, the foreign deposits still decreased by 12% or EUR 1.1 billion (5.5% with the USD/EUR currency rate correction) over the year. The decrease in foreign deposits was also affected by the weak economic development in the countries of origin of the customers. In turn, the balance of domestic deposits in 2017, faced an insignificant increase, namely, by EUR 5 million. The acquisition of the European Union funds, as well as the favourable economic environment in the key trade partner countries facilitated private non-financial corporate investment growth, resulting in the reduction of corporate assets accumulated in the banks. The deposits of the government and financial institutions reduced, as well. In turn, the strong growth of domestic household deposits (by EUR 479 million) compensated for the rest of the reduction in domestic deposits. Therewith, at the end of the reporting year, the total amount of domestic customer deposits remained practically unchanged in the amount of EUR 12.2 billion. As a result of opposing trends in domestic and foreign deposits, foreign currency deposits dropped to 39.7% over the year (at the end of 2016 – 42.9%), and at the end of the reporting year, most of the deposits with Latvian banks were domestic customer deposits.

Figure 4
Dynamics of deposits with banks (in billion EUR)



Financing attracted by banks. Domestic deposits play an increasingly larger role within the structure of the financing of the banks, and, at the end of the reporting year, the share thereof grew to 43% (at the

6 Excluding the influence of VISA transactions (according to the FCMC estimates).

end of 2016 – 41.4%). In turn, in light of the fall in foreign deposits, the share thereof in the financing structure decreased to 28.4% (at the end of 2016 – 31%).

The scope of liabilities to affiliated institutions has not considerably changed for the second year in a row already – the share thereof in total liabilities comprised ~10% (at the end of 2016 – ~9%), while the liabilities to other MFIs continued to decrease and remained insignificant.

The balance of the issued debt securities slightly decreased over the reporting year, reaching 2.3% of the total liabilities at the end of the reporting year.

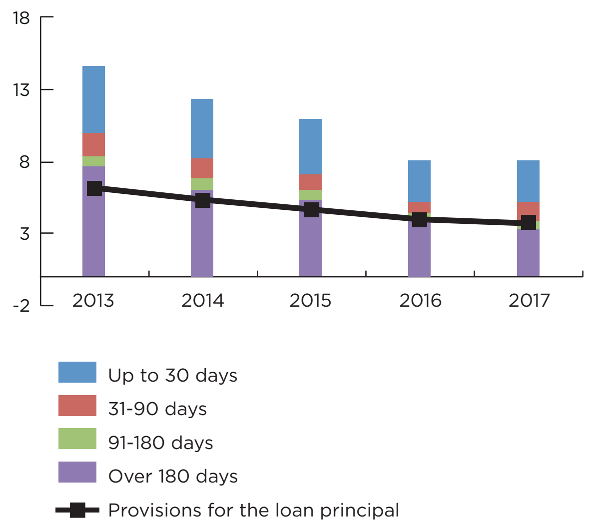
Loan portfolio. In 2017, the total loan portfolio decreased by 4.6%, mainly due to the bank merger process. Over the year, the balance of the loan portfolio of Latvian enterprises reduced by 4.0%, that of the households – by 0.9%, while that of the foreign customers – by 14%. Excluding the impact of the merger process, the total loan portfolio reduced by 0.3%, while the corporate loan portfolio increased by 3.8%[7].

On the whole, during the reporting year, the newly issued loans to domestic customers comprised EUR 2.3 billion, namely, 23.6% less than the year before. The decrease was triggered by a one-third smaller amount of the newly issued loans in the domestic non-financial corporate segment. In turn, the domestic household segment, for the fourth year in row, experienced a moderate increase in the newly issued loans, namely, by 5% over the period of 2017.

Quality of the loan portfolio. Quality of the loan portfolio continued to improve, as the share of loans overdue by more than 90 days decreased by 4.1%. Improvement in the quality of the loans is observed, mainly, in the domestic customer segment, where the share loans overdue by more than 90 days decreased to 2.9%. This was mainly triggered by the reduction in loans overdue by more than 90 days of domestic households to 3.5%, while for domestic enterprises it remained practically unchanged (2.5%). Opposing trends were observed in the foreign customer segment, where the share of loans overdue by more than 90 days, during the reporting period, grew to 11.1%. The total share of overdue loans in the loan portfolio remained unchanged during the year.

Figure 5

Overdue loans and provisions (% of the loan portfolio)



Insurance sector

Insurance sector performance indicators

At the end of the reporting year, there were seven insurance companies in Latvia (two life insurance and four non-life insurance companies), as well as 11 branches of EU Member State insurance companies (four life insurance and seven non-life insurance company branches). In the middle of the year, *Compagnie francaise d'assurance pour le commerce exterieur* Branch in Latvia (France) left the Latvian market, transferring the activities to Lithuania. In turn, at the end of 2017, the reorganisation of AAS *BTA Baltic Insurance Company* and *InterRisk Vienna Insurance Group* AAS took effect, namely, a merger by way of acquisition, therewith *InterRis Vienna Insurance Group* AAS ceased existing.

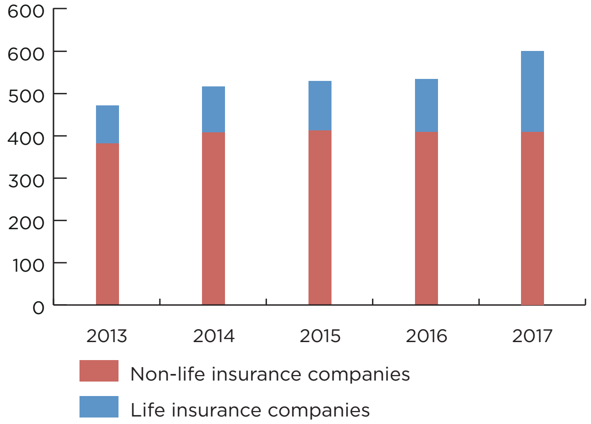
Premiums written. Both Latvian economic growth, and the expanded activities of the insurers outside Latvia promoted the development of the insurance market and the amount of gross premiums written by the insurers (insurance companies and branches of foreign insurance companies) grew steeply over the period of 2017 (by 21%), reaching EUR 646 million at the end of December, *inter alia*, the gross premiums written by the branches of foreign insurance companies comprised EUR 227 million or 35% of the total premiums written). *Inter alia*, the gross premiums written in Latvia in the total insurance market comprised 68%, and the amount thereof per capita achieved the pre-crisis

7 FCMC estimates.

level – EUR 228 (in 2008 – EUR 216). In turn, the rest of the gross premiums written were written in other EEA countries.

Figure 6

Premiums written by insurers (in million EUR)

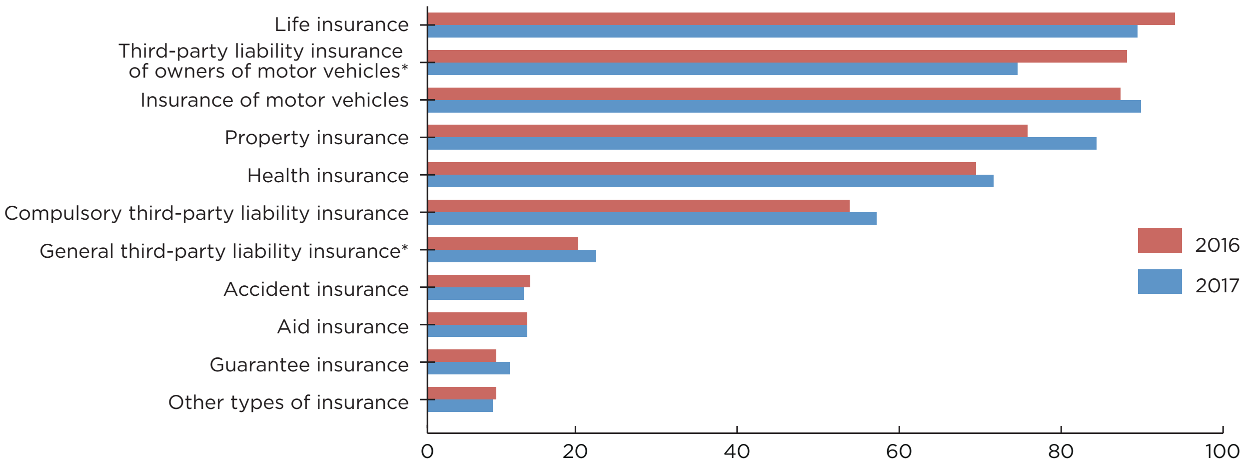


During the reporting year, the gross premiums written continued to grow in all of the largest insurance lines (except for the general third party liability insurance – 0.2%), without causing considerable changes in the structure. Almost one half (47%) of the gross premiums written was for transport insurance – achieving EUR 301 million (In 2016 – EUR 229 million). The second most significant insurance line was life insurance, as the total gross premiums written achieved 18% (or EUR 115 million), followed by property and health insurance (correspondingly, 13% or EUR 84 million and 12% or EUR 79 million).

Whereas in the EU Member States, in terms of the share of the gross premiums written, third-party liability insurance of the owners of motor vehicles, property insurance, and motor vehicles insurance accounted for the high est shares (60%, 13% and 15%, respectively).

Figure 7

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



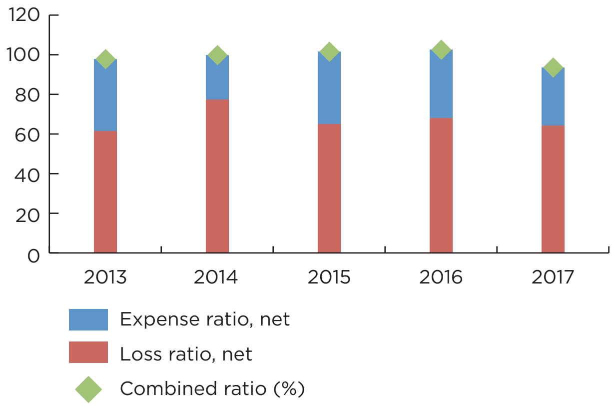
* Third-party liability insurance

Earning capacity. In 2017, the earnings of insurance companies amounted to EUR 16 million, including the earnings of non-life insurance companies of EUR 15 million; life insurance companies as a whole earned EUR 1 million.

Premiums earned grew much steeper than the applied indemnities and operating expenses, which also ensured the rapid improvement in the combined ratio (characterises the earning capacity of the non-life insurance companies over the year), namely, from 102.2% at the end of 2016 to 95.7% at the end of the reporting year (above 100% showing to the losses from the non-life insurance activities, not including the investment income).

Figure 8

Combined ratio (%)



Even though, during the reporting year, the return on investments of insurance companies was slightly lower compared to the year before, it should, nevertheless, be deemed as a good performance, because all insurance companies operated with positive investment return, namely, the average investment return of life insurance companies comprised 3.1%, that of non-life insurance companies – 0.8%.

Solvency. Insurance companies are well-capitalised and their average solvency ratio (the adequacy of own capital to the solvency capital requirement, which, under the Solvency II supervisory regime, is being determined, on the basis of risk assessment) at the end of the reporting year was 135%, including 132% for non-life insurance companies and 157% for life insurance companies (the lowest allowable limit of the indicator is 100%).

Cooperative credit unions

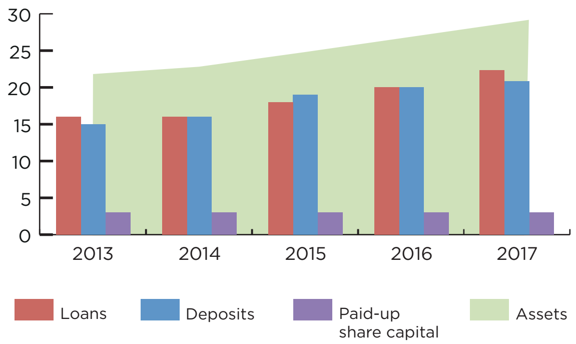
Performance indicators of cooperative credit unions

At the end of the reporting year, there were 33 cooperative credit unions in Latvia; and the total amount of their assets increased by 7.4% or EUR 2 million during the year reaching EUR 29.3 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 20.9 million, whereof the majority (88%) consisted of 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 22.5% at the end of December (the set minimum capital adequacy requirement being set at 10%).

Figure 9

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 EUR 2.8 million or 14%, amounting to EUR 22.3 million at the end of December, furthermore, 99% of the loan portfolio were issued to private persons. The growth was mainly ensured by consumer loans (by EUR 1.6 million) and home acquisition loans (by EUR 0.9 million), which constituted the key types of loans in the loan portfolio (correspondingly, 42% and 46% of the total loan portfolio).

The quality of the loan portfolio slightly deteriorated and, at the end of December, 57.4% of the credit unions' loan portfolio was rated as standard loans, 38.1% as to be supervised, whereas 4.5% of total loans were assessed as substandard, doubtful and lost (at the end of 2016 – 63.3%, 31.9%, and 4.9%, respectively).

During the reporting year, the amount of provisions created for bad debts increased amounting to 7.2% of the total loan portfolio of credit unions at the end of December (6.9% at the end of 2016).

As the quality of the loan portfolio became slightly weaker, the expenses of provisions for bad debts correspondingly grew, having an adverse effect on the amount of the obtained profit. During the reporting year, in general, the cooperative credit unions earned EUR 347 thousand, namely, 18.5% less than the year before. During the reporting year, the majority of credit unions worked with profit, namely, 23 (out of total 33) earning EUR 363 thousand in total.

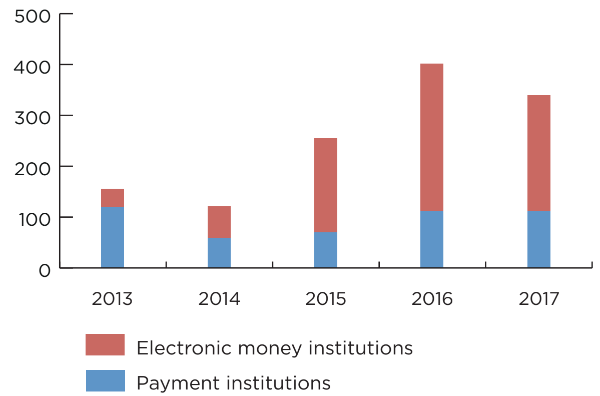
Payment institutions and electronic money institutions

Performance indicators of the payment institutions and electronic money institutions

During the reporting year, the number of payment institutions and electronic money institutions operating in Latvia decreased and, at the end of December, 22 payment institutions (of which 19 registered and three licensed) and 13 electronic money institutions (of which 10 registered and three licensed) were operating in Latvia.

As the number of the providers of payment services decreased (i.e., over the year, the number of payment institutions reduced by seven, while the number of electronic money institutions – by two), the total amount of payments performed by these institutions also considerably decreased – during the reporting year, in total, payments in the amount of EUR 321 million were performed, namely, 20.3% less than the year before.

Figure 10
Total annual amount of performed payments (in million EUR)



At the end of December, the total amount of the liquid assets of the payment institutions (funds for the fulfilment of the payments initiated by customers) reached EUR 1.5 million (including claims towards the banks for securing payment services – EUR 1.4 million), and it ensured the covering of the payables owed to the users of payment services (EUR 1.5 million).

The total amount of electronic money redeemed by the electronic money institutions characterising the exchange of the issued electronic money to cash, during the reporting year, grew by EUR 24.3 million or 65.7%, reaching EUR 61.2 million. At the end of December, the sum total of liquid assets of these institutions (funds securing the cover of the issued electronic money, and the funds for the execution of the payment initiated by the customers) comprised EUR 21.8 million (including claims against banks for securing the liabilities of the issued electronic money – EUR 6.4 million and the claims against banks for securing payment services – EUR 15.4 million), which secured covering of the liabilities both towards the electronic money holders and towards the users of payment services (EUR 7 million and EUR 10.9 million correspondingly).

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 2017, 12 investment management companies and 16 managers of alternative investment funds (including four investment management companies) were operating in Latvia. At the end of the year, the amount of assets under the management of the investment management companies reached almost EUR 4 billion, whereas the amount of assets under the management of the managers of alternative investment funds reached EUR 113.3 million at the end of December.

Performance indicators of investment funds

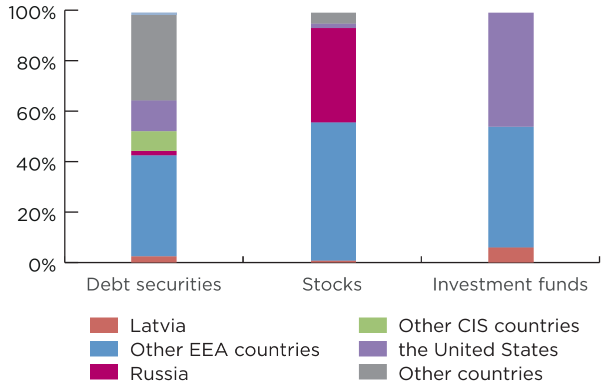
At the end of 2017, 27 investment funds registered in the FCMC were operating in Latvia, including 15 bond funds, three mixed funds and 9 stock funds.

Over the year, the assets of bond and stock funds slightly decreased (by 1.3% and 2.6%, respectively), while the assets of the mixed funds grew by 5.6%. Total investment fund assets decreased by 1% over the year, reaching EUR 216.1 million at the end of December, including the assets of bond funds amounting to EUR 178.1 million and EUR 13.9 million – of mixed funds, and EUR 24.1 million of stock funds.

Debt securities accounted for the major share of the overall securities portfolio of the investment funds (84%), followed by investment fund investment certificates (12%), as well as stocks and other variable-yield securities (4%). An important share of all asset classes consisted of investments in securities issued by EEA-based issuers. Investments in debt securities are focussed on a high-yield/high-risk segment, i.e., 63% of debt securities had a credit rating below the investment level (below BBB-). The majority, i.e., 67% of the investment certificates of investment funds were exchange traded funds (ETFs) (source: *Bloomberg*). Whereas equity investments are focussed on the financial, energy, consumer goods, and commodities sectors.

Figure 11

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 2017

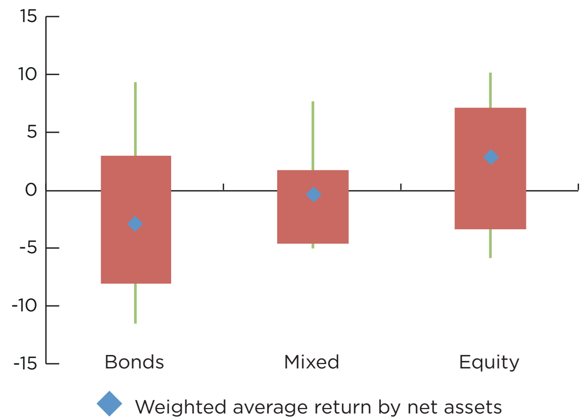


In 2017, the majority of investment funds had a negative return, and their performance was largely determined by the currency of fund investments, namely, high performance in terms of the euro was shown by the funds whose investment currency is the Euro.

The annual return of the bond funds ranged from – 11.5% to 9.3%, mixed funds from – 5% to 7.7%, whereas the stock funds from – 5.8% to 10.2%.

Figure 12

Annual return of investment funds by type of fund at 31 December 2017 (%)

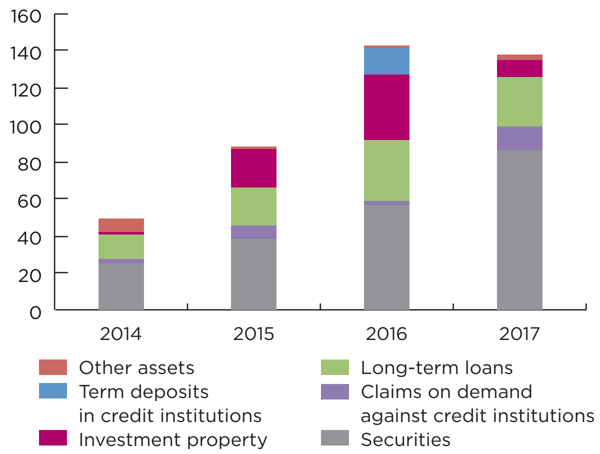


Performance indicators of alternative investment funds

At the end of the reporting year, there were 20 alternative investment funds operating. During the year, the assets thereof decreased by 4.2%, reaching EUR 137.5 million at the end of December. As the depositors performed new contributions, the assets of private equity investment strategy funds increased by 29%, reaching EUR 103 million at the end of the year, whereas, along with partial or full disbursement of investments to the investors, the assets of real estate investment strategy funds reduced by 46%, reaching EUR 34.5 million at the end of the year. The majority of the aggregate assets of alternative funds consisted of securities (EUR 85.9 million), long-term loans (EUR 27.2 million) and investment property (EUR 8.9 million). At the end of the year, 78% of the assets of alternative funds were invested in Latvia, 16% in Estonia and 5% in the UK.

Figure 13

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



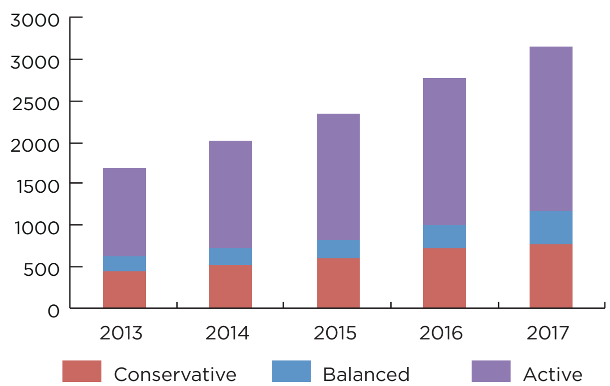
State-funded pension scheme (second pillar pensions)

Performance indicators of the state-funded pension scheme investment plans

At the end of the reporting year, 23 investment plans of the state-funded pension scheme were operating in Latvia, including eight conservative plans, four balanced plans and eleven active plans. Over the year, as a result of investment, profit of EUR 90.2 million was obtained, namely, 69% more than the year before. The pension capital accrued in the investment plans grew by 18.6% or to half a billion euro in 2017, totalling EUR 3.28 billion at the end of the year. Net assets grew for all types of investment plans.

Figure 14

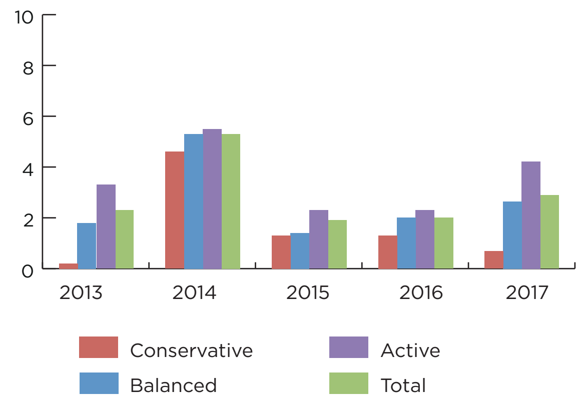
Accrued pension capital by type of investment plan (in million EUR)



In 2017, the rise in prices was observed in the European, US, as well as the global stock market, being promoted by improvement in the macroeconomic environment in the Eurozone and the USA. This was reflected in the performance results of the investment plans. During the reporting year, all active and balanced plans operated with positive return (for active plans it ranged from 3.4% to 13.4%, while for the balanced ones – from 1.6% to 10%). In the low interest rate environment, the earning capacity of the conservative plans remained limited and the annual return thereof was from -0.8% to 3.7%.

Figure 15

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



As the managers sought investment possibilities with potentially higher return, the share of the investment fund in certificates also continued to grow during the reporting year, namely, at the end of the year it already reached 46.2% of the total investment portfolio.

55% of investment fund certificates had a focus on investments in equities or the funds thereof, and 39% on fixed income instruments (source: Bloomberg). Investments in alternative investment funds slightly increased, accounting for 2.5% of total investments at the end of the reporting year (2.1% at the end of 2016). In light of the low interest rate environment, during the reporting year, the share of the claims on demand and term deposits in the credit institutions continued to decrease. Also, the share of debt securities in the total investment portfolio decreased slightly compared to the end of 2016, reaching 44.2% by the end of the year. In total, 85% of the debt securities had the investment credit rating (source: Bloomberg).

As investment plan deposits in credit institutions, as well as the investments into debt securities of the Latvian state and commercial companies declined, investments in Latvia dropped by one fourth during the year, reaching EUR 710.4 million at the end of the year or 21.7% of total investments (including EUR 377.2 million investments in the securities issued or guaranteed by the government, EUR 74.1 million — in debt securities issued by commercial companies, EUR 3.3 million — in stocks, EUR 28.8 million — in investment funds, EUR 8.2 million — in the venture capital market, and EUR 218.4 million was placed with credit institutions). In turn, 93% of all foreign investments were made in the European Union Member States.

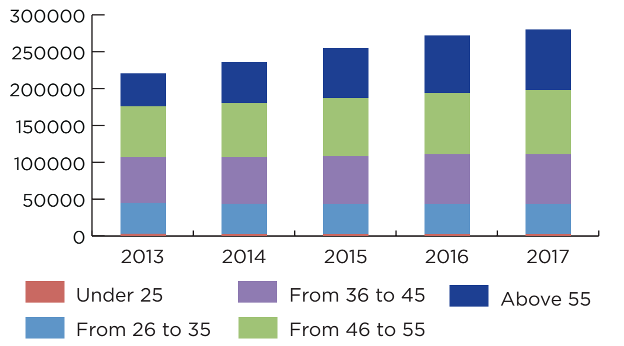
Private pension funds and pension plans (third-pillar pension plans)

Performance indicators of private pension funds

At the end of 2017, there were five open-end pension funds and one closed-end pension fund in Latvia, administering 18 pension plans in total. As in the previous year, in 2017, the population was rather interested in saving for pensions, and trends such as an increase in the number of participants and achievement of the new historical maximum with respect to the contributions paid by participants continued. According to the age structure of third-pillar pensioners, those who are approaching retirement age are more actively involved in making pension savings.

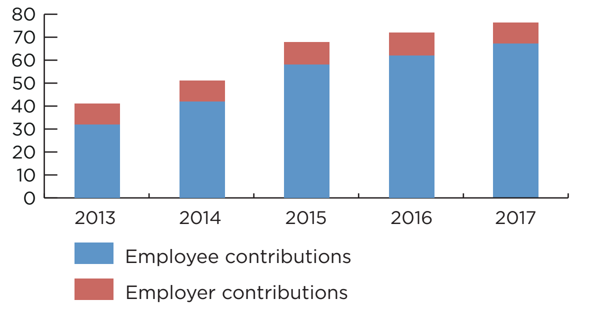
During the year, the total number of participants joining the private pension plans increased by 14.3 thousand or by 5.3%, amounting to 286,507 participants, namely, 29.2% of economically active Latvian residents at the end of the year.

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



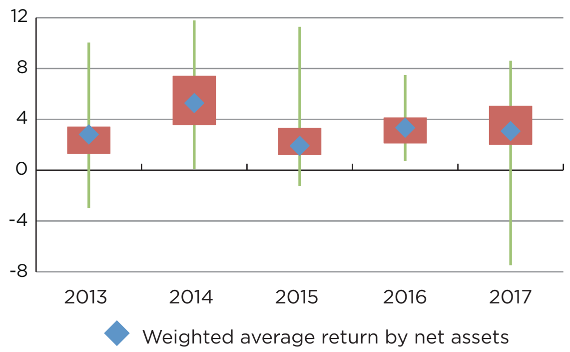
In 2017, a total of EUR 77.6 million was paid into pension plans, i.e., 8.1% more than in the previous year. Compared to 2016, the contributions of participants increased by 8.9%, whereas employer contributions – by 4.8%.

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



At the end of the year, the capital accumulated by third-pillar pension plans amounted to EUR 434.5 million, increasing by 14.1% 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 12.4 million was also earned during the year, i.e. 11% more than in the previous year.
During the reporting year, the average return of pension plans was 3.1%, whereas for individual plans it ranged from 7.5% to 8.6%. The annual return was only negative for two plans, where the investment currency was the US dollar.

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



Investment fund certificates accounted for the major share in the structure of portfolio of pension plans (54%), of which 52% had a focus on stocks or the indices thereof, while 42% had a focus on investments in fixed income instruments. Over the year, the share of investment fund certificates increased and the share of the debt securities and term deposits declined, facilitated by the low interest rate environment. In total, 84% of the debt securities had an investment credit rating (data source: Bloomberg).
During the year, investments in Latvia dropped by EUR 14.1 million, amounting to EUR 94.4 million at the end of December, and the share of these investments in the total portfolio also dropped to 21.7% at the end of the year. Investments in other EEA Member States accounted for 76.5% of all investments.
As the number of the participants who have reached retirement age increases, EUR 35.2 million was disbursed from pension plan capital during the year (i.e., 14% more than in 2016).

Investment service providers

Performance indicators of investment firms

In the reporting year, out of the five investment firms, three operated with profit, earning a total of EUR 1.7 million. Income from commission fees and other similar income for the services rendered to customers accounted for 98% of all income of investment firms, whereas administrative expenses was the highest expense item, comprising 69% of total expenses.

In 2017, four 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. In turn, during the reporting year, the amount of cash owned by customers held by investment firms for the performance of transactions in financial instruments, remained practically unchanged in the amount of EUR 11.6 million (-0.8%).

At the end of the reporting year, the total capital ratio of investment firms[8] comprised 24.2% (for individual market participants it ranged from 10.9% to 141.3%), i.e., three times exceeding the minimum capital requirement of 8%.

8 Investment firms, which are subject to observance of the capital adequacy requirements prescribed by Regulation No. 575/2013.

7. LICENSING

In 2017, minor changes were observed in all segments of the financial market. The enhancement of the SSM continued in the licensing of the banks and the merger project of *DNB Bank* and *Nordea Bank* commenced at the pan-Baltic level has to be mentioned as the key milestone, resulting in the transfer of the customer portfolio of *Nordea Bank* Branch in Latvia to *DNB Bank*. In 2017, 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 also 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 2017, two banks changed their names: *Baltikums Bank* became *BlueOrange Bank*, while, as a result of the change of stockholders, *Bank M2M Europe* became *Signet Bank*.

In 2017, changes were also observed in the insurance sector, namely, the reorganisation of *InterRisk Vienna Insurance Group* was completed, and it was merged to *BTA Baltic Insurance Company*. Also *Compagnie francaise d' assurance pour le commerce exterieur Branch* in Latvia ceased operating in Latvia. In 2017, a licence was issued to the *IMJSC Indexo* for the provision of investment management services and it was registered in the Register of Managers of Funds of the State-funded Pension Scheme.

In 2017, registration was cancelled for seven payment institutions and three electronic money institutions, and these changes were mainly related to the willingness of the companies to restructure their activity, whereas in some cases the cancellation was related to the identified long-term breaches of laws and regulations.

During the reporting year, two managers of alternative investment funds were registered, as well as two licences were issued for the activities of the manager of alternative investment funds.

Table 1
Changes in the number of licensed market participants in 2017

	AT THE BEGINNING OF 2017	AT THE END OF 2017	NEW MARKET ENTRANTS IN 2017
Banks	16	16	0[9]
Branches of EU Member State banks	7	5 (-2 branches)	0[10]
Cooperative credit unions	34	33 (-1 company)	0[11]
EEA-based providers of banking services	327	353 (-1 bank)	+27
Insurance companies	7	6 (-1 company)	0[12]
Branches of EU Member State-based insurers	12	11 (-1 company)	0[13]
EEA-based providers of insurance services	526	531 (13 companies less)	+18

9 Banks:
On 1 October 2017, the customer portfolio of *Nordea Bank AB* Branch in Latvia was transferred to AS *DNB banka*, and on 3 October 2017, AS *DNB banka* changed the name to *Luminor Bank* AS.
In September 2017, *Baltikums Bank* AS changed the name to AS *BlueOrange Bank*.
On 10 October 2017, *Bank M2M Europe* AS changed the name to *Signet Bank* AS.

10 The branches of EU Member State-based banks:
On 30 June 2017, *Aktsiaselts Eesti Krediidipank* Branch in Latvia was dissolved.
On 1 October 2017, the customer portfolio of *Nordea Bank* AB Branch in Latvia was transferred to AS *DNB banka* (*Luminor Bank* AS) and the liquidation of the Branch was commenced.

11 Cooperative credit unions:
On 12 September 2017, the licence of *Hanzas* cooperative credit union was withdrawn.

12 Insurance companies:
On 27 December 2017, the reorganisation of *InterRisk Vienna Insurance Group* AAS took effect, resulting in *InterRisk Vienna Insurance Group* AAS being merged with AAS *BTA Baltic Insurance Company*. Within the scope of reorganisation, all insurance contracts concluded by *InterRisk Vienna Insurance Group* AAS were transferred to AAS *BTA Baltic Insurance Company* and *InterRisk Vienna Insurance Group* AAS ceased to exist without the liquidation procedure.
On 9 January 2018, the licence of *InterRisk Vienna Insurance Group* AAS was withdrawn.

13 Branches of EU Member State-based insurance companies:
On 15 May 2017, *Compagnie francaise d' assurance pour le commerce exterieur* Branch in Latvia was dissolved.

	AT THE BEGINNING OF 2017	AT THE END OF 2017	NEW MARKET ENTRANTS IN 2017
Investment management companies	12	13 (-1 company)	+1[14]
EEA-based providers of investment management services	20	21	+1
Investment firms	4	5	+1[15]
EU Member State-based investment firms	2	2	0
EEA-based providers of investment firm services	1960	2034 (63 companies less)	+137
Agents engaged by the EEA-based providers of investment services	30	37 (-1 company)	+8
Private pension funds	6	6	0
Insurance brokerage firms	83	80 (6 companies less)	+3[16]
Insurance agents	494	459 (55 agents fewer)	+20
EEA-based providers of payment services	331	362 (18 companies less)	+49
Payment institutions (registered)	26	19 (7 companies less)	0[17]
Payment institutions (licensed)	3	3	0

14 Investment management companies:
On 9 May 2017, the licence of the IMC *Hipo Fondi aktīvu pārvalde* (*Hipo Fondi asset management*) for the provision of investment management services was withdrawn and the record was cancelled in the Register of Managers of Funds of the State-funded Pension Scheme.
On 17 May 2017, the licence was issued to the IMJSC *Indexo* for the provision of investment management services and it was registered with the Register of Managers of Funds of the State-funded Pension Scheme.

15 Investment firms:
On 24 October 2017, the licence was issued to AS *Alpari Europe IBS* for the provision of investment services and non-core investment services.

16 Insurance brokers:
Cancelled: SIA *RC7 Brokeri*, SIA *Mobilus RE*, SIA *McKay & Poulton Ltd*, SIA *IIZI*, SIA *Apdrošināšanas reģionālais brokeris*, SIA *Apdrošināšanas Brokeri Ločmelis un Rusmane*.
Registered: SIA *Molleno*, SIA *JVC Risk management & Insurance,* SIA *BA ROOT.*

17 Payment institutions:
In 2017, the entries related to the following payment institutions were deleted from the Register of Payment Institutions: SIA *Jelgavas nekustamā īpašuma pārvalde*, SIA *Alfapay*, SIA *PAYTECH*, SIA *BalticPay Corporation,* AS *StreamPay*, SIA *ECOMMPAY*, SIA *PAYDELTA*.

	AT THE BEGINNING OF 2017	AT THE END OF 2017	NEW MARKET ENTRANTS IN 2017
Electronic money institutions (registered)	12	10 (3 companies less)	1[18]
Electronic money institutions (licensed)	3	3	0
EEA-based electronic money institutions	104	153	+49
Licensed alternative investment fund managers	5	7	+2[19]
Registered alternative investment fund managers	8	10	+2[20]

18 Electronic money institutions:
In 2017, the entries related to the following electronic money institutions were deleted from the Register of Electronic Money Institutions: SIA *FSC EU*, SIA *E-Money Systems*, SIA *QR Pay.*

19 Managers of alternative investment funds:
On 5 July 2017, the licence for the activities of the manager of alternative investment funds was issued to the Joint Stock Company *AIFP Baltic Asset Management.*
On 11 July 2017, the licence for the activities of the manager of alternative investment funds was issued to the Joint Stock Company *BIB Alternative Investment Management.*

20 Registered alternative investment fund managers:
On 24 January 2017, the alternative investment fund manager was registered – SIA *EcoEnergy AIFP.*
On 5 July 2017, alternative investment fund manager was registered – SIA *Alfa Asset Management AIFP*.

RESOLUTION MECHANISM

The principles of the resolution mechanism

One of the three stability pillars of the financial system, i.e., the resolution mechanism was established 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.

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 timely prevent the consequences related to the banking crisis;
- 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 resolution in Latvia is the FCMC, and it is responsible for the drawing up resolution plans, as well as for carrying out resolution activities or the rescue 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.

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

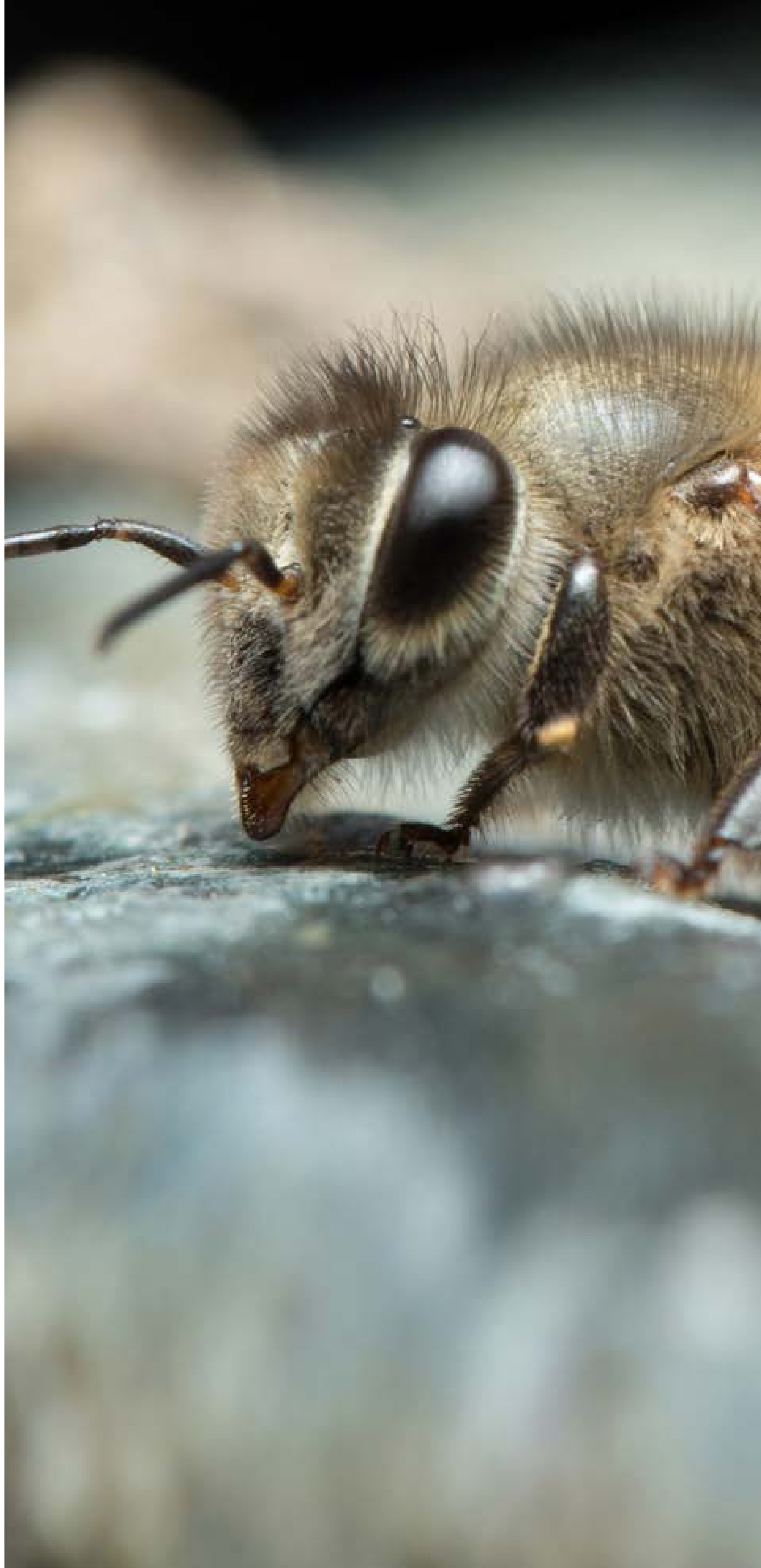
Single Resolution Mechanism

Taking into account that Latvia is a Eurozone country, it automatically obtains the status of a member state of the single resolution mechanism. A Single Resolution Board (SRB) has been established, which, in cooperation with the involved national resolution authorities of the EU member States (including the FCMC), implements 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 (SRF), 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, can be used to finance the resolution of the bank. The SRB is financed through 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, amounting to approximately EUR 55 billion.

The SRB carries out the functions of a resolution authority over the Latvian banks which are subject to direct supervision by the ECB within the scope of the SSM, whereas the FCMC prepares the SRB decisions and implements the adopted 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 the 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. In 2017, five bank resolution plans were developed.



CHANGES TO REGULATORY REQUIREMENTS

In 2017, 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 were based not only on the experience gained during the financial crisis, but also on the latest trends observed in financial and capital markets and the principles of best international practice. The FCMC, based on the laws and regulations issued by the EU institutions, as well as having considered the nature and the dynamic environment of the Latvian financial sector, and within the scope of the powers conferred on it, introduced the necessary changes to national laws and regulations, in order to not only regulate the activities of Latvian market participants, but also to promote the protection of the interests of investors, depositors and the insured.

In general, broad changes were introduced to the framework of regulatory requirements in 2017. Changes referred to the fields such as asset quality assessment and the formation of provisions, application of the International Financial Reporting Standard 9, introduction of the Solvency II regime, remuneration policy, establishment of governance systems, as well as a number of other fields.

Regulation in the field of audit services

Starting from 2017, a new regulation in the field of audit services took effect – in addition to the directly applicable EU legal act Regulation (EU) No. 57/2014 (has already been applicable since June 2016), new provisions of the Law on Audit Services have been adopted, considerably changing the regulation of audit services and laying down the rights and obligations of the competent authorities, as well as the audit service providers, introducing the requirement for all enterprises that are public-interest entities (PIE) to observe the conditions on the establishment of the audit committee. New requirements were also set in the Law on the Financial Instruments Market with respect to the formation of the audit committee, operation and supervision thereof. In accordance with the delegation laid down in the Law on Audit Services the Ministry of Finance is responsible for the implementation of the state policy in the field of audit and is the competent authority in charge of the fulfilment of the tasks prescribed by Regulation (EU) No. 537/2014, while the FCMC is the competent authority supervising whether the PIE observes the requirements prescribed by laws and regulations regarding the establishment of the audit committee, appointment of the certified auditor for the audit of the PIE's annual report, *inter alia*, also consolidated report (if applicable) and the duration of the term for the performance of the audit task per each PIE. To facilitate the best possible understanding of the PIE and the actions with respect to the establishment of the audit committee and the operation thereof, in the first half of 2017, the FCMC took part in the development of the guidelines for the establishment of the audit committees and the operation thereof. At the end of the year, the FCMC and the Ministry of Finance signed the inter-sectoral agreement on cooperation and information exchange in the field of the regulation of audit services, which might considerably facilitate the supervisory activities to be carried out by each competent authority.

Regulations on the Calculation of Solvency Capital Requirement and Own Funds for Insurers and Reinsurers

In 2017, the regulations were drafted, replacing the regulations previously approved by the FCMC with respect to the calculation of solvency capital requirement and own funds, preserving the requirements prescribed therein, as well as supplementing them with detailed requirements with respect to separate aspects of the determination of capital adequacy in accordance with that which is stated by the EIOPA. The new regulations contain new requirements, in order to identify the shareholding of the insurer or reinsurer in the capital of the financial institutions and credit institutions for the purposes of calculating own funds, and in order to determine the solvency capital requirements of the associated company, the transparency access requirements for the market participants prescribed by Regulation (EU) No. 2015/35 are supplemented, as well as the requirements with respect to setting other venture capital requirements, if contributions in securities (for example, catastrophe bonds) do not meet the criteria for the application of risk mitigation methods. The regulations prescribe additional requirements with respect to the base risk, application of the life insurance underwriting risk modules, determination of the value of benefits to be paid out, implementation of the long-term guarantee measures, classification of instruments of own funds and other requirements.

Regulations on the Self-Assessment of Risks and Solvency of Insurers and Reinsurers

To introduce the EIOPA guidelines, the regulations were developed, ensuring a uniform understanding of the market participants regarding the process of self-assessment of risks and solvency of insurance and reinsurance companies. The regulations lay down a number of requirements, including, the requirements with respect to the periodicity of the process of self-assessment of risks and solvency, documentation thereof, prescribe the aspects to be considered, in addition to that which is stated in Regulation (EU) No. 2015/35, when carrying out the general solvency assessment, as well as adjust the elements to be assessed when determining whether the insurer or reinsurer is able to meet the technical reserves and capital requirements.

Regulations for Establishing the Governance System

In 2017, the regulations took effect, setting detailed criteria and conditions for insurance and reinsurance companies and non-Member State insurance branch offices with respect to the assessment of the appropriateness and suitability of individuals, risk management, prudential contribution principles, internal control, outsourcing, as well as group governance. The regulations will promote the harmonisation of the requirements set for the governance systems, and market participants, within a period of six months from the date of coming into effect of the regulations, had to improve their governance systems and ensure conformity to the new requirements.

Packaged retail and insurance-based investment products (PRIIP)

Starting from 2018, the requirements of Regulation (EU) No. 1286/2014 with respect to the packaged retail and insurance-based investment products (PRIIP) took effect. The PRIIP regulation imposes a duty on the developer, advisor and seller thereof to provide private investors with the key information document in a standardised form, thus not only promoting the understanding of the non-professional investors regarding the investment risks, but also ensuring the comparability of various products. In light of ambiguities related to the practical application of the PRIIP regulation, for example, product conformity to the PRIIP definition and preparation of the key information document, in 2017, the FCMC met with the market participants and discussed the problematic issues, as well as provided answers to questions about several requirements of the regulation, available on the FCMC website.

International Financial Reporting Standard 9 (IFRS 9)

Starting from 2018, the IFRS 9 "Financial Instruments" must be applied in financial accounting. The application of this standard affects those financial and capital market participants, who prepare financial statements in accordance with the international accounting standards and international financial reporting standards (credit institutions, insurers, reinsurers, investment management companies, investment firms, open alternative investment funds, private pension funds and issuers (in a consolidated form)).

The most significant changes refer to the calculation of the financial instruments impairment losses, providing an estimate of the amount of the expected credit losses over the next 12 months or the amount of the expected credit losses during the entire term of the agreement, if a considerable increase of a credit risk is observed, and to correspondingly form provisions for such potential losses. The new standard also provides for changes in the classification of financial instruments, stating that financial instruments shall be classified according to a business model and nature of cash flows.

In 2017, both market participants and the FCMC carried out the IFRS 9 impact assessment, to determine the readiness of institutions to introduce the standard, the possible impact thereof on the volume of provisions and to ensure consistent introduction of the standard. The assessment carried out by the FCMC shows that, on average, the volume of provisions will grow by 16.25%, which would decrease the common equity tier 1 (CET 1) of the institutions within the range from 0.25% to 4%. To ensure successful introduction of the standard, the institutions must pay special attention to the procedure for the classification of assets in sections, must assess whether the model-based credit risk characteristic features (PD, LGD), applied development scenarios of future events, the impact and integration thereof into the model precisely reflect the risks of particular transactions, as well as must ensure the appropriate model validation procedure.

Regulations for Asset Quality Assessment and the Formation of Provisions

At the beginning of 2018, the regulations were adopted in the new wording and they adjust the requirements of the supervisory authority in the asset quality assessment and formation of provisions after the IFRS 9 took effect on 1 January 2018. Without carrying out the asset quality assessment and formation of provisions in accordance with the best practice and internationally recognised standards, the capital adequacy ratios might be assessed incorrectly, thereby providing a misleading outlook on the true capitalisation level of the institutions. To avoid the above mentioned situation, the regulations prescribe detailed requirements for the estimate of future cash flows, to be applied for the determination of the credit amount to be recovered, the need to verify the conformity of the formed provisions to the actual losses on a regular basis and to introduce corrections to the estimates to minimise the differences. More stringent requirements are also set for the appraisers and the process of appraisal of the real estate serving as the security for non-performing loans, conditions are set for the application of indexation methods, requirements are prescribed for the timely write-off of the irrecoverable assets or the irrecoverable part thereof from the balance sheet of the institutions, as well as the minimum level of provisions is set for prudential needs and a number of other requirements, based on the ECB's instructions on accounting non-performing loans and the guidelines issued by the EBA on credit institutions' credit risk management practices and accounting for expected credit losses. In addition, the FCMC plans to revise the Credit Risk Management Regulations, in order to introduce the requirements of the above mentioned EBA guidelines and ECB instructions applicable to the credit risk management, as well as to introduce the EBA guidelines on the application of the definition of default contained in Article 178 of Regulation (EU) No. 575/2013.

Regulations on the General Principles of the Remuneration Policy for the Managers of Investment Management Companies and Alternative Investment Funds

The regulations lay down the requirements in more detail with respect to the remuneration policy and practice, which were not put in more detail in the Law on Investment Management Companies, as well as introduce the guidelines of Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions and the ESMA guidelines regarding the remuneration policy and practice. The regulations lay down uniform requirements for both alternative investment fund managers and investment fund managers, as well as concurrently supplement the requirements for the establishment of an internal control system in the field of remuneration for investment management companies in accordance with the above mentioned guidelines.

With respect to the alternative investment fund managers licensed in the Republic of Latvia, the regulations provide for changes in the existing requirements, mainly, in fields such as the correction of the proportion of the considerable and especially high variable component of remuneration, adjustment of job categories influencing the risk profile, requirements with respect to the remuneration policy and practice in cases when the fund management rights are assigned to another company and another manager, as well as in cases when the services or non-core services are delegated to another company and another manager, criteria for the formation of the composition of the remuneration committee and procedure for deferral and determination of the considerable and especially high variable component of remuneration in instruments.

Regulations on the Correction of the Modified Duration of Debt Instruments

The regulations prescribe the procedure for the introduction of corrections to the modified duration calculation set out in Article 340 (3) paragraph 2 of Regulation (EU) No. 575/2013. Corrections to the calculation of modified duration are necessary, in order to take into account the risk of pre-payment of debt instruments classified in the sales portfolio. Correspondingly, laws and regulations adjust the cases when the corrections of the calculation of modified duration of debt instruments are to be carried out, set out the procedure for calculation, as well as supplement the terminology.

Regulations for the Assessment of the Fulfilment of the Conditions for the Provision of Financial Support

The regulations set out the information to be annexed to the notification of the credit institutions and investment firms on the decision to provide intra-group financial support, in more detail – substantiation of the purposes of providing financial support, substantiation of the ability of the entity receiving the financial support to correspondingly pay the remuneration for receipt of the support and repay the loan within the term set in the agreement, substantiation of the impact of the provision of financial support on the financial stability of the Republic of Latvia or another Member State, substantiation of the ability of the entity providing the financial support to comply with, as well as not to infringe upon the operational regulatory requirements binding on it due to the provision of the financial support and the substantiation, confirming the fulfilment of the conditions of the Law on the Recovery and Resolution of Credit Institutions and Investment Firms in accordance with the requirements of Chapter III of Commission Delegated Regulation (EU) 2016/075.

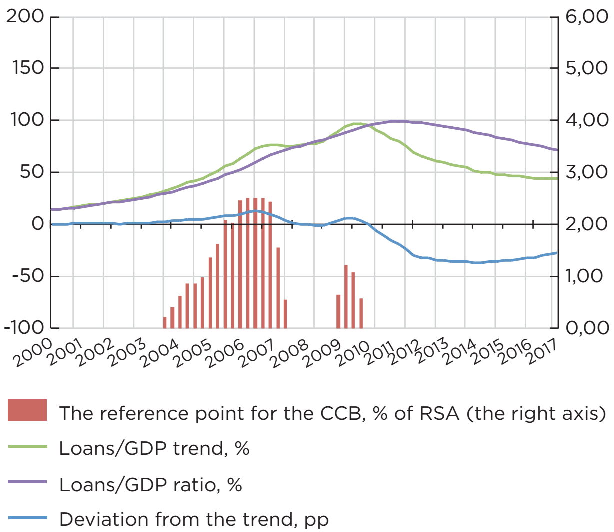
Macro-prudential instruments

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 preserve the stability of the financial system as a whole. Therefore, in addition to the traditional supervisory approach, macro-prudential supervision was introduced, which requires taking appropriate measures in cases, when **cyclical** (e.g. an excessive increase in lending) or **structural – systemic** risks, for example, in relation to systemically important credit institutions, 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.

Within the context of cyclical risks, under Section 35[5] of the Credit Institution Law, the FCMC, starting from 2015, has been determining and publishing the **countercyclical capital buffer requirement** for transactions with Latvian residents once a quarter. 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 may absorb losses during an economic slowdown or stagnation. The counter-cyclical capital buffer serves as a kind of a buffer, enabling credit institutions to also continue lending 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. In light of weak lending, in 2017, as well as at the beginning of 2018, the FCMC preserved a counter-cyclical buffer requirement of the transactions with Latvian residents in the amount of 0%.

Figure 19

Counter-cyclical capital buffer (CCB) reference point[21]



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 particular financial system 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 determined. The application of macro-prudential instruments enables the 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 other systemically significant institutions (O-SSI)[22] once a year, and can set an O-SSI capital buffer requirement for them of up to 2% of the exposure amount. In 2017, the FCMC identified six local financial sector C-SSOs, whom the C-SSI buffer requirements and more rigid requirements in corporate governance are set to (the list is posted on the website of the FCMC). The identified C-SSIs are the same credit institutions that were already identified last year, except for one – instead of AS *DNB banka*, *Luminor Bank* AS is included in the list of C-SSI, which started its activities on 1 October 2017, as *Nordea Bank AB* transferred the assets and liabilities of *Nordea Bank* AS Branch in Latvia into the ownership of AS *DNB banka*; and afterwards AS *DNB banka* was renamed to *Luminor Bank* AS. A transitional period by 30 June 2018 was set to give time for the identified institutions to be able to get prepared for compliance with the capital buffer requirement. Significant feature of C-SSI identification is that it is a preventive measure, to apply a stricter capital buffer and other requirements to the identified C-SSIs, which would henceforth reduce the systemic risk potentially created by the suspension or interferences in the activities thereof. In resolving conduct under crisis circumstances, the systemic significance of credit institutions is to be assessed by other criteria, taking into account the specifics of the crisis and the latest available information about their activities. Therewith, the credit institution, previously identified as C-SSI, in a crisis situation may also not receive State aid, if, under relevant circumstances, the potential of the suspension or interferences in the activities thereof to create the systemic risk is evaluated as sufficiently low. At the beginning of 2018, such scenario came to life, when *ABLV Bank* AS was dissolved, which was identified as C-SSI at the end of 2017, but on 24 February 2018 the Single Resolution Board adopted the decision not to carry out the resolution thereof, motivating it by the fact that the performance thereof would not correspond to the interests of society of Latvia[23].

21 The reference point for the CCB is calculated using loans/GDP deviation from the long-term trend (based on the narrow definition of loans).
22 The FCMC carries out the identification of C-SSI in accordance with the EBA guidelines EBA/GL/2014/10). The Basel Committee, in cooperation with the Financial Stability Board, identified and published the list of the globally systemically significant credit institutions (21 November 2017), which does not contain the credit institutions licensed in Latvia.
23 The decision was substantiated by the fact that, in the opinion of the Single Resolution Board, ABLV Bank AS was not performing the critically important functions at that time and it was not expected that the suspension of the activities thereof would create a material adverse effect on financial stability in Latvia.

Table 2

Transitional provisions for the capital buffer of other systemically significant institutions

CREDIT INSTITUTION	THE C-SSI RATE TO BE MAINTAINED, IN % OF THE WEIGHTED RISK ASSETS (AS OF 30 JUNE 2017)	THE C-SSI RATE TO BE MAINTAINED, IN % OF THE WEIGHTED RISK ASSETS (AS OF 31 DECEMBER 2017)	THE C-SSI RATE TO BE MAINTAINED, IN % OF THE WEIGHTED RISK ASSETS (AS OF 30 JUNE 2018)
AS *ABLV Bank*	1%	1%	2%*
AS *Swedbank*	1%	1%	2%
AS SEB banka	1%	1%	2%
AS *Luminor Bank*	–	1%	2%
Joint stock company *Citadele banka*	0.75%	0.75%	1.50%
Joint stock company *Rietumu Banka*	0.75%	0.75%	1.50%

European Commission initiatives in 2017

2017 had not been so abundant in new European Commission initiatives, because there were several projects from the previous years still being actively discussed at the Council and European Parliament level. There had been three new initiatives, with the Commission experts taking part in the discussions thereon in the working groups in the EU Council.

In June 2017, a proposal was published on the Regulation of the European Parliament and of the Council regarding a **Pan-European Personal Pension Product** (PEPP). The essence of the proposal is to establish a voluntary pension scheme of a cross-border nature in addition to the national pension plans. The proposal provides for the procedure for receipt of a licence for such product, investment policy, procedure under which the PEPP investor can continue performing contributions, when moving from one Member State to another, the supervisory procedure and other issues.

In September 2017, the European Commission announced a proposal on **revision of the European System of Financial Supervision**. In 2011, the European System of Financial Supervision was established, rooted in three European supervisory authorities – EBA, EIOPA and ESMA – European Systemic Risk Board (ESRB) and national supervisory authorities. The European Commission carried out the assessment of the European System of Financial Supervision. As a result, in September 2017, the proposals were developed for the amendments to the regulations establishing the European supervisory authorities and the ESRB, as well as for the related amendments to various sectoral legal acts. The main objective of the proposal is to update and enhance the regulations of the European System of Supervision, *inter alia*, to introduce the necessary amendments with respect to the establishment of the banking union and capital markets union. The most significant changes in the activities of the European supervisory authorities are planned, by granting wider authorities thereto in the field of direct supervision of the financial market participants, and it is also planned to introduce changes to the financing of the authorities. At present, the Member States have considerable objections with respect to both issues.

At the end of 2017, the European Commission announced a proposal for the **Directive** of the European Parliament and of the Council **regarding**

the prudential supervision of investment firms and the **Regulation** of the European Parliament and of the Council **regarding the requirements for the prudential supervision of the investment firms**. The proposal of the Directive lays down the requirements with respect to the initial capital of the investment firms, powers of the supervisory authorities and mechanisms for prudential supervision of the investment firms. The proposal of the Regulation prescribes the requirements for all investment firms other than the systematic ones, with respect to own funds, minimum capital levels, concentration risk, liquidity, reporting and public disclosure of information.

The **negotiations** launched in previous years **continued** in the Council with respect to **the amendments within the scope of the capital requirements and activity recovery and resolution of the credit institutions** and on the establishment of the European **deposit insurance system**, as well as regarding the proposal for the regulation on the establishment **of a regime for activity recovery and resolution of the central counterparties**. Negotiations regarding current changes to the Directive on the prevention of the use of the financial system **for the purpose of money laundering or terrorist financing** are at the final stage.

In 2017, with respect to the financial sector, the following regulations and directives of the European Parliament and of the Council were **approved and published**:

- Regulation (EU) 2017/2402 of the European Parliament and of the Council laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation; and the amendments related thereto to Regulation No. 575/2013 on prudential requirements for credit institutions and investment firms;
- Regulation (EU) 2017/2395, amending Regulation (EU) No. 575/2013 as regards transitional arrangements for mitigating the impact of the introduction of IFRS 9 on own funds and for the large exposure treatment of certain public sector exposures denominated in the domestic currency of any Member State;
- Directive (EU) 2017/2399, amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy;
- Regulation (EU) 2017/1991, amending Regulation (EU) No. 345/2013 on European venture capital funds and Regulation (EU) No. 346/2013 on European social entrepreneurship funds;
- Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market;
- Directive (EU) 2017/828, amending Directive 2007/36/EC as regards the encouragement of a long-term shareholder engagement;
- Regulation (EU) 2017/113 on money market funds.

In 2017, a number of delegated and **implementation regulations of the European Commission** were adopted, laying down the technical standards for the application of certain previously adopted EU norms of law, including for the implementation of *CRR/CRD IV, Solvency II, PSD2, MIFID II/MIFIR,* etc. first-level legal acts. The relevant legislation is published on the FCMC website http://www.fktk.lv/lv/tiesibu-akti/jaunumi.html in breakdown by market segment.

10 GUARANTEE SYSTEM

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 200,000.

> 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 are provided by 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. For the purposes of managing the FCMC risks, if the DGF has to commence the disbursement of guaranteed compensations within the term set by the Deposit Guarantee Law and if the funds of DGF are not sufficient, the FCMC has developed the procedure under which it concludes the loan agreements on borrowing of the missing amount.

Table 3
Deposits of Latvian deposit takers as on 31 December 2017

	AMOUNT	SHARE, %
Total number of depositors	2,304,763	100.0
including residents	2,215,036	96.1
including non-residents	89,727	3.9
Balance of covered deposits, in thousand EUR	8,452,301.8	100.0
including residents	6,597,270.7	78.1
including non-residents	1,855,031.1	21.9
Amount paid by the deposit takers into the DGF by 31 December 2017, in thousand EUR	314,384.1	-

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 covered 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. In 2017, the average applicable adjustment ratio applicable to the banks was 122.01%, but to credit unions – 97.10%, meaning that the banks paid in 22.01% more than they would have had to pay to cover the amount of the covered deposits, while the credit unions – on average, 2.9% less. Deposit-takers paid EUR 17.3 million into the DGF for 2017.

During the reporting year, the FCMC continued to ensure the disbursements of State guaranteed compensation via AS *Citadele banka* (the disbursing bank) to the depositors of the liquidated AS *Latvijas Krājbanka* (LAS *Latvijas Krājbanka*) in the amount prescribed by the Deposit Guarantee Law.

During the reporting year, the guaranteed compensations were disbursed in the amount of EUR 274.1 thousand:

- EUR 257.5 thousand to the depositors of LAS *Latvijas Krājbanka*;
- EUR 16.6 thousand to the depositors of the insolvent *Raunas* cooperative credit union.

Table 4
Ensuring the disbursement of guaranteed compensation (GC) to AS *Latvijas Krājbanka* depositors at 31 December 2017.

	NUMBER OF DEPOSITORS	*GC AMOUNT, THOUSAND EUR*	GC MOUNT SHARE, %
Rights to GC	220,604	478,705.7	100
Disbursed GCs*	128,018	472,061.3	98.6
Unpaid GCs	92,586	6,644.7	1.4

* Excluding the overpaid GCs of EUR 347.6.

Table 5

Accrued liabilities for the GCs to be disbursed, as at 31 December 2017

DEPOSIT-TAKER	ACCRUED LIABILITIES, THOUSAND EUR	NUMBER OF DEPOSITORS
AS *Latvijas Krājbanka*	9,303.1	92,586
AS *Ogres komercbanka* under liquidation	31.	10
AS *VEF banka* under liquidation	45.7	54
Insolvent *Raunas* cooperative credit union	0.4	12
Total	9,380.2	92,662

** The accrued liabilities are reflected together with the potential GC that might be recognised as subject to disbursement, but the number of depositors includes those depositors, whom the GC is transferred for disbursement, but who have not applied for the receipt thereof.

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 remaining creditors to claim receivables in the amount of the disbursed guaranteed compensation. Notwithstanding the first priority claim rights of the DGF against the bank to be liquidated, the FCMC still has to assess the ability of the bank to be liquidated to sell the assets of the bank and to determine the recoverable value thereof, in order to evaluate its claims in the balance of the DGF. To this effect, there are provisions formed in the DGF in the amount of EUR 213,979.7 thousand, out of which EUR 16.6 thousand have been formed in 2017.

After the reporting period, on 27 February 2018, the FCMC adopted the decision on unavailability of the AS *ABLV Bank* deposits, providing for the transfer of its monetary funds in the amount of EUR 480 million into the DGF's current account, ensuring the funds for the disbursement of guaranteed compensation to the depositors of AS *ABLV Bank* in the amount of the covered deposits. On 2 March 2018, the FCMC entered into an agreement with AS *Citadele banka*, in order to secure the disbursements of guaranteed compensation to the depositors of AS *ABLV Bank*.

The disbursement of guaranteed compensation from the DGF will be ensured to the depositors of the liquidated or insolvent deposit-takers within the term prescribed by the Deposit Guarantee Law.

In 2017, the FCMC ensured the accumulation and management of the DGF funds, and at the end of the year there were EUR 159.7 million in the DGF account with the Bank of Latvia, out of which EUR 6.3 million had been reserved for ensuring the guaranteed compensations (to the depositors of the liquidated deposit-takers).

The FCMC ensures keeping the accounts of the DGF in accordance with its accounting policy. The financial statements of the DGF for 2017 and the independent auditor's report thereon are available on the FCMC website at: http://www.fktk.lv/lv/statistika/valsts-garantiju-fondi.html

Disbursements of guaranteed compensation to the depositors of AS *TRASTA KOMERCBANKA*

The FCMC made the decision to perform the disbursements of guaranteed compensation of TKB 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 were used to disburse guaranteed compensation to the depositors of TKB.

Table 6
Ensuring the disbursement of guaranteed compensation to TKB depositors at 31 December 2017

31.12.2017	NUMBER OF DEPOSITORS	SUM OF GC, THOUSANDS, EUR	PROPORTION OF SUM, %
Total GC sum	5,193	60,646.29	100%
Paid GC	2,832	55,921.52	92%
Nonpaid GC	2,361	4,724.77	8%

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 EUR 12.3 thousand for the disbursement of guaranteed compensation.

> As since the end of 2015, 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 2017, EUR 18.9 million was accumulated in the FPI.

The payment of insurance indemnity in the case of defaulting on the liabilities by the 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

Protection of customers of the financial instruments market (investors)

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 Council of the Financial and Capital Market Commission 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 instrument 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 instrument 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 purpose of the Financial Stability Fee (the FSF) is to consolidate the entire financial system to finance, if necessary, the measures that would mitigate the negative impact of those credit institutions that have encountered financial difficulties on other participants of the financial market, as well as to partially compensate the State budget funds that have been channelled to stabilise the situation in the financial sector, from which the banking sector as a whole has benefitted directly or indirectly.

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

In 2017, the FCMC controlled the payment of the FSF into the state budget account, the calculation of the FSF, and the completeness and accuracy of the information underlying the calculation. The object of the FSF is comprised of the tax payers' liabilities, excluding deposits subject to the deposit guarantee scheme of the Republic of Latvia or other Member State, issued mortgage bonds and subordinated liabilities, subject to the FSF rate in the amount of 0.072%. In 2017, the FSF was collected in the amount of EUR 11.2 million, which, as compared to 2016 (EUR 15.0 million, decreased by 25%.

Table 7
FSF payers' indicators

	2017	2016
FSF payers	23	26
FSF object, in million EUR	15,563.1	16,802.9
FSF, in EUR	11,201,499	12,098,346
Fee payment received in the State budget, in EUR	11,249,954	14,973,548

11 INTERNATIONAL COOPERATION

On an international scale, the activities of the FCMC are mainly focused on cooperation with supervisory authorities of other countries either at a bilateral or multilateral level - participation in the SSM and the work of the European financial supervision authorities. Just as in previous years, also in 2017, the FCMC provided support to the ministries in international forums regarding projects and issues relevant to the Latvian financial market, for example, by participating in the work of the Council of the European Union Council or the OECD committees, and other forums.

During the reporting year, active discussions continued in the **Council of the European Union** regarding the **amendments to the capital requirements and activity recovery and resolution of credit institutions**, as well as the **establishment of the European deposit insurance system**. With respect to these projects, the FCMC experts both took part in on-site discussions of them, and expressed their opinion and position in writing to the Latvian representatives at the meetings. The FCMC experts involved in discussing the proposal on **the amendments to the regulations governing the activities of the European financial supervision authorities** and followed up the review of the new proposal on the regulation regarding **the Pan-European Personal Pension Product.**

After joining the **OECD**, Latvia had to continue working on the fulfilment of recommendations in separate fields. The FCMC management took part in **the Plenary Session of the OECD Anti-Bribery Working Group**, where Latvian representatives provided the report on the accomplishments of Latvia in the fulfilment of the Stage 2 recommendations of the OECD, *inter alia*, on the anti-money laundering measures taken by the FCMC. The work and information exchange in other committees proceeded in an everyday mode. The FCMC has been regularly preparing the statistics in fields such as pensions and insurance, which the OECD employs, when preparing the sectoral summaries in all OECD countries.

At the end of 2017, the visit of the experts of the **Moneyval committee of the Council** was held in Latvia, in order to assess the conformity of the Latvian anti-money laundering and counter-terrorism financing system to the international standards. The FCMC, within the scope of its competence, also provided voluminous information to the experts prior to the visit and during the visit, as well as took measures for the implementation of the recommendations of this committee.

In 2017, the dialogue with the **International Monetary Fund** (IMF) continued, on the basis of the **consultation framework of Article IV** of the IMF Articles of Agreement. During the visits of the IMF experts, information was provided regarding the market indices and topicalities in the sector, as well as on the adopted and planned changes to laws. To exchange information on the development trends in the financial sector and latest developments in supervisory matters, FCMC management continued the practice commenced during the previous years — **arranging a meeting with the US public administration and financial supervisory authorities** during the annual meeting of the International Monetary Fund.

Participating in the work of European supervisory authorities

One of the key aspects of international cooperation is the participation of the FCMC in the work of the European supervisory authorities and the ESRB, in order to influence the formation of the European regulatory and supervisory policy and practice. 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 benefits and develops not only large but also small countries. At the FCMC expert level, the work was carried out in the committees and working groups of the European supervisory authorities, whereas the FCMC management took part in the meetings of the Supervisory Board of these authorities.

EBA

Also in 2017, the EBA continued its work at developing the Single Rulebook for the European banking sector. The EBA focussed on the development of the technical standards and guidelines for the introduction of the payment account directive and payment service directive (PSD 2), as well as the AML/CTF field, credit risk, liquidity risk and other fields. The preparation and development of the methodology took place in the EBA for the 2018 bank stress test, and the EBA also defined a single approach to further activity with respect to the activities of the United Kingdom market participants after the exit thereof from the EU. In 2017, the EBA carried out the peer review on the compliance of the Member States to the EBA guidelines on other systemic institutions (O-SIIs). The report is available on the website of the EBA (http://www.eba.europa.eu/documents/10180/1720738/Final+Peer+review+Report+on+EBA+O-SIIs+Guidelines.pdf).

EIOPA

In 2017, the EIOPA approved the technical standards in the field of the PRIIPS and provided an opinion to the European Commission regarding the development of the acts delegated for the introduction of 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. Exchange of opinion was also commenced with respect to the necessity of a single framework for the recovery and resolution of activity of insurance companies.

ESMA

In 2017, significant work on the development of the technical standards and guidelines and preparation or questions and answers was completed, because in 2018 the new financial instruments markets regulations took effect (MIFID II/MIFIR). Likewise, there was active work on the development of standards in fields such as market abuse, indexes used as benchmarks in financial instruments, central securities depositories, money market funds, etc. Two extensive information technology projects were still on the agenda (FIRDS and TREM), aimed at creating a database for the centralised collection and maintenance of information on over-the-counter transactions with financial derivatives, as well as a financial instrument reference database; during the reporting year, the testing of these systems took place. Equally important were the negotiations with the countries belonging to the International Organisation of Securities Commissions (IOSCO), in order to introduce changes in the information exchange agreement in accordance with the new European regulation in the field of data protection. Taking into account the United Kingdom financial market, it was important to agree on a joint position with respect to the cooperation with its market participants after the exit of the United Kingdom from the EU.

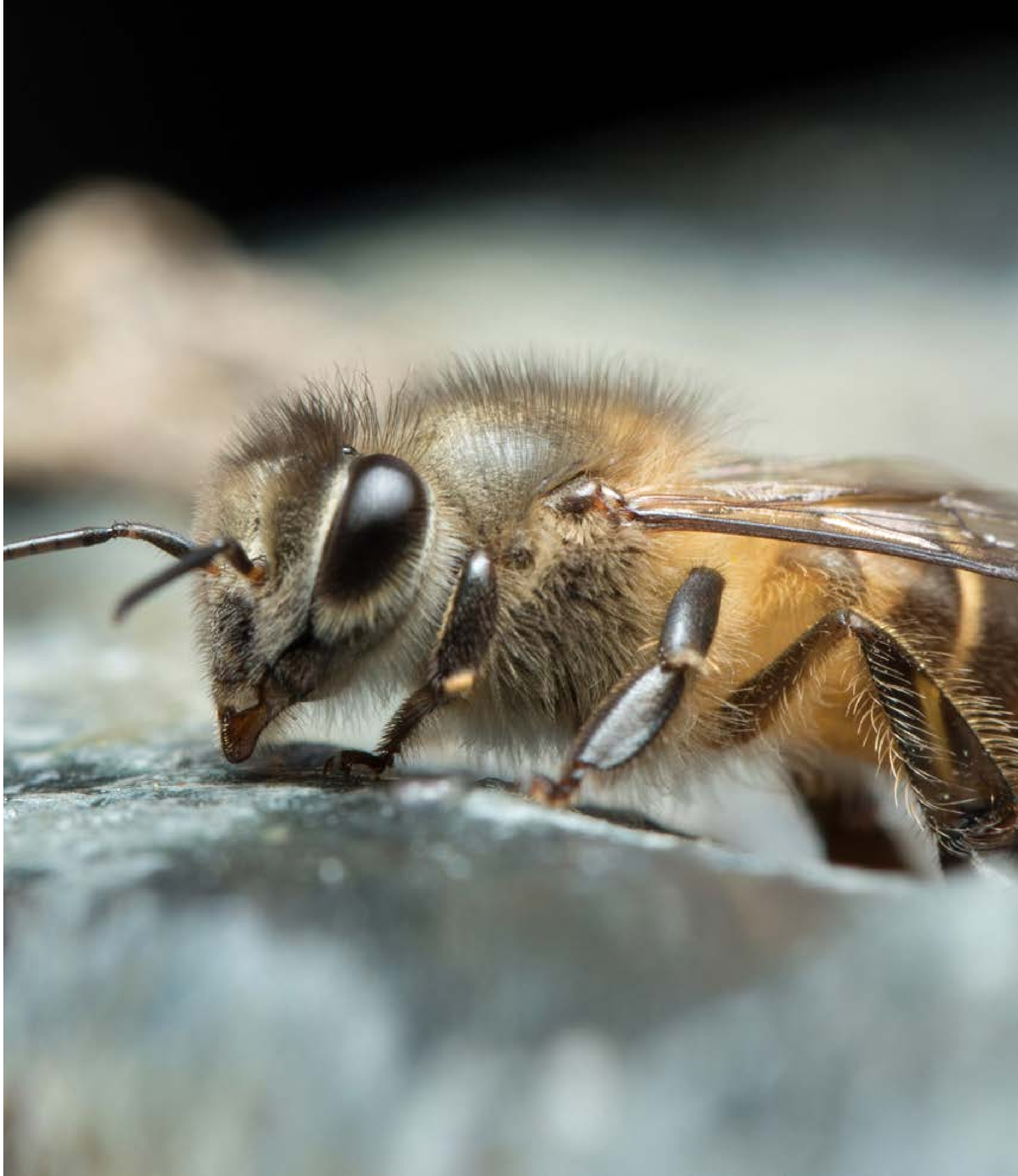
During the reporting year, the FCMC organised the meeting of the ESMA European Enforcers Coordination Session in Latvia.

During the reporting year, the ESRB continued the work focussed on analysis and operation of a stable macro-prudential supervision system across the EU. Reports were published on the impact of the IFRS 9 on the financial stability, non-performing loans and insurance macro-prudential aspects, as well as information was collected and published about the macro-prudential instruments of the Member States.

Cooperation with supervisory authorities of other countries

Cooperation with the region of the Nordic and Baltic countries still plays an important role. A new Memorandum of Understanding was signed on the cooperation and coordination between the relevant ministries, central banks, financial supervision authorities and resolution authorities in the field of financial stability of Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden. In accordance with this Memorandum the FCMC takes part in the financial stability group of the Nordic and Baltic countries whose task is to exchange views on the financial stability risks in the region and such financial market shocks, which affect the cross-border financial stability, to coordinate public announcements in the event of such shocks and to carry out joint crisis simulation.

In light of the changes in the structure of the central securities depositories, the cooperation and information agreement signed in December 2017 between the FCMC, the Bank of Latvia, the Estonian Supervisory Authority, the Bank of Estonia and the Bank of Lithuania, setting the operational principles of the *Nasdaq CSD* SE supervisory college, is also new to the cooperation in the region.



12. COMMUNICATION WITH THE GENERAL PUBLIC AND PROMOTING FINANCIAL LITERACY

In continuing the pursued strategic direction, in 2017 the FCMC, via media, also ensured broad information to the public on topical issues, as well as, in order to strengthen the financial literacy, facilitated the understanding of the customers of the sector about the financial services and their risks, especially in the segment of digital services.

In 2017, the FCMC has been mentioned 3,043 times in various Latvian media, which is considerably less than the year before (4,269) and this can be explained by a stable and controlled period in the financial sector in terms of information. FCMC experts have provided over 70 interviews to Latvian and international media, as well as the Communications Division has distributed 114 communications (in 2016 – 132) to the media regarding the decisions passed by the FCMC Board, the developments of regulatory requirements, the activity of the financial market participants sanctions imposed by the FCMC and other matters. Several new infographics were created, under the management of the Communications Division covering topics on the strict authentication for internet payments, the FCMC structure and tasks, the regulatory sandbox, as well as the outlook on the banking activities in Latvia in 2016 in a graphic form.

During the reporting year, the Communications Division organised **three media events:** on the topicalities of the banking activities in 2016 "Adapting the Business Strategies to the Changing Circumstances", the Financial Literacy Competence Standard Opening Celebration in the National Library of Latvia within the scope of the Fifth Financial Education Week and a press conference on the application of sanctions on Latvian banks engaged in indirect evasion from the international sanctions of North Korea.

During the reporting year, the FCMC launched a new corporate communication activity "FCMC Dialogue" – negotiation platform with market participants regarding important development issues. At the end of the year, by ensuring the regulatory sandbox framework for Latvian FinTech start-ups, the Communications Division additionally created an informative environment in the home page of the FCMC Innovations Sandbox, providing for the possibility to obtain all of the necessary information in one place, as well as to directly address the FCMC experts. In 2017, in cooperation with the University of Economics and Culture, the first international expert discussion "Financial Literacy Issues in the Baltic States" was organised, as well as the annual **media campaign** was implemented – the Fifth Financial Education Week in Latvia. The FCMC also took part in the annual event of public institutions "Open Doors".

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

The annual study carried out by the SKDS research centre on the confidence of the Latvian population in the financial sector suggests that, over the period of 2017, **the recognition of the FCMC increased – 65% of the population were informed about the FCMC and its activities** (in 2016 – 60%), what is more, the number of population, who knew practically nothing about the financial sector supervisor, decreased to 29% (in 2016 – 34%). In turn, the knowledge of the State guarantees in the banking sector (in the amount of EUR 100,000) remained at approximately the same level as before – in total, 53% of the population are aware of the guarantees or are aware of an exact sum of guarantees. It is important that people with higher education and higher income are somewhat more aware of the guaranteed compensation, correspondingly, 71% and 64% of the respondents. Nevertheless, in 2017, the level of confidence reduced for almost all market participants, on average, remaining at the level of the previous year – 44.8% (in 2016 – 45%), *inter alia*, only the insurance companies received a positive evaluation.

Financial literacy strategy and other activities

One of the priority directions of the work of the FCMC was to 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 assessing the fulfilment of the planning document "Strategy for Financial Literacy of the Population of Latvia for 2014 – 2020" (Strategy), the FCMC can conclude that all indicators of the achievement of the strategic goals of the financial literacy demonstrate the desirable progress. The main positive trends – the constantly growing involvement of population in the use of e-services in the field of finance, the planning habits change in favour of long-term savings, the confidence in the State guarantee system grows, as well as a healthier loan to deposit proportion has been achieved – 90/100. Having aggregated the data on the financial sustainability of households, the FCMC experts concluded that the financial stability and sustainability index in 2017 with the result of the reporting year of +9.5 points (in 2016 – +7.2 points) demonstrated an already steady desirable development stage over the period of four years.

Financial Education Week 2017

Also this year, concurrently with the sixth Global Money Week organised by the *Child and Youth Finance International*, the FCMC together with partners hosted the fifth *Financial Education Week* (FIN 2017) in Latvia aimed at popularising financial literacy. The slogan of 2017 was **"A Trip into Financial Literacy 2017 – Smarty's Audit!"** Its aim was to invite everyone to look into their financial affairs – habits, plans, budgets and invoices, to understand what there is to change and to supplement for more effective management of one's finance. The joint invitation of the financial literacy messengers – "Plan? Audit. Earn," also refers to the revision of knowledge and skills in the field of finance, in the pursuit of new knowledge. Over the period of one week, the partners ensured the measures promoting the financial literacy of population – guest lectures and seminars, school visits, as well as special financial literacy tours to two regions of Latvia – *Cēsis* and *Kuldīga*, where free-of-charge events took place for various audiences, available to all stakeholders. In addition to these activities, lectures and practical workshops were held in Latvian high schools and universities throughout the year.

Basic Competence Standard

The competence standard on financial literacy for adults developed by the FCMC and partner working group, **on the basis of the approach of the developed countries of the world – the OECD INFE core competencies framework on financial literacy** (established in 2016), is to be assessed as a significant milestone in 2017 in promoting lifelong education in financial literacy. The competence standard is the first step towards the single financial literacy lifelong education programme in Latvia, as financial literacy is one of the main competencies of the 21st century, facilitating the sustainable development of society. It is useful for both the experts creating the study lessons on financial literacy and the population prepared to elaborate on their literacy. The competence standard contains 23 financial literacy aspects by topics: Money and Transactions, Planning and Management of Private Finance, Loans and Debts, Risks and Profit, Financial and Economic Environment. It distinguishes the core performance level that would be necessary to any financial sector customer from the highest performance level, which is possible to pursue applying financial literacy.

The standard was developed by the experts from the FCMC, the Bank of Latvia, the BA School of Business and Finance, Riga Technical University, the University of Economics and Culture, the Ministry of Education and Science, the Association of Latvian Commercial Banks, in cooperation with the Latvian Insurers Association, Latvian Actuarial Association and *Nasdaq Riga* Stock Exchange.

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 ABC, which explains all of the current issues and concepts related to financial performance. In 2017, 12 new explanatory materials were added, mainly with respect to financial literacy in the e-environment. In 2017, a new activity was continued at the CLIENT SCHOOL, i.e., regular lectures at the National Library.

KEY TASKS IN 2018

SUPERVISING CREDIT INSTITUTIONS:

- the assessment of the strategies, business models, and the earning capacity of banks, with a focus on risk management, sustainability and the balancing of earning capacity;
- consolidating the operational compliance and risk control functions by paying attention to the processes and effectiveness of the carrying out of the stress tests of banks, improvement of the operational recovery plan and the application thereof in practice, as well as the quality of reports;
- the credit risk, *inter alia*, exposure concentration management, assessment of adequacy of provisions, with the main focus on problematic loans (overdue, restructured) and organisation and effectiveness of the loan recovery process, as well as by adjusting the requirements for credit risk management (amendments to the Regulations on Credit Risk Management);
- application of macro-prudential instruments in accordance with the identified cyclical and structural systemic risks;
- implementation of the supervisory measures for the application of the IFRS 9 and the assessment of the impact thereof on financial indicators of the banks and the fulfilment of regulatory requirements.

SUPERVISING THE FINANCIAL INSTRUMENTS MARKET:

- improving the monitoring process of the providers of investment services, regulated market operator and other financial instruments market participants, pursuant to the requirements of the Financial Instruments Market Directive (MiFID II) and the Financial Instruments Market Regulation (MiFIR);
- introducing and implementing the supervisory process of the central securities depository in accordance with the EU Regulation on the Central Securities Depositories (CSDR);
- convergence of the supervisory practice of the financial instruments market participants, taking into account the ESMA framework;
- enhancing the financial instruments market regulation, in order to promote the effectiveness of the operation, growth of the financial instruments market and protection of investor interests;
- enhancing the existing information systems, including participation in the IT projects (TREM, TRACE, FIRTS, etc.), *inter alia*, by carrying out the quality assessment of the data contained in these information systems, in order to ensure the fulfilment of the requirements of the topical EU legal acts and to fit into the single EU financial instruments market supervisory and transparency infrastructure;
- introducing and implementing the supervisory process in accordance with the requirements of the EU legal acts.

SUPERVISING INSURANCE:

- enhancing the on-site and off-site supervisory processes of insurance business persons, correspondingly supplementing the on-site and off-site supervision handbooks and in practice applying the conditions incorporated in the Supervisory Rulebook developed by the EIOPA, in order to promote the convergence of supervision of the Member States;
- enhancing the supervisory framework of the insurance and reinsurance distributors, in order to ensure the supervision of the compliance of the activities of the insurance and reinsurance distributors with the requirements of the Insurance Distribution Directive ensuring the protection of interests of their customers (consumers) corresponding to the requirements of the referred to Directive.

SUPERVISING PENSION AND INVESTMENT FUNDS:

- enhancing the supervisory methods of the private pension funds, investment management companies, including the managers of the funds of the State-funded pension schemes, and the managers of alternative investment funds, in order to strengthen the application of the risk-based approach;
- enhancing the regulation of the activities of the OPCAI, in order to transpose the requirements of the directive regarding the activities and supervision of the OPCAI into the national legislation, thus ensuring better protection and information for the members of the pension plans, by eliminating the obstacles for the cross-border operation of the pension funds, promoting long-term and responsible investing and ensuring that the pension plans are financially stable.

SUPERVISING COMPLIANCE:

- enhancing the statutory regulation in the AML/CTF field, in order to:
  - ensure the updating of the risk factors in accordance with the current changes in the AML/CTF field;
  - improve the ML/TF and international sanctions risk management in credit institutions and financial institutions, providing services in Latvia;
- ensuring effective application of the requirements of the Law on the Prevention of Money Laundering and Terrorism Financing in non-bank financial institutions, taking the ML/TF risks into account;
- systemic and regular supervision of the changes in the business models of the credit institutions directed towards reducing the share of high risk customers, thereby, in total, achieving the goals set for the financial sector of Latvia;
- promoting cooperation with other supervisory authorities and partners in the Eurozone and the USA in the field of anti-money laundering and combating crime;
- continuing the introduction of the requirements set by the FATF, in order to ensure the compliance of the credit institutions with the international standards in the AML/CTF field.

IN THE FIELD OF REGULATORY REQUIREMENTS:

- active involvement in the examination of the proposals for amendments to the European Commission Capital Requirement Directive (CRD) and the Capital Requirement Regulation (CRR), as well as the proposal of the new prudential regime of the investment firms, 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 the nature of the Latvian financial sector into account;
- submission of the proposals on the application of macro-prudential instruments in accordance with the identified trends in structural and cyclical risks to the Macro-Prudential Board (MPB);
- updating the Credit Risk Management Regulations, in order to introduce the requirements of the EBA guidelines and the ECB instructions applicable to credit risk management, as well as to introduce the EBA guidelines on the application of the definition of default contained in Article 178 of Regulation (EU) No. 575/2013.

IN THE FIELD OF THE CRISIS MANAGEMENT RESOLUTION MECHANISM:

- ensuring effective integration into the single resolution and single investment insurance mechanism, by enhancing the internal regulatory framework of the resolution and cooperation with the foreign investment guarantee fund managers;
- enhancing the crisis management process, by means of an effective and coordinated crises management mechanism, including communication mechanism;
- continuing the process of development of resolution plans.

IN THE FCMC GOVERNANCE:

- promoting corporate culture rooted in cooperation and team approach, at the same time optimising the processes and resources;
- purposeful development of the staff competences, professional qualification and skills;
- introducing effective, safe and cost-effective changes in information technology solutions and infrastructure.

GOVERNANCE AND STRUCTURE OF THE FCMC

13. STAFF POLICY

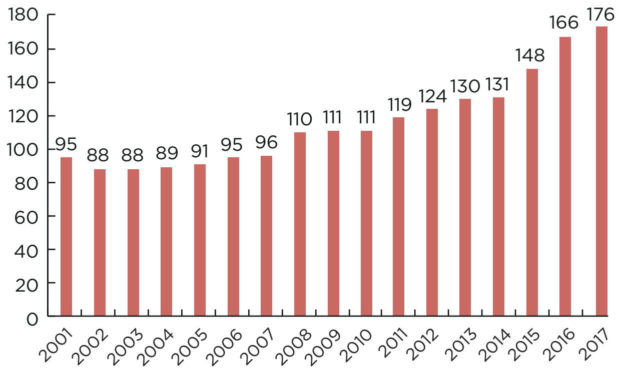
Highly educated and professional staff plays a major role in the achievement of the strategic goals of the FCMC and the further development of the institution.

Staff breakdown by number and the changes thereof

During the reporting year, the number of job positions has increased to 176 job positions (please see Figure 3).

For the purposes of more efficient organisation of the work of structural units in accordance with the areas of supervision, the job vacancy of the Director of the Department on the issues of supervision of the monetary financial institutions and the job vacancy of the Deputy Director of the Department on the issues of supervision of the non-monetary financial institutions have been opened in the Supervision Department. Along with the increasing intensity of cooperation with the ECB in the field of significant credit institutions and in the field of less-significant credit institutions, the job vacancy of the Deputy Head of the Division on the issues of supervision of less-significant banks and the job vacancy of the Deputy Head of the Division on the issues of supervision of significant banks have been opened in the Monetary Financial Institutions Operations Analysis Division. Having assessed the workload in the Financial Division, the job position of the accountant was closed.

Figure 20
Staff number dynamics (2001-2017)



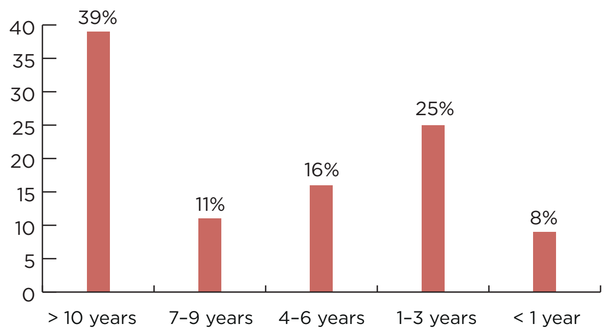
In 2017, the average number of employees, including those on long-term leave, was 164. At 31 December 2017, the FCMC employed 166 employees, whereof:

- 137 (83%) were engaged in performing principal activities and 29 (17%) were engaged in performing support functions;
- 116 (70%) were civil servants and 50 (30%) were employees;
- all employees are engaged in performing intellectual work.

In 2017, the staff turnover rate was 4.2%. In the reporting year, 14 employees were hired by the FCMC, with 11 employees being hired for ensuring core activities and three employees – for support functions, of which three employees were hired by the FCMC for a specified period of time – for the term of the extended leave of absence of employees (child care leave). After the expiry of the probation period, in accordance with the established adaptation period plan, all of the new employees received a positive assessment and continue to be employed by the FCMC. During the reporting year, the FCMC terminated employment relationships with eight employees, including one employee who had been hired by the FCMC to replace an employee on an extended leave of absence (child care leave). Of the seven permanent employees who terminated their employment relationship with the FCMC, two employees retired, while the other five chose to pursue a career in the private sector.

At the end of 2017, 92% (153) of employees of the FCMC had been employed by the FCMC for more than one year, 27% (45) employees — for 16 years, i.e. as of its establishment in 2001, and 8% (13) employees had been employed by the FCMC for less than a year (please see Figure 21).

Figure 21
Breakdown of staff by length of service at the FCMC (%)



During the reporting year, 92 (55%) employees were assigned on 503 business trips, of which:

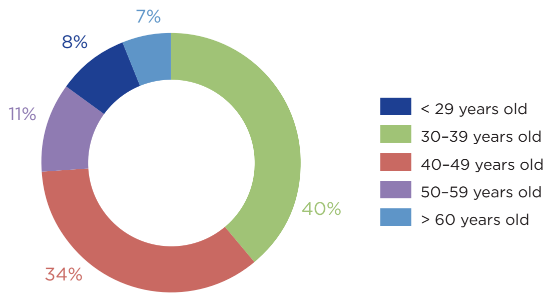
- 78 (47%) employees were involved, on a regular basis, in the work of the task forces established by the European Union and the European financial supervisory authorities (EBA, EIOPA, and ESMA);
- Ten (6%) employees were regularly involved in the events of the task forces of the European Council;
- The Chairman of the FCMC, as the representative of the Republic of Latvia, participated in the Spring and Autumn sessions of the International Monetary Fnd and the World Bank;
- six employees met with the US financial supervision authorities as experts in Washington and New York.

Breakdown of FCMC staff by gender and age

In 2017, 73% (121) of all FCMC employees were women, whereas 27% (45) were men. In the reporting year, the age profile of the staff is characterised by the following indicators: 8% (13) of employees were aged up to 29 years old, 40% (67) were aged from 30 to 39 years old, 34% (56) were aged from 40 to 49 years old, and 18% (30) were aged over 50 years old (please see Figure 22).

In 2017, the average age of the FCMC staff was 42.7 years old.

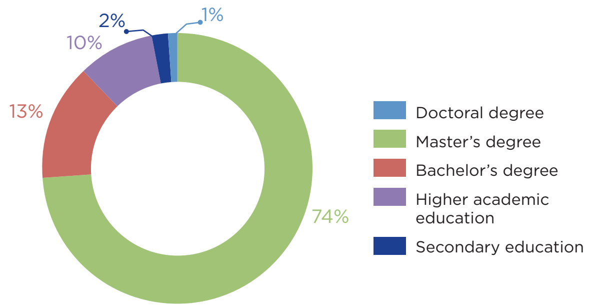
Figure 22
Breakdown of the FCMC staff by age groups (%)



Staff qualifications

In the reporting year, 98% (163) of FCMC employees had a university degree (whereof 74% held a Master's degree), whereas 2% (3) of employees had secondary or professional secondary education (please see Figure 23).

Figure 23
Breakdown of FCMC staff by educational attainment level (%)



Improving staff qualifications

With a view to improving FCMC activity processes whilst thereby raising the effectiveness and efficiency of the performance, as well as to carrying out the supervision of the financial sector, especially of the banking sector, 80% (133) of FCMC staff improved their qualifications by attending job-related training held in Latvia and abroad. The seminars on the issues of bank supervision, application of IFRS 9 personal data protection, legislation, risk management, IT systems safety, project management culture and FinTech (financial services with IT solutions) were attended in Latvia, as well as project management training regarding the process of implementation of verification and application of project management principles within the process of the implementation of verification. Within the scope of the Structural Reforms Support Programme of the European Commission, the FCMC employees attended the training in the field of raising the effectiveness of anti-money laundering.

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*, Supervisory Review and Evaluation Process and on other matters related to financial supervision, 65 (39%) of FCMC employees attended seminars held abroad.

Staff performance appraisal

In 2017, under the procedure set forth by the FCMC, 158 employees underwent staff performance appraisals, including 30 heads of structural units (including three members of the board) and 128 subject-matter experts.

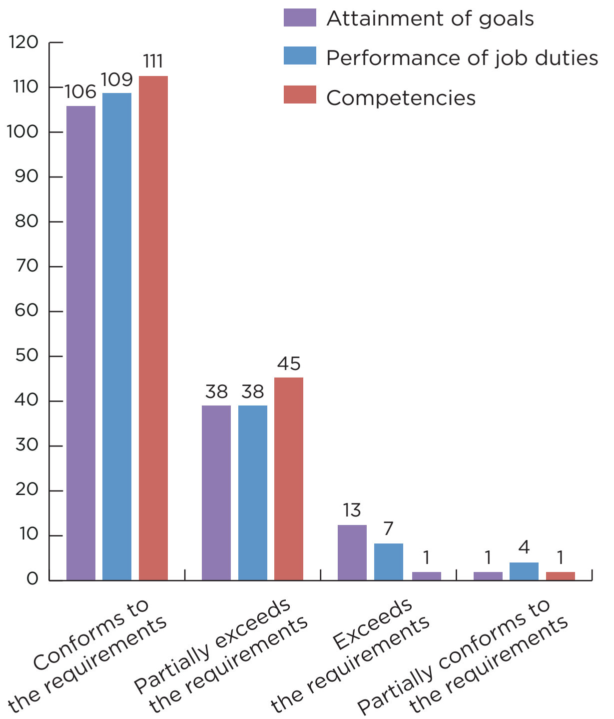
Three criteria were set for assessing performance: attainment of established goals, performing of job duties, and the required job-related competencies.

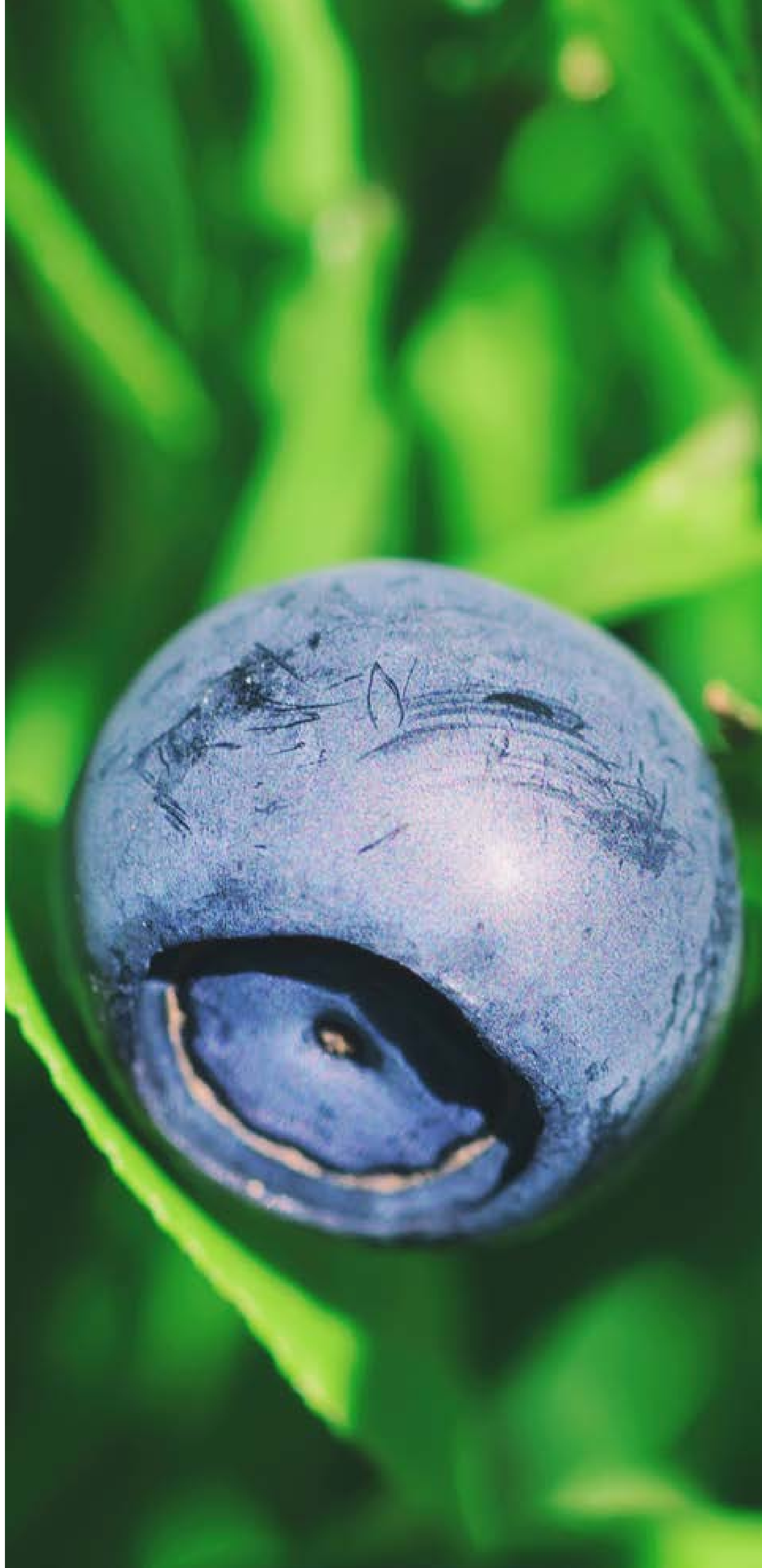
64% of employees (101) received the overall assessment of all criteria as *Conforms to the requirements*, 33% of employees (52) received the assessment *Partially exceeds the requirements*, 2% of employees (3) received the assessment *Exceeds the requirements*, while 1% of employees (2) received the assessment *Partially conforms to the requirements*. In 2017, none of the employees received the overall assessment of all criteria as *'Not conforming to the requirements'.*

The majority of employees also received the assessment *Conforms to the requirements*, including regarding each individual criterion — for attaining established goals — 67% (106) of employees, for the performance of job duties — 69% (109) of employees, and for the required job-related competencies — 70% (111) of employees (please see Figure 24).

Figure 24

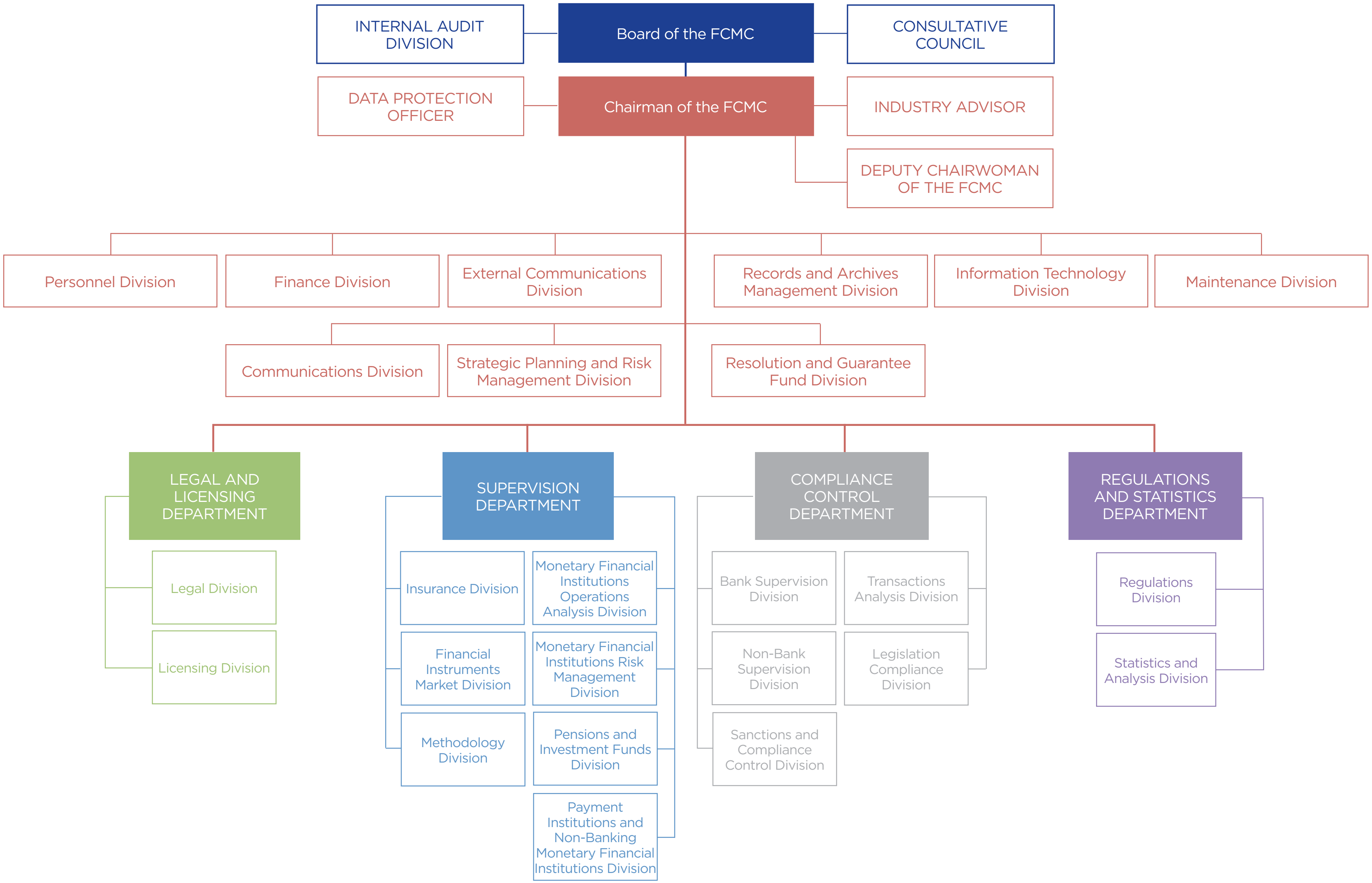
Breakdown of the spa assessment by criteria (number)





14.

FCMC STRUCTURE


INTERNAL AUDIT DIVISION
Board of the FCMC
CONSULTATIVE COUNCIL
DATA PROTECTION OFFICER
Chairman of the FCMC
INDUSTRY ADVISOR
DEPUTY CHAIRWOMAN OF THE FCMC
Personnel Division
Finance Division
External Communications Division
Records and Archives Management Division
Information Technology Division
Maintenance Division
Communications Division
Strategic Planning and Risk Management Division
Resolution and Guarantee Fund Division
LEGAL AND LICENSING DEPARTMENT
Legal Division
Licensing Division
SUPERVISION DEPARTMENT
Insurance Division
Monetary Financial Institutions Operations Analysis Division
Financial Instruments Market Division
Monetary Financial Institutions Risk Management Division
Methodology Division
Pensions and Investment Funds Division
Payment Institutions and Non-Banking Monetary Financial Institutions Division
COMPLIANCE CONTROL DEPARTMENT
Bank Supervision Division
Transactions Analysis Division
Non-Bank Supervision Division
Legislation Compliance Division
Sanctions and Compliance Control Division
REGULATIONS AND STATISTICS DEPARTMENT
Regulations Division
Statistics and Analysis Division

15. QUALITY AND RISK MANAGEMENT

Quality and risk management in the FCMC is ensured by the Strategic Planning and Risk Management Division, the aim of operation whereof is in line with its competence, to promote constant enhancement and improvement of the activities of the FCMC. In 2017, the FCMC continued to enhance the quality management system. During the reporting year, the opinion of the main external stakeholders regarding the FCMC activities was gathered, the FCMC staff satisfaction survey was carried out and the FCMC governance assessment was commenced in accordance with the criteria of the CAF (Common Assessment Framework) model. This assessment will continue in 2018, and the results thereof will be employed for enhancing and improving the activities of the FCMC.

Risk management is an important component of the FCMC management processes, within the scope whereof the risks are identified, analysed and assessed, by planning and implementing the risk mitigating measures, monitoring and reviewing the risks, thereby promoting the achievement of the goals of the FCMC and the effective process of project management. In 2017, the FCMC commenced the enhancement of the risk management process established during the previous years in accordance with the international best practice in the field of risk management, as well as in line with the requirements set by the ECB in the field of risk management. Enhancement of the risk management process will continue in 2018.

16. 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 governance, internal control and risk management 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 provides recommendations for the improvement thereof.

In 2017, the Internal Audit Division has conducted scheduled internal audits of the FCMC, as well as internal audits in accordance with the audit plan approved by the Internal Audit Committee.

Internal audits are planned and conducted based on a risk-based approach and considering the strategy of the FCMC. The findings of the results of internal auditing are 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 carries out a regular follow-up of the course of introduction of the recommendation, ensuring that the key recommendations are fulfilled and the control environment is correspondingly improved.

Internal audit takes due care of the quality of fulfilment of the audits, therefore, in carrying out its activity, it complies with the general principles of the International Standards for the Professional Practice of Internal Auditing, the Code of Ethics, and the guidelines. The Internal Audit Division has developed and maintains a current quality assurance and improvement programme. The performance quality and results of the internal audit are reported to the Board of the FCMC.

17. FINANCING OF FCMC ACTIVITIES

In 2017, the activity of the FCMC was fully financed by 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 financial stability fees and contributions to the single resolution fund. The assets of the DGF and FPI are only used for the purposes thereof mentioned in the Deposit Guarantee Law and the Activities of Insurance and Reinsurance Intermediaries Law, and 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 8
Financing of the activities of the FCMC in 2016-2017, in EUR

	ACTUAL PERFORMANCE IN 2016	ACTUAL PERFORMANCE IN 2017	BUDGET FOR 2017	BUDGET PERFORMANCE FOR 2017, %	SHARE OF THE ACTUAL PERFORMANCE IN TOTAL IN 2017, %
REVENUE (+)	**8,865,788**	**10,515,550**	**10,649,546**	**99**	**100**
PAYMENTS BY THE PARTICIPANTS OF THE FINANCIAL AND CAPITAL MARKET	8,848,711	10,484,140	10,639,546	99	99.7
REVENUE RELATED TO THE SUPERVISION OF MONETARY FINANCIAL INSTITUTIONS	6,638,148	7,793,057	8,146,106	96	74.1
Payments by credit institutions	6,369,514	7,491,052	7,883,190		
Payments by credit unions	34,515	36,988	37,554		
Payments by payment institutions	66,508	96,038	57,422		
Payments by electronic money institutions	185,255	170,431	167,940		
Lost income	-17,644	-1,452			
REVENUE RELATED TO THE SUPERVISION OF THE FINANCIAL INSTRUMENTS MARKET AND PRIVATE PENSION FUNDS	803,460	991,718	914,512	108	9.4
Payments by participants of the financial instruments market	528,619	689,205	654,532		
Payments by private pension funds	274,841	302,513	259,980		
REVENUE RELATED TO THE SUPERVISION OF INSURANCE	1,407,103	1,699,365	1,578,928	108	16.2

	ACTUAL PERFORMANCE IN 2016	ACTUAL PERFORMANCE IN 2017	BUDGET FOR 2017	BUDGET PERFORMANCE FOR 2017, %	SHARE OF THE ACTUAL PERFORMANCE IN TOTAL IN 2017, %
Payments by life insurance companies	276,168	341,584	267,298		
Payments by other insurance companies	1,073,680	1,301,076	1,254,655		
Payments by insurance brokers	57,255	56,755	56,975		
Lost income		-50			
OTHER REVENUE	17,077	31,410	10,000	184	0.3
EXPENSES (-)	**8,615,892**	**9,915,835**	**10,899,208**	**91**	**100**
Salary for work, other payments to employees, and national social insurance mandatory contributions	6,198,352	7,220,561	7,939,803	91	72.8
Employee insurance	55,040	56,815	61,325	93	0.6
Improving professional qualifications of the staff	103,871	179,585	190,964	94	1.8
Telecommunications, communications, and information	160,106	153,473	190,523	81	1.5
Information to the general public, internal and external communication	51,787	76,650	105,513	73	0.8
Maintenance and operational expenses	770,706	823,114	824,659	100	8.3
Services for the provision of supervision	111,758	114,323	121,405	94	1.2
International cooperation	1,003,316	1,095,813	1,237,375	89	11.0
Amortisation/depreciation of capital investments	160,956	195,501	227,641	86	2.0
RESULT	**249,896**	**599,715**	**-249,662**		

In 2017, the actual financing of the FCMC grew by 18% compared to 2016, because over the period of 2017 the functions were implemented in the field of enhancement of the compliance control and resolution and guarantee system, the increase whereto had already been provided in 2016, but in 2017 it reached 14% of the FCMC's operational provision expenses. Considerable funds were devoted for the control of anti-money laundering and counter terrorism financing to outsourced services provided by the hired US experts. For the provision of the supervisory measures of the FCMC (apart from anti-money laundering and counter-terrorism financing control supervision) the amount of expenses in 2017 comprised 63% of the total FCMC's operational provision expenses, and 23% – for the management and support functions.

In 2017, it was intended to cover 95% of the FCMC budget revenue from the payments made by market participants. It was planned that 76% of all payments by market participants are sourced from monetary financial institutions, 9% from financial instruments market participants together with private pension funds, and 15% of payments are sourced from insurance market participants. However, in accordance with the actual fulfilment of the plan the monetary financial institutions ensured financing in the amount of 96% of the planned one, thus ensuring contributions into the FCMC budget in the amount of 74% of the total financing by market participants in 2017. In 2017, the actual total expenses of budget implementation (without provisions for annual leave and without the reinstatement costs of the previous periods) comprised EUR 9,915.8 thousand, which is 9% less than planned (EUR 10,899.2 thousand).

The planned non-acquisition of the budget expenses is connected to several reasons – gradual introduction of the reorganisation of the staff remuneration system, implementation of training possibilities, the outcome of the competitiveness of the prices of telecommunication services, the attendance ability of the scheduled business trips, prioritising of the planned projects.

In 2017, the largest costs of operational provision of the FCMC were comprised of the expenses on remuneration of employees of the FCMC (72.8%).

Table 9

Breakdown of FCMC staff remuneration in 2017, in EUR

Salaries and similar payments	**5,857,344**
including bonuses	221,704
including additional payments	64,150
including remuneration to the FCMC Board	397,555
National social insurance mandatory contributions	**1,363,217**
including the national social insurance mandatory contributions on the remuneration of the FCMC Board	93,638

In 2017, the leasehold expenses of the FCMC were EUR 442.5 thousand, which comprises 53.8% of the maintenance and operational services. The leasehold expenses also include archive shelf lease and the expenses of lease of the branch advisor's office in the USA. As the number of employees of the FCMC grew in 2016 and continued to increase in 2017, the leased office premises in Riga had to be expanded, by concluding a new agreement to the existing lease contract in 2017 on the lease of additional premises in an area of 204.10 m^2 at 2 Krāmu Street, but the office lease contract at 3 Kungu Street in the total area of 64 m^2 was terminated, therewith the total office area leased by the FCMC in Riga, at the end of the year, comprised 2,306.10 m^2, which increased the maintenance and operational costs.

During the reporting year, the FCMC represented Latvia in eight European and global level financial market organisations involved in supervision and the coordination thereof, the membership of which cost 12.5% more than in 2016.

Table 10

Membership fees paid by the FCMC to the EU and global organisations in 2016-2017, in EUR

	2016	2017	Changes in 2017/2016
Payments to EU organisations	504,784	568,007	12.5
Payments in international organisations	44,967	50,530	12.4%
Total	**549,751**	**618,537**	**12.5**

In 2017, the intensity of the participation of FCMC staff in the activities of the ECB, the European Commission and other bodies and organisations, as well as in the working groups for the 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 organisational structures of which the representatives of the FCMC have also been actively involved for the entire of 2017, therefore the number of official business trips during the reporting year slightly exceeded 500 (the same as in 2016), whereas the costs thereof amounted to EUR 474 thousand.

The FCMC has been continuously improving the technical resources of the activity support thereof, in particular in the field of information technology. Therefore EUR 257.5 thousand was spent on capital expenditure during the reporting year (in accordance with the cash flow principles), whereof 93% consisted of investments in computer hardware and software.

The financial statements of the FCMC for 2017, approved on 24 April 2018, the financial statements of the DGF and FPI for 2017, as well as independent certified auditor's reports on them are available on the FCMC website www.fktk.lv.

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