

BANK OF LATVIA

FINANCIAL STATEMENTS OF THE BANK OF LATVIA
FOR THE YEAR ENDED 31 DECEMBER 2011
INDEPENDENT AUDITORS' REPORT TO THE COUNCIL
OF THE BANK OF LATVIA

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ABBREVIATIONS

| | |
|------|--|
| BIS | Bank for International Settlements |
| EC | European Commission |
| ECB | European Central Bank |
| ESCB | European System of Central Banks |
| EU | European Union |
| IMF | International Monetary Fund |
| JSC | Joint Stock Company |
| OECD | Organisation for Economic Co-operation and Development |
| SDR | Special Drawing Rights |
| US | United States of America |

BALANCE SHEET

(at the end of the year; in thousands of lats)

| ASSETS | Notes ¹ | 2011 | 2010 |
|--|--------------------|------------------|-----------|
| FOREIGN ASSETS | | 3 507 542 | 4 074 611 |
| Gold | 7 | 210 066 | 187 179 |
| Special Drawing Rights | 8 | 79 069 | 99 356 |
| Convertible foreign currencies | 9 | 3 184 920 | 3 782 167 |
| Participating interest in the European Central Bank | 10 | 750 | 750 |
| Participating interest in the Bank for International Settlements | 11 | 18 997 | 1 763 |
| Other foreign assets | 12 | 13 740 | 3 396 |
| DOMESTIC ASSETS | | 31 683 | 32 722 |
| Fixed assets | 13, 14 | 30 675 | 31 003 |
| Other domestic assets | 15, 16 | 1 008 | 1 719 |
| TOTAL ASSETS | | 3 539 225 | 4 107 333 |

¹ The accompanying Notes set out on pages 9 to 45 are an integral part of these financial statements.

(cont.)

(at the end of the year; in thousands of lats)

| LIABILITIES, CAPITAL AND RESERVES | Notes | 2011 | 2010 |
|--|--------|------------------|-----------|
| FOREIGN LIABILITIES | | 72 372 | 42 556 |
| Convertible foreign currencies | 17 | 9 560 | 13 682 |
| International Monetary Fund | 8 | 313 | 274 |
| Other international institution deposits in lats | 18 | 18 271 | 8 505 |
| Foreign bank deposits in lats | | 712 | 726 |
| Other foreign liabilities | 19 | 43 516 | 19 369 |
| LATS IN CIRCULATION | 20 | 1 160 183 | 937 904 |
| DOMESTIC LIABILITIES | | 1 979 508 | 2 830 233 |
| Balances due to credit institutions | 21 | 1 197 740 | 1 690 230 |
| Balances due to the government | 22 | 737 088 | 1 081 010 |
| Balances due to other financial institutions | | 42 715 | 56 738 |
| Other domestic liabilities | 23, 24 | 1 965 | 2 255 |
| CAPITAL AND RESERVES | | 327 162 | 296 640 |
| Nominal capital | 25 | 25 000 | 25 000 |
| Reserve capital | 25 | 148 587 | 140 273 |
| Valuation account | 25 | 121 547 | 107 613 |
| Profit of the reporting year | 25 | 32 028 | 23 754 |
| TOTAL LIABILITIES, CAPITAL AND RESERVES | | 3 539 225 | 4 107 333 |

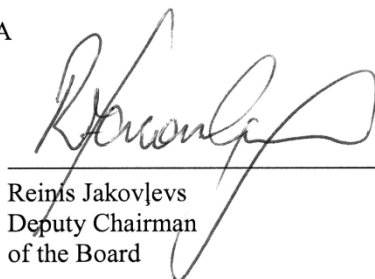
The financial statements, which are set out on pages 3 to 45, were authorised by the Board of the Bank of Latvia on 13 March 2012.

BOARD OF THE BANK OF LATVIA

BOARD OF THE BANK OF LATVIA



Māris Kālis
Chairman of the Board



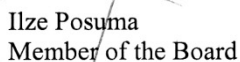
Reinis Jakovļevs
Deputy Chairman
of the Board



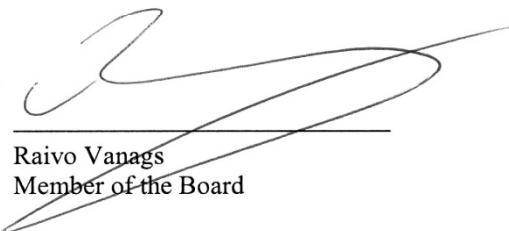
Andris Nīkitins
Member of the Board



Harijs Ozols
Member of the Board



Ilze Posuma
Member of the Board



Raivo Vanags
Member of the Board

PROFIT AND LOSS STATEMENT

(in thousands of lats)

| | Notes | 2011 | 2010 |
|--|-------|----------------|---------|
| INTEREST INCOME | | | |
| Foreign operations | 26 | 73 265 | 57 055 |
| Interest on securities | | 58 813 | 52 405 |
| Interest on deposits with foreign credit institutions and other foreign financial institutions | | 5 832 | 2 792 |
| Interest on derivative financial instruments | | 8 620 | 1 858 |
| Domestic operations | 26 | 13 | 3 618 |
| Interest on loans to credit institutions | | 1 | 3 618 |
| Interest on derivative financial instruments | | 12 | – |
| INTEREST EXPENSE | | | |
| Foreign operations | 26 | –494 | –967 |
| Interest on deposits | | –7 | –1 |
| Interest on derivative financial instruments | | –487 | –966 |
| Domestic operations | 26 | –11 475 | –13 362 |
| Interest on deposits of credit institutions | | –4 057 | –9 140 |
| Interest on government deposits | | –7 125 | –4 127 |
| Interest on deposits of other financial institutions | | –293 | –95 |
| NET INTEREST INCOME | 26 | 61 309 | 46 344 |

(cont.)

(in thousands of lats)

| | Notes | 2011 | 2010 |
|---|--------|---------|---------|
| REALISED GAINS/LOSSES (-) FROM FINANCIAL OPERATIONS | 27 | 5 942 | 9 147 |
| Foreign operations | | -3 505 | -6 315 |
| Debt securities | | 11 836 | 17 599 |
| Derivative financial instruments | | -15 341 | -23 914 |
| Foreign currency exchange transactions | | 9 447 | 15 462 |
| WRITE-DOWNS OF REVALUATION RESULT ON FINANCIAL ASSETS AND POSITIONS | 25, 28 | -16 556 | -12 995 |
| Foreign operations | | -14 905 | -11 639 |
| Debt securities | | -14 905 | -11 639 |
| Foreign currency position | | -1 651 | -1 356 |
| INCOME FROM PARTICIPATING INTEREST | 29 | 245 | 611 |
| OTHER OPERATING INCOME | 30 | 1 261 | 1 278 |
| BANKNOTE PRODUCTION AND COINAGE COSTS | 31 | -582 | -541 |
| OTHER OPERATING EXPENSES | | -19 591 | -20 090 |
| Remuneration | 32 | -9 902 | -10 278 |
| Social security costs | 32 | -2 373 | -2 449 |
| Depreciation and amortisation charges | 13, 16 | -2 948 | -3 044 |
| Maintenance and operation of information systems | | -1 670 | -1 554 |
| Other operating expenses | 33 | -2 698 | -2 765 |
| PROFIT OF THE REPORTING YEAR | | 32 028 | 23 754 |

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

(in thousands of lats)

| | Notes | 2011 | 2010 |
|---|--------|----------------|---------|
| REVALUATION | 25 | 27 871 | 35 482 |
| Equity instruments | | 17 233 | — |
| Foreign currency and gold | | 6 068 | 36 680 |
| Non-traded interest rate swap arrangements | | 25 | — |
| Debt securities | | 4 545 | -1 198 |
| REALISATION OF ACCUMULATED REVALUATION RESULT | 25 | -30 493 | -14 993 |
| Foreign currency and gold | | -13 761 | -3 889 |
| Debt securities | | -16 732 | -11 104 |
| WRITE-DOWNS OF REVALUATION RESULT ON FINANCIAL ASSETS AND POSITIONS | 25, 28 | 16 556 | 12 995 |
| PROFIT OF THE REPORTING YEAR | | 32 028 | 23 754 |
| TOTAL | | 45 962 | 57 238 |

CASH FLOW STATEMENT

(in thousands of lats)

| | Notes | 2011 | 2010 |
|--|--------|----------------|----------|
| CASH FLOW FROM OPERATING ACTIVITIES | | | |
| Profit of the reporting year | | 32 028 | 23 754 |
| Non-cash transaction adjustments | 34 (1) | 19 506 | 16 294 |
| Net movements in balance sheet positions | 34 (1) | 6 178 | -378 945 |
| Net cash and cash equivalents inflow/outflow (-) from operating activities | | 57 712 | -338 897 |
| CASH FLOW FROM INVESTING ACTIVITIES | | | |
| Dividends on shares of the Bank for International Settlements | 29 | 245 | 611 |
| Acquisition of fixed assets | 13 | -2 345 | -788 |
| Acquisition of intangible assets | 16 | -92 | -146 |
| Net cash and cash equivalents outflow from investing activities | | -2 192 | -323 |
| CASH FLOW FROM FINANCING ACTIVITIES | | | |
| Profit appropriated to the state budget | 25 | -15 440 | -48 355 |
| Net cash and cash equivalents outflow from financing activities | | -15 440 | -48 355 |
| NET CASH AND CASH EQUIVALENTS INFLOW/OUTFLOW (-) | | 40 080 | -387 575 |
| Cash and cash equivalents at the beginning of the year | 34 (2) | 556 650 | 944 225 |
| Cash and cash equivalents at the end of the year | 34 (2) | 596 730 | 556 650 |

NOTES TO THE FINANCIAL STATEMENTS

1. PRINCIPAL ACTIVITIES

The Bank of Latvia is the central bank of Latvia. It was established on 31 July 1990 and operates under the Law of the Republic of Latvia "On the Bank of Latvia" and other legislative provisions.

The primary goal of the Bank of Latvia is to maintain price stability in Latvia. Pursuant to the Law "On the Bank of Latvia", its primary tasks are as follows:

- establishment and implementation of monetary policy;
- management of foreign currency and gold reserves;
- issue of the national currency, both banknotes and coins;
- promotion of a smooth operation of the payment systems in Latvia and organisation and management of the interbank payment system;
- collecting, compiling and publishing financial statistics and Latvia's balance of payments;
- representation of Latvia in foreign central banks and international financial institutions;
- acting as a financial agent for the Latvian government.

The Bank of Latvia also ensures the operation of the Credit Register as of 1 January 2008. The Bank of Latvia issues licences to legal persons listed in the Republic of Latvia Register of Enterprises, except credit institutions, for the purchase and sale of foreign currency cash as a commercial activity, and controls compliance with the procedure it has established for effecting foreign currency cash purchase and sales transactions.

In the execution of its tasks and control in accordance with the Law "On the Bank of Latvia" and the Law "On Credit Institutions", the Bank of Latvia neither seeks nor takes instructions from the government or any other institution. The Bank of Latvia is independent in setting and implementing policy under its legal mandate. The Bank of Latvia is supervised by the Parliament (Saeima) of the Republic of Latvia.

The Bank of Latvia does not engage in any commercial activity, and its operation related to the execution of its tasks is mainly financed from income received from foreign currency and gold reserves (hereinafter, foreign reserves) management.

The Head Office of the Bank of Latvia is situated in K. Valdemāra iela 2A, Riga. The Bank of Latvia manages the storage, processing and circulation of cash through its Riga Branch and the regional branches in Daugavpils and Liepāja.

2. RISK MANAGEMENT

The main risks associated with the Bank of Latvia's activities are financial and operational risks. Therefore, the Board of the Bank of Latvia has established a risk management framework under the principles and guidelines set forth by the Council of the Bank of Latvia, which is continuously improved in line with the developments in financial markets and the Bank of Latvia's operations. Management of the Bank of Latvia's financial and operational risks are reviewed by the Internal Audit Department and is monitored by the Security Supervision Commission, Audit Committee, and Budget Commission of the Bank of Latvia, each of which is comprised of Members of the Council of the Bank of Latvia.

2.1. Financial risks

Market risk (price, interest rate and currency risks), credit and liquidity risks are the most significant financial risks to which the Bank of Latvia is exposed in its daily activities.

The Bank of Latvia manages financial risks related to foreign reserves in accordance with the "Guidelines for Managing the Bank of Latvia's Foreign Reserves" (hereinafter, the Guidelines), as approved by the Council of the Bank of Latvia. The basic principles of investment policy set out in the Guidelines are provided in Note 5. Foreign reserves are managed by classifying them into different investment portfolios. Parameters for a benchmark reflecting the acceptable level of financial risks and return target are set out for each portfolio type in the Guidelines. On a business day basis, the Risk Management Division of the Market Operations Department monitors the compliance of foreign reserves with the requirements set out in the Guidelines.

For the purpose of foreign reserves management, including management of related financial risks, the Investment Committee of the Bank of Latvia that develops the investment management strategy, approves tactical decisions and sets detailed limits for financial risks within the framework of the Guidelines as well as oversees the operation of external foreign reserve managers. The Investment Committee of the Bank of Latvia reviews the investment strategy once a quarter, and on a weekly basis receives and reviews reports and forecasts for developments in financial markets, which are prepared by foreign reserves investment portfolio managers, reviews the reports by financial risk managers and approves the investment management tactical decisions for the forthcoming week. Once every two months the Market Operations Department informs the Council and the Board of the Bank of Latvia about the results of management of foreign reserves.

Market Risk

Market risk is exposure to losses due to adverse changes in financial markets (for example, movements in interest rates or exchange rates).

The Bank of Latvia is exposed to interest rate risk primarily due to investing in foreign debt securities and interest rate derivatives that are subject to interest rate fluctuations and used within the course of foreign reserve management. The Bank of Latvia manages the interest rate risk by using a modified duration limit set individually for each investment portfolio.

Bank of Latvia's exposure to currency and gold price risk (hereinafter, currency risk) is determined by the structure of its foreign reserves, which cannot be formed in compliance with the Bank of Latvia's liability parameters. The Bank of Latvia manages the currency risk by determining open currency position limits or using tracking error. Tracking error is calculated as the expected annualised standard deviation of the difference in return between the investment portfolio and a respective benchmark. The aggregate market and credit risk of portfolios managed against multi-currency fixed income securities benchmark and asset-backed securities benchmark (see also Note 5) is managed by determining the tracking error limit. Tracking error in 2011 and 2010 is provided in Note 41.

For investment portfolios, except for portfolios of borrowed funds, the benchmark currency is the euro. For portfolios of borrowed funds, the benchmark currency structure is formed in compliance with the parameters of respective liabilities. Deviations from the benchmark currency structure give rise to the open currency position. In order to achieve the compliance of open foreign currency positions with the limits, the Bank of Latvia hedges the currency risk by using forward exchange rate and currency future contracts.

Every business day, the Risk Management Division of the Market Operations Department monitors the compliance of the modified duration limits and open currency positions with the Guidelines and the related resolutions passed by the Investment Committee of the Bank of Latvia.

The Bank of Latvia does not hedge interest rate risk related to domestic financial assets in order to avoid a conflict with the monetary policy pursued by the Bank.

Exposure of the Bank of Latvia to market risk (as at the end of 2011 and 2010) is provided in Notes 40 and 41.

Credit Risk

Credit risk is exposure to losses resulting from counterparty default. The Bank of Latvia's exposure to credit risk results mainly from investments in foreign financial instruments, including short-term cash and gold deposits, and short-term lending to domestic credit institutions.

The Bank of Latvia manages exposure to credit risk related to investments made in foreign financial instruments, including short-term cash and gold deposits, by establishing limits on investments of different credit quality in the Guidelines. Credit quality is evaluated on the basis of ratings assigned by the international credit rating agencies Fitch Ratings, Moody's Investors Service and Standard & Poor's. The Bank of Latvia is allowed to invest in financial instruments of certain credit quality of the OECD countries. Limits are set also on the maximum investment in financial instruments of the same class and counterparty, as well as in financial instruments of one issuer. In order to monitor the Bank's exposure to credit risk associated with its foreign operations, the Risk Management Division of the Market Operations Department is involved in monitoring of the Bank of Latvia's compliance with the Guidelines on a business day basis.

Short-term loans granted to domestic credit institutions are secured by collateral of Latvian government securities and such private sector debt securities, according to the requirements established by the Council of the Bank of Latvia. The Market Operations Department reviews the compliance of credit ratings assigned to issuers of these securities with the requirements of the Council of the Bank of Latvia and monitors the adequacy of collateral on a regular basis.

Exposure of the Bank of Latvia to credit risk (as at the end of 2011 and 2010) is provided in Notes 43 to 45.

Liquidity Risk

Liquidity risk is associated with a failure to meet liabilities timely. Bank of Latvia's exposure to liquidity risk arises mainly from the need to ensure foreign currency for conducting foreign exchange transactions with credit institutions and repaying deposits of the Latvian government and other institutions. The Bank of Latvia manages liquidity risk by investing foreign reserves in liquid debt securities issued by international institutions, foreign governments and the corporate sector, short-term deposits with foreign financial institutions and other financial instruments. Investments are made so as to ensure timely meeting of the Bank of Latvia's liabilities. The structure of the Bank of Latvia's cash and its equivalents is provided in Note 34. The liquidity profile of the Bank of Latvia's assets and liabilities as at the end of 2011 and 2010 is provided in Note 42.

The Bank of Latvia manages liquidity risk also by setting limits on the maximum investment in financial instruments of the same class and in financial instruments of the same issuer.

2.2. Operational risks

Operational risk is exposure to financial and non-financial losses resulting from inadequate or failed internal processes, individual's actions, operation of information or technical systems, or from external events.

The basic principles of the Bank of Latvia's operational risk management are determined by the Council of the Bank of Latvia. The Bank of Latvia's operational risk management is implemented by the Board of the Bank of Latvia, which has established the Committee for Managing the Bank of Latvia's Operational Risks to coordinate, on a daily basis, the activities under the operational risk management process and to provide support to the Board of the Bank of Latvia on operational risk management issues. The Committee is presided by a Member of the Board of the Bank of Latvia and includes the Operational Risk Manager, Operational Continuity Manager, Information Security Manager, Information Systems Security Manager, and the Head of Security Department.

In 2011, the risks were reviewed and reevaluated taking into account the incurred incidents and disturbances, and new operational risks were identified, analysed and assessed, with relevant risk limiting measures being developed and appraised. The information thus obtained is compiled in the Risk Register of the Bank of Latvia, an information system which is available to the Bank of Latvia department heads responsible for processes, project managers and other authorised Bank of Latvia staff.

In order to ensure confidentiality, authorised access to and integrity of information, the Bank of Latvia information systems are classified into levels depending on their significance. . The Bank of Latvia has appointed owners of information systems who are responsible for determination of security requirements and regulations for use and approve the risk analysis results of the respective information system. Information systems security manager of the Bank of Latvia coordinates the implementation of information systems risk analysis and oversees the introduction of measures aimed at minimising the identified risks. The Head of Information Systems Department ensures logical and physical security of the Bank of Latvia information systems, including accessibility to information systems and compliance with other security requirements coordinated with the information system owners. The Bank of Latvia conducts, on a regular basis, the analysis of information systems security risks and improves security measures and tools.

The management of Bank of Latvia business continuity is organised and conducted in accordance with the "Bank of Latvia Business Continuity Policy", approved by the Council, abiding by the internationally recognised standards and taking into account the ECB recommendations regarding business continuity management.

The Bank of Latvia conducts, on a regular basis, educational sessions for employees on information and information systems security, risk management and management of operational continuity.

Within the overall limitation of operational risks, the Bank of Latvia is insured against certain types of operational risks.

In 2011, the Bank of Latvia was not exposed to the risks that could substantially affect or hamper its operation.

3. PRINCIPAL ACCOUNTING POLICIES

A summary of the principal accounting policies adopted by the Bank of Latvia in the preparation of these financial statements is set out below.

3.1. Change in accounting policy

In order to promote the presentation of useful information in the financial statements and in the light of developments of the financial reporting framework, in 2011, the Council of the Bank of Latvia introduced amendments to the "Financial Accounting Policy of the Bank of Latvia" providing for the reporting of equity instruments at fair value in the balance sheet, except the participating interest in the ECB, which is reported at cost in the balance sheet in accordance with the legal framework for accounting and financial reporting in the ESCB. The change in fair value of participating interest is reported in the balance sheet caption "Valuation account". Previously, participating interest was reported at cost. The change in the accounting policy has been applied prospectively as of 31 December 2011.

As a result of this change in the accounting policy, book value of participating interest increased by 17 233 thousand lats in 2011 (see also Notes 11 and 25).

3.2. Basis of presentation

These financial statements have been prepared in accordance with the "Financial Accounting Policy of the Bank of Latvia" approved by the Bank of Latvia's Council, and the Law "On the Bank of Latvia".

The "Financial Accounting Policy of the Bank of Latvia" requires that events and financial transactions of the Bank of Latvia relating to the implementation of monetary policy and management of foreign reserves as well as participating interest in the ECB are reported in accordance with the legal framework for accounting and financial reporting in the ESCB.

3.3. Basis of measurement

These financial statements have been prepared in accordance with the historical cost basis of accounting except gold, debt securities, participating interest (except the participating interest in the ECB), currency future contracts and interest rate derivatives, which are accounted for at fair value. Forward exchange rate contracts and currency swap arrangements are valued according to the principles described in Note 3.16. The reconciliation of the book value and fair value of these instruments is provided in Note 38.

3.4. Fair value of financial assets and financial liabilities

Fair value is the estimated amount at which financial assets could be exchanged, or financial liabilities settled in a transaction on an arm's length basis between knowledgeable and willing parties.

Fair value of financial instruments is determined by the Bank of Latvia using quoted prices in active markets, other financial market information sources or discounted cash flows. The discounted cash flows are modelled using quoted market prices of financial instruments and money market interest rates. The breakdown of assets and liabilities measured at fair value, taking into account the hierarchy of fair value determination, is provided in Note 6.

Fair value of the Bank of Latvia's financial assets and financial liabilities does not differ materially from the reported book value of the respective assets and liabilities.

3.5. Foreign currency and gold translation

Transactions denominated in foreign currencies are recorded in lats at the exchange rates quoted by the Bank of Latvia for the day of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into lats at the exchange rates set by the Bank of Latvia at the end of the reporting period. Non-monetary assets and liabilities, measured at cost or amortised cost, are translated into lats at the exchange rate for the respective foreign currency set by the Bank of Latvia on the day of the transaction. Taking into account the lats peg to the euro, the Bank of Latvia sets the exchange rates for other currencies on the basis of the exchange rate of euro against the US dollar and the exchange rates of the US dollar against other currencies as quoted in the electronic information system *Reuters*.

Transactions in foreign currencies are included in the calculation of net foreign currency position of the respective currency. The transactions in foreign currencies reducing the respective currency position result in realised gains or losses. Any gain or loss arising from revaluation of transactions in foreign currencies and currency positions are credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles referred to in Note 3.26. The principles referred to herein and in Note 3.26 for valuation and recording of transactions denominated in foreign currencies shall be applicable also to gold reserves and transactions in gold.

The exchange rates of principal foreign currencies set by the Bank of Latvia and used in the preparation of the balance sheet for the year ended 31 December 2011 and the year ended 31 December 2010 are as follows:

| | (at the end of the year) | | |
|------------------------------|--------------------------|----------|-------------|
| | 2011 | 2010 | Changes (%) |
| Euro (EUR) | 0.702804 | 0.702804 | 0 |
| US dollar (USD) | 0.544 | 0.535 | 1.7 |
| Japanese yen (JPY) | 0.007 | 0.00651 | 7.5 |
| Gold (XAU) | 844.634 | 752.612 | 12.2 |
| Special Drawing Rights (XDR) | 0.839 | 0.82 | 2.3 |

3.6. Recognition and derecognition of financial assets and liabilities

Financial assets and financial liabilities are recognised in the balance sheet when the Bank of Latvia becomes a contractual party in the respective financial transaction.

A financial asset is derecognised when the contractual rights to cash flows arising from the respective financial asset expire or are transferred, hereby risks and rewards related to the particular asset are transferred, and the Bank of Latvia does not retain control over the asset. Financial liabilities are derecognised when the respective obligations are settled.

A regular way purchase or sale of financial assets is recognised and derecognised on the settlement day.

3.7. Offsetting financial assets and financial liabilities

Financial assets and financial liabilities are offset and the net amount in the financial statements reported only in cases when there is a legally enforceable right to set off the recognised amounts, and there is an intention to settle on a net basis, or dispose the asset and settle the liability simultaneously.

3.8. Use of estimates

Estimates and assumptions have been made in the preparation of the financial statements that affect the amounts of certain assets, liabilities and contingent liabilities reported in the financial statements. Future events may affect the above mentioned estimates and assumptions. The effect of a change in such estimates and assumptions is reported in the financial statements of the reporting period and each particular future period to which it refers.

3.9. Gold

Gold reserves are stated at market value in the balance sheet in accordance with the principles described in Note 3.5.

Any gain or loss arising from transactions in gold and revaluation of gold reserves is credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles described in Note 3.26.

3.10. Debt securities

Debt securities are stated at fair value in the balance sheet.

Interest on securities, including premium and discount, is recognised in the profit and loss statement as interest income. Gain or loss arising from transactions in debt securities and revaluation are credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles referred to in Note 3.26.

3.11. Reverse repurchase agreements

Reverse repurchase agreements are accounted for as financing transactions. Securities purchased under reverse repurchase agreements are not included in the Bank of Latvia's balance sheet. The related funding provided to the counterparty is included in the Bank of Latvia's balance sheet at nominal value as claims on domestic credit institutions or foreign credit institutions and other foreign financial institutions, as appropriate.

The difference between the purchase and resale price of securities is recognised as interest income in the profit and loss statement over the term of the agreement.

3.12. Repurchase agreements

Repurchase agreements are accounted for as financing transactions. Securities sold under repurchase agreements are retained in the Bank of Latvia's balance sheet along with other securities that are not involved in these transactions. Funding received from such sales is included in the balance sheet at nominal value as a liability to the counterparty.

The difference between the sale and repurchase price of securities is recognised as interest expense in the profit and loss statement over the term of the agreement.

3.13. Securities lending

Securities lent under automatic securities lending programme agreements are retained in the Bank of Latvia's balance sheet caption "Convertible foreign currencies" along with other securities that are not involved in these transactions. Only cash collateral placed on the account of the Bank of Latvia, is recognised in the balance sheet.

Income from securities lending transactions is recognised as interest income in the profit and loss statement.

3.14. Loans to credit institutions, deposits and similar financial claims and financial liabilities

Loans to credit institutions, deposits and similar financial claims and liabilities are recorded at nominal value in the balance sheet.

3.15. Participating interest

Participating interest includes long-term investments of the Bank of Latvia in equity instruments. The Bank of Latvia has no control or significant influence in any institution, therefore participating interest is not accounted for as an investment in a subsidiary or an associate. Equity instruments are reported at fair value in the balance sheet, except participating interest in the ECB, which is reported at cost in the balance sheet (see also Note 3.1).

3.16. Derivative financial instruments

The Bank of Latvia enters into commitments involving forward exchange rate contracts, currency and interest rate swap arrangements, and interest rate and currency future contracts, which are reported in off-balance sheet accounts at their contract or notional amount. Forward exchange rate contracts and currency swap arrangements are included in the net position of the respective currency on transaction day at the spot rate of the transaction and are recorded in the balance sheet in lats at the exchange rate of the respective currency set by the

Bank of Latvia at the end of the reporting period. Other derivative financial instruments are reported in the balance sheet at fair value.

Interest on derivative financial instruments, including the spot and forward interest rate spread of forward exchange rate contracts and currency swap arrangements, is recognised in the profit and loss statement as interest income or interest expense. Any gain or loss arising from a change in fair value of interest rate and currency future contracts is included in the profit and loss statement upon settlement. Any gain or loss arising from a change in fair value of other derivative financial instruments is credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles referred to in Note 3.26.

3.17. Accrued interest income and expense

Accrued interest income on securities is included in the carrying amount of the respective interest bearing securities. Accrued interest income and expense on other financial instruments are reported under relevant balance sheet captions of other assets or other liabilities.

3.18. Fixed assets

Fixed assets are tangible long-term investments with the useful life over one year. Capitalisation limit of fixed assets is 100 lats, except the costs related to real estate improvements and replacement of fixed asset parts for which the Board of the Bank of Latvia has set a higher capitalisation limit depending on their significance. These assets are used in the provision of services as well as in the maintenance of other fixed assets and to ensure the Bank of Latvia's operation.

Fixed assets are recorded at cost less accumulated depreciation and impairment, if any.

Depreciation is recognised using the straight-line method over the estimated useful life of the asset. Assets under construction or development, land and works of art are not depreciated. Buildings and structures are accounted by separate components, with individual useful life set for each such component.

In 2010 and 2011, the useful life set for fixed assets was as follows:

| | (years) |
|--|---------|
| Buildings and their components, improvement of territory | 5–100 |
| Transport vehicles | 10 |
| Office equipment and inventories | 5–25 |
| Cash processing and verifying equipment | 5–15 |
| Computer and telecommunication equipment | 2–7 |
| Other fixed assets | 5–15 |

In accordance with generally accepted principles for hedge accounting, the cost of individual fixed assets includes an effective result arising from financial instruments designated as hedges of exchange risk associated with development of the respective fixed assets.

3.19. Intangible assets

Intangible assets are long-term investments without physical substance with a useful life of over one year. Capitalisation limit of intangible assets is 100 lats. Intangible assets include software application rights and other rights.

Intangible assets are reported in the balance sheet at cost less accumulated amortisation and impairment, if any.

Acquisition costs of intangible assets are amortised over the useful life of the relevant assets using the straight-line method; however, this period may not exceed 10 years.

Costs related to software development by the Bank of Latvia are recognised in the profit and loss statement when incurred.

3.20. Impairment of assets

An asset is impaired when its carrying amount exceeds its recoverable amount. Upon detecting any indications of impairment of an asset, the recoverable amount of the respective asset is estimated. If the recoverable amount is less than the carrying amount of the respective asset, adequate allowances for the relevant asset are made. Such allowances are recognised in the profit and loss statement with a respective reduction in the asset's carrying amount.

3.21. Lats in circulation

Lats banknotes and coins in circulation issued by the Bank of Latvia, except for gold circulation coins and collector coins, are included in the balance sheet caption "Lats in circulation" at nominal value reflecting the Bank of Latvia's liabilities to holders of the respective banknotes and coins.

3.22. Gold circulation coins

Gold circulation coins (fineness .999) held in the vaults of the Bank of Latvia are included in the balance sheet caption "Other domestic assets", as their value is directly supported by their content of gold. These coins are stated in the balance sheet at the market value of their content of gold.

When gold circulation coins are issued, they are excluded from the balance sheet caption "Other domestic assets". The respective coins in circulation are not included in the balance sheet caption "Lats in circulation", as their value is directly supported by their content of gold.

3.23. Collector coins

Collector coins sold are not included in the balance sheet liabilities, as the reselling probability of those coins is low or the value of precious metals of which the coins are made exceeds repurchase value. Proceeds from sales of collector coins are recognised in the profit and loss statement when incurred.

3.24. Provisions

Provisions are recognised in the financial statements when the Bank of Latvia has incurred a present legal or constructive obligation arising from a past event or transaction and a reliable estimate can be made of the obligation and it can be expected to result in a cash outflow from the Bank of Latvia.

3.25. Cash and cash equivalents

Cash and cash equivalents stated in the cash flow statement include convertible foreign currency in cash, demand deposits and deposits with an original maturity up to 5 business days made with foreign credit institutions and other foreign financial institutions.

3.26. Recognition of gains or losses on financial instruments

Gains or losses on financial instruments are recognised in accordance with the following principles provided by the legal framework for accounting and financial reporting in the ESCB:

- (a) realised gains and losses shall be recognised in the profit and loss statement;
- (b) unrealised gains shall be recognised in the balance sheet caption "Valuation account";
- (c) unrealised losses recognised in the balance sheet caption "Valuation account" at the end of the reporting year shall be transferred to the profit and loss statement if they exceed previous revaluation gain on the respective financial instrument, foreign currency or gold holding;
- (d) unrealised losses recognised in the profit and loss statement at the end of the reporting year shall not be reversed and offset by unrealised gains of the respective financial instrument, foreign currency or gold holding in the subsequent years;
- (e) there shall be no netting of unrealised losses in a financial instrument, foreign currency or gold holding against unrealised gains in other financial instrument, foreign currency or gold holding.

The average cost method shall be used to calculate realised and unrealised gains and losses of financial instrument, foreign currency or gold holding. The average cost of financial instrument, foreign currency or gold holding shall be increased or reduced by unrealised losses that are recognised in the profit and loss statement at year-end.

3.27. Interest income and expense

Interest income and expense are recognised in the profit and loss statement on an accrual basis.

Interest income includes interest on securities, securities lending, deposits, loans granted, forward exchange rate contracts, and currency and interest rate swap arrangements. Interest on securities also includes premium and discount, which is amortised over the remaining life of the respective securities using the straight-line method.

Interest expense includes interest on deposits received from the Latvian government, domestic credit institutions and other financial market participants, as well as forward exchange rate contracts, and currency and interest rate swap arrangements.

3.28. Realised gains or losses from financial operations

Realised gains or losses from financial operations are recognised in the profit and loss statement at the time of disposal of financial instrument or at the moment of settlement.

Realised gains or losses from financial operations include realised gains or losses of derivative financial instruments, disposal of debt securities, and foreign exchange transactions.

3.29. Income from participating interest

The change in fair value of participating interest is reported in the balance sheet caption "Valuation account".

Dividends on participating interest are recognised in the profit and loss statement when the right to receive payment is established.

3.30. Banknote production and coinage costs

Banknote and coin acquisition costs, except gold circulation coin acquisition costs, are charged to the profit and loss statement at the moment of banknote and coin acquisition.

3.31. Other expense and income

Bank's other operating expense and income is recognised in the profit and loss statement on an accrual basis. The amount of accrued expense and income for the reporting period is calculated in accordance with the volume of services received or rendered in the reporting period. Lease payments are recognised in the profit and loss statement proportionally over the term of the respective agreement.

4. SUMMARY OF THE BANK OF LATVIA'S FINANCIAL POSITION AND FINANCIAL PERFORMANCE

4.1. Financial position

The Bank of Latvia's assets dropped by 568.1 million lats in 2011, primarily on account of a decrease in foreign assets.

Convertible foreign currencies posted a decrease of 597.2 million lats mainly on account of a reduction in the amount of 524.8 million lats of the Latvian government deposits with the Bank of Latvia. The Bank of Latvia foreign exchange transactions with credit institutions in the amount of 235.9 million lats¹ had a decreasing effect, while deposits in foreign currencies of credit institutions with the Bank of Latvia increased by 123.7 million lats.

Although credit institutions' deposits in lats decreased by 616.2 million lats, credit institutions had excess liquidity and by the end of 2011, the Bank of Latvia had not issued any loans to credit institutions.

With the demand for cash growing, the amount of cash in circulation grew in 2011, hence the Bank of Latvia balance sheet caption "Lats in circulation" increased by 222.3 million lats.

Capital and reserves of the Bank of Latvia grew by 30.5 million lats on account of profits earned in 2011 (32.0 million lats) and net changes in valuation of financial instruments (13.9 million lats), whereas profits remitted to the state budget revenue (15.4 million lats) had a decreasing effect.

4.2. Financial performance

In 2011, the Bank of Latvia profit amounted to 32.0 million lats (23.7 million lats in 2010).

Net interest income was by 15.0 million lats higher in 2011 than in 2010. Interest income continued to be adversely affected by low interest rates in the US and euro area. Interest income on securities grew by 6.4 million lats primarily on account of higher euro area interest rates in the first half of 2011. The spread between the euro and US dollar short-term interest rates widened in this period as well and pushed up income from financial derivatives used for hedging currency risk exposure.

Given the excess lats liquidity of credit institutions, the Bank of Latvia issued loans to credit institutions in minimum amounts in 2011, bringing the respective interest income down to 1 thousand lats.

With credit institution deposits in lats with the Bank of Latvia decreasing and duly accounting for the lower average interest rates on these deposits than in 2010, the interest expense on credit institution deposits contracted by 5.1 million lats. Higher interest rates accounted for a 3.0 million lats rise in interest paid on government deposits in foreign currencies.

Realised gains arising from financial operations decreased by 3.2 million lats, while write-downs of the negative revaluation result on financial assets and positions were by 3.6 million lats higher than in 2010. It was primarily driven by an increase in the euro area interest rates in the first half of 2011 and uneven interest rate changes in debt securities markets of the euro area countries at the end of 2011, which had a negative effect on market value of these securities. Realised gains arising from financial operations were impacted also by the result of currency future contracts concluded for the purpose of hedging the currency risk and realised gains on foreign exchange transactions. The positive revaluation result of the hedged balance sheet items is reported in the balance sheet caption "Valuation account".

With the Bank of Latvia cutting its administrative expense, including remuneration of employees, the Bank of Latvia's other operating expense decreased year-on-year by 0.5 million lats in 2011.

The uncertainty of the Bank of Latvia's further financial performance is mostly related to interest rate developments in the euro area and US financial markets since the Bank of Latvia is exposed to the interest rate risk. In view of the very low levels of interest rates, a further interest rate fall is potentially negligible in

¹ On a settlement date basis.

comparison with a potential rise; thus, the expected pickup in interest rates in foreign financial markets may negatively affect the income on foreign fixed income securities.

5. INVESTMENT POLICY

Managing of foreign reserves is conducted in compliance with the basic principles set out in the Guidelines, including preserving the value of foreign reserves, ensuring their liquidity and earning income within the framework of acceptable risk without contradicting to the Bank of Latvia's monetary policy.

Foreign reserves include the assets reported under "Gold", "Special Drawing Rights" and "Convertible foreign currencies" as well as derivative financial instruments and spot exchange rate contracts whose book value is reported under relevant balance sheet captions of other assets or other liabilities.

Foreign reserves are managed by classifying them into different investment portfolios by investment strategy and source of funding. Portfolios of borrowed funds include foreign reserves which correspond to the Bank of Latvia's liabilities in foreign currencies to other institutions, mainly foreign reserves arising from the Treasury deposits and foreign exchange swaps conducted in pursuit of monetary policy. Foreign reserves that are not included in the portfolios of borrowed funds (net reserves) are included in the portfolios of gold reserves, portfolios managed against multi-currency fixed income securities benchmark and asset-backed securities benchmark. A part of foreign currency reserves included in the portfolios managed against multi-currency fixed income securities benchmark and asset-backed securities benchmark are managed by external foreign reserves managers.

The parameters for a benchmark reflecting the acceptable level of financial risks and return target are set out for each portfolio type in the Guidelines.

The breakdown of foreign reserves by type of investment portfolio at the end of 2011 and 2010 was as follows:

| | Amount (in thousands of lats) | | Percentage (%) | |
|---|-------------------------------|-----------|----------------|-------|
| | 2011 | 2010 | 2011 | 2010 |
| Portfolios managed against multi-currency fixed income securities benchmark | 2 388 804 | 2 602 693 | 72.7 | 64.9 |
| Portfolios of borrowed funds | 507 330 | 1 061 213 | 15.4 | 26.4 |
| Gold reserves portfolio | 215 374 | 184 090 | 6.5 | 4.6 |
| Portfolios managed against asset-backed securities benchmark | 175 883 | 165 090 | 5.4 | 4.1 |
| Total | 3 287 391 | 4 013 086 | 100.0 | 100.0 |

The benchmark of portfolios managed against multi-currency fixed income securities benchmark is pledged to the weighted 1–3 year government securities index of the euro area countries, US and Japan and denominated in euro, eliminating the currency risk.

The benchmark for borrowed funds portfolios is formed in compliance with the parameters of respective liabilities.

The benchmark of gold reserves portfolio is pledged to the euro money market short-term index.

The benchmark of portfolios managed against asset-backed securities benchmark is pledged to the US mortgage-backed securities index and denominated in euro, eliminating the currency risk.

According to the exchange rate policy of the Bank of Latvia, the Guidelines provide that, except for portfolios of borrowed funds, the currency of the foreign reserves benchmark is the euro. For portfolios of borrowed funds, the benchmark currency structure is formed in compliance with the parameters of respective liabilities.

The description of the main methods used in financial risk management is provided in Note 2.1.

6. ASSETS AND LIABILITIES AT FAIR VALUE

Fair value of Bank of Latvia's assets and liabilities is determined using the following hierarchy:

- quoted price. Fair value is determined using quoted prices for identical financial instruments in active markets;

- observable data. Fair value is determined using quoted prices for similar financial instruments in active markets, quoted prices for similar or identical financial instruments in inactive markets or using models where all significant inputs are observable;

- non-observable data. Fair value is determined using models where significant inputs are not observable.

At the end of 2011 and 2010, Bank of Latvia's investments in debt securities were generally valued on the basis of quoted price.

At the end of 2011, participating interest in the BIS was assessed using non-observable data. The assessment was conducted using the 70% net asset value model (see also Note 11).

At the end of 2011 and 2010, the breakdown of assets and liabilities carried at fair value according to the fair value hierarchy was as follows:

| | (in thousands of lats) | | | |
|--|------------------------|--------------------|----------------------------|------------------|
| | Quoted price | Observable data | Non- observable data | Total |
| As at 31 December 2011 | | | | |
| FOREIGN ASSETS | | | | |
| Gold | 210 066 | – | – | 210 066 |
| Convertible foreign currencies | | | | |
| Debt securities | 2 404 354 | 38 355 | – | 2 442 709 |
| Participating interest in the Bank for International Settlements | – | – | 18 997 | 18 997 |
| Other foreign assets | | | | |
| Forward transactions in securities | 560 | – | – | 560 |
| Non-traded interest rate swap arrangements | – | 25 | – | 25 |
| Total foreign assets at fair value | 2 614 980 | 38 380 | 18 997 | 2 672 357 |
| FOREIGN LIABILITIES | | | | |
| Other foreign liabilities | | | | |
| Forward transactions in securities | 147 | – | – | 147 |
| Total foreign liabilities at fair value | 147 | – | – | 147 |
| As at 31 December 2010 | | | | |
| FOREIGN ASSETS | | | | |
| Gold | 187 179 | – | – | 187 179 |
| Convertible foreign currencies | | | | |
| Debt securities | 2 637 581 | 51 831 | – | 2 689 412 |
| Other foreign assets | | | | |
| Forward transactions in securities | 63 | – | – | 63 |
| Total foreign assets at fair value | 2 824 823 | 51 831 | – | 2 876 654 |
| FOREIGN LIABILITIES | | | | |
| Other foreign liabilities | | | | |
| Forward transactions in securities | 319 | 1 | – | 320 |
| Total foreign liabilities at fair value | 319 | 1 | – | 320 |

The average market prices on the last trading day of the reporting year are obtained from the electronic information systems *Bloomberg* and *Interactive Data*. Where the above price for a financial instrument is inaccessible in the electronic information systems, the latest available market price or the price determined by applying the discounted cash flow approach is used for evaluating the financial instrument. The method for assessing fair value of assets falling into the group of non-observable data is described in Note 11.

7. GOLD

Movements in gold reserves in 2011 and 2010 were as follows:

| | Troy ounces | In thousands of lats |
|--|----------------|-------------------------|
| As at 31 December 2009 | 248 707 | 134 365 |
| During 2010 | | |
| Increase in gold market value | x | 52 815 |
| Net change resulting from gold depositing and deposit withdrawal | -1 | -1 |
| As at 31 December 2010 | 248 706 | 187 179 |
| During 2011 | | |
| Increase in gold market value | x | 22 887 |
| As at 31 December 2011 | 248 706 | 210 066 |

The Bank of Latvia hedges the risk related to fluctuations in gold reserves market value by entering into forward exchange rate and currency future contracts (see also Note 40). Revaluation of gold reserves and forward exchange rate contracts is recognised in the balance sheet caption "Valuation account", whereas revaluation of currency future contracts is recognised in the profit and loss statement caption "Realised gains/losses from financial operations".

8. SPECIAL DRAWING RIGHTS, INTERNATIONAL MONETARY FUND

Pursuant to the Law "On the Republic of Latvia Joining the International Monetary Fund" the Bank of Latvia serves as a depository for the IMF and services the IMF accounts in the member state currency without compensation. The IMF holdings in lats comprise promissory notes issued by the Latvian government, Account No. 1 used for financial transactions with the IMF, and Account No. 2 used for the IMF administrative expenditure and receipts.

Latvia's claims on the IMF include SDR and Latvia's quota in the IMF. SDR is an international reserve asset created by the IMF and used in transactions between the IMF and its members. The quota in the IMF reflects the subscription in the IMF of respective members. Latvia's quota in the IMF is secured by the Latvian government promissory note issued to the IMF and is recorded as an asset denominated in SDR. In March 2011, Latvia's quota in the IMF was increased to 142 100 thousand SDR.

Latvia's liabilities to the IMF are made up of the IMF holdings in lats and IMF allocations. In 2011, liabilities to the IMF increased by 15 300 thousand SDR as a result of the increased quota.

At the end of 2011, the claims on the IMF in SDR as recorded on the Bank of Latvia's balance sheet were equivalent to 79 069 thousand lats (at the end of 2010 – 99 356 thousand lats), whereas the liabilities to the IMF are made up of funds at the disposal of the IMF in the amount of 313 thousand lats (at the end of 2010 – 274 thousand lats) held on its Accounts No. 1 and No. 2.

At the end of 2011 and 2010, Latvia's net claims and liabilities to the IMF were as follows:

| | (in thousands of lats) | | (in thousands of SDR) | |
|--|------------------------|----------|-----------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| Latvia's quota in the IMF | 119 222 | 103 976 | 142 100 | 126 800 |
| IMF holdings in lats | -943 290 | -909 382 | -1 124 302 | -1 109 002 |
| Promissory notes of the Latvian government | -942 977 | -909 108 | -1 123 930 | -1 108 668 |
| Account No. 1 | -298 | -260 | -355 | -317 |
| Account No. 2 | -15 | -14 | -17 | -17 |
| Stand-by Arrangement for Latvia | 824 099 | 805 437 | 982 240 | 982 240 |
| Reserve position in IMF | 46 | 45 | 55 | 55 |
| SDR | 79 069 | 99 356 | 94 242 | 121 166 |
| General allocation | -78 864 | -77 077 | -93 998 | -93 998 |
| Special allocation | -22 505 | -21 996 | -26 824 | -26 824 |
| Latvia's net claims/liabilities (-) to the IMF | -22 254 | 328 | -26 525 | 399 |

The reserve position in the IMF is the difference between the total Latvian quota in the IMF and the IMF holdings in lats, excluding the balance on Account No. 2 and adding the amount of the IMF loan.

Claims on and liabilities to the IMF are translated into lats at the SDR exchange rate set by the Bank of Latvia at the end of the year.

9. CONVERTIBLE FOREIGN CURRENCIES

Bank of Latvia's foreign assets in convertible foreign currencies are invested primarily in debt securities of high liquidity and short-term deposits.

The carrying amount of interest bearing debt securities includes accrued interest income (19 604 thousand lats at the end of 2011 and 24 234 thousand lats at the end of 2010).

At the end of 2011 and 2010, the balance sheet asset caption "Convertible foreign currencies" was comprised of the following assets:

| | (in thousands of lats) | |
|--|------------------------|-----------|
| | 2011 | 2010 |
| Debt securities of foreign governments, financial institutions and non-financial corporations | 2 442 709 | 2 689 412 |
| Demand deposits with foreign central banks, credit institutions and international institutions | 519 867 | 531 735 |
| Time deposits with foreign credit institutions and other foreign financial institutions | 208 733 | 545 307 |
| Foreign currency in cash | 13 611 | 15 713 |
| Total | 3 184 920 | 3 782 167 |

10. PARTICIPATING INTEREST IN THE EUROPEAN CENTRAL BANK

With Latvia's accession to the EU, the Bank of Latvia became a subscriber of the capital of the ECB. In accordance with the Statute of the ESCB and of the ECB, the share of the Bank of Latvia in the ECB's capital was calculated on the basis of the EU states' population and gross domestic product data and is adjusted every five years or at shorter intervals depending on changes in the number of the EU Member States.

At the end of 2011 and 2010, the Bank of Latvia's percentage share in the ECB's capital was 0.2837% equivalent to 30 528 thousand euro (21 455 thousand lats). As Latvia does not participate in the euro area, pursuant to the transitional provisions of the Statute of the ESCB and of the ECB and Decision of the ECB's General Council, the Bank of Latvia has paid up a 3.75% minimum contribution of its total subscribed capital in the ECB amounting to 1 145 thousand euro or 750 thousand lats (1 145 thousand euro or 750 thousand lats at the end of 2010; see also Note 39).

In accordance with the legal framework for accounting and financial reporting in the ESCB participating interest in the ECB's capital has been reported at cost in the balance sheet of the Bank of Latvia. ECB's capital shares are not traded in the public securities market, and the share of the Bank of Latvia in the ECB's capital can be increased or decreased only in the cases referred to in this Note.

11. PARTICIPATING INTEREST IN THE BANK FOR INTERNATIONAL SETTLEMENTS

At the end of 2011 and 2010, the Bank of Latvia owned 1 070 shares in the BIS, which correspond to 0.20% of the total subscribed and paid-up BIS capital.

The nominal value of the Bank of Latvia's shareholding in the BIS is 5 350 thousand SDR (the nominal value per share is 5 thousand SDR), paid up in the amount of 1 338 thousand SDR or 25%. In 2011, the Bank of Latvia changed its valuation policy of the BIS shares; at the end of 2011, the BIS shareholding is reported in the Bank of Latvia balance sheet at fair value (see also Notes 3.1 and 39). In the opinion of the Bank of Latvia's management, the most appropriate method for establishing the fair value of the BIS shares is 70% of the BIS net assets based on the latest audited financial statements of the BIS. The BIS applied this valuation method for calculating the price of its shares; the International Court at the Hague has also recognised it as appropriate for the valuation of shares when repurchasing them from former private shareholders of the BIS. BIS shares are not traded in the public securities market. Pursuant to the Statutes of the BIS, only central banks can be shareholders in the BIS. At the end of 2011, the fair value of BIS shares was 18 997 thousand lats (17 320 thousand lats at the end of 2010). In the Bank of Latvia financial statements for 2010, the BIS shareholding was reported at cost (1 763 thousand lats).

The Bank of Latvia balance sheet items restated to show the figures in the case the accounting policy referred to in Note 3.1 had been applied retrospectively:

| | 2011 | (in thousands of lats) | | |
|---|------------------|------------------------|-----------|------------|
| | | Published | Restated | Difference |
| Foreign assets | 3 507 542 | 4 074 611 | 4 090 168 | 15 557 |
| Participating interest in the Bank for International Settlements | 18 997 | 1 763 | 17 320 | 15 557 |
| Domestic assets | 31 683 | 32 722 | 32 722 | – |
| Total assets | 3 539 225 | 4 107 333 | 4 122 890 | 15 557 |
| Foreign liabilities | 72 372 | 42 556 | 42 556 | – |
| Lats in circulation | 1 160 183 | 937 904 | 937 904 | – |
| Domestic liabilities | 1 979 508 | 2 830 233 | 2 830 233 | – |
| Capital and reserves | 327 162 | 296 640 | 312 197 | 15 557 |
| Valuation account | 121 547 | 107 613 | 123 170 | 15 557 |
| Total liabilities | 3 539 225 | 4 107 333 | 4 122 890 | 15 557 |

Items of the Bank of Latvia statement of total recognised gains and losses restated to show the figures in the case the accounting policy referred to in Note 3.1 had been applied retrospectively:

| | (in thousands of lats) | | | | | |
|---|------------------------|---------|----------------|----------|----------------|-------|
| | Published | | Restated | | Difference | |
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| Revaluation | 27 871 | 35 482 | 12 314 | 38 545 | -15 557 | 3 063 |
| Equity instruments | 17 233 | – | 1 676 | 3 063 | -15 557 | 3 063 |
| Realisation of accumulated revaluation result | -30 493 | -14 993 | -30 493 | - 14 993 | – | – |
| Write-downs of revaluation result on financial assets and positions | 16 556 | 12 995 | 16 556 | 12 995 | – | – |
| Profit of the reporting year | 32 028 | 23 754 | 32 028 | 23 754 | – | – |
| Total recognised gains and losses | 45 962 | 57 238 | 30 405 | 60 301 | -15 557 | 3 063 |

12. OTHER FOREIGN ASSETS

At the end of 2011 and 2010, other foreign assets consisted of the following items:

| | (in thousands of lats) | |
|--|------------------------|-------|
| | 2011 | 2010 |
| Non-traded financial derivative and spot exchange rate contracts with foreign financial institutions | 13 143 | 2 825 |
| Prepaid expense | 461 | 459 |
| Interest accrued on deposits | 59 | 79 |
| Other | 77 | 33 |
| Total | 13 740 | 3 396 |

13. FIXED ASSETS

The following changes in fixed assets took place in 2011 and 2010:

| | (in thousands of lats) | | | | | |
|--|--|--------------------------------------|---------------------------------|-----------------------|--------------------------|---------------|
| | Buildings, improvement of territory, and land | Furniture and office equipment | Cash processing equipment | Transport vehicles | Other fixed assets | Total |
| As at 31 December 2009 | | | | | | |
| Cost | 37 157 | 6 345 | 4 629 | 1 285 | 5 183 | 54 599 |
| Accumulated depreciation | -9 319 | -4 900 | -2 294 | -688 | -4 166 | -21 367 |
| Net book value | 27 838 | 1 445 | 2 335 | 597 | 1 017 | 33 232 |
| During 2010 | | | | | | |
| Additions | 206 | 430 | - | - | 152 | 788 |
| Change in classification | -66 | -29 | - | - | 95 | - |
| Disposals and write-offs | -297 | -378 | -49 | -50 | -297 | -1 071 |
| Net change in cost | -157 | 23 | -49 | -50 | -50 | -283 |
| Depreciation charge | -1 800 | -365 | -243 | -104 | -250 | -2 762 |
| Change in classification | 23 | 12 | - | - | -35 | - |
| Accumulated depreciation on disposals and write-offs | 55 | 375 | 49 | 49 | 288 | 816 |
| Net change in accumulated depreciation | -1 722 | 22 | -194 | -55 | 3 | -1 946 |
| As at 31 December 2010 | | | | | | |
| Cost | 37 000 | 6 368 | 4 580 | 1 235 | 5 133 | 54 316 |
| Accumulated depreciation | -11 041 | -4 878 | -2 488 | -743 | -4 163 | -23 313 |
| Net book value | 25 959 | 1 490 | 2 092 | 492 | 970 | 31 003 |
| During 2011 | | | | | | |
| Additions | 1 566 | 306 | 30 | - | 443 | 2 345 |
| Change in classification | - | 88 | -37 | - | -51 | - |
| Disposals and write-offs | - | -64 | -3 | -24 | -169 | -260 |
| Net change in cost | 1 566 | 330 | -10 | -24 | 223 | 2 085 |
| Depreciation charge | -1 694 | -372 | -238 | -102 | -265 | -2 671 |
| Change in classification | - | -39 | 36 | - | 3 | - |
| Accumulated depreciation on disposals and write-offs | - | 63 | 3 | 24 | 168 | 258 |
| Net change in accumulated depreciation | -1 694 | -348 | -199 | -78 | -94 | -2 413 |
| As at 31 December 2011 | | | | | | |
| Cost | 38 566 | 6 698 | 4 570 | 1 211 | 5 356 | 56 401 |
| Accumulated depreciation | -12 735 | -5 226 | -2 687 | -821 | -4 257 | -25 726 |
| Net book value | 25 831 | 1 472 | 1 883 | 390 | 1 099 | 30 675 |

At the end of 2011, the total cadastral value of land under the ownership and possession of the Bank of Latvia was 1 811 thousand lats (1 999 thousand lats at the end of 2010; the change is related to a change in the cadastral value of land). Land is reported in the balance sheet of the Bank of Latvia at cost (1 669 thousand lats at the end of 2011 and 2010).

At the end of 2011, the Bank of Latvia's contractual commitments related to acquisition of fixed assets were 3 338 thousand lats (4 456 thousand lats at the end of 2010), mostly related to the reconstruction of the building at K. Valdemāra iela 1B, Riga.

14. LEASING

The Bank of Latvia's assets subject to leases are premises, land, and equipment. In the balance sheet they are reported as fixed assets. Asset lease agreements where the Bank of Latvia acts as a lessor are operating leases. Lease payments, except those that are directly transferred to the state budget, are recognised in the profit and loss statement proportionally over the term of the respective agreement. The depreciation of the leased assets is calculated on the basis of the depreciation policy described in Note 3.18 and reported in the profit and loss statement as depreciation charges.

Carrying amount of leased assets at the end of 2011 and 2010 was as follows:

| | (in thousands of lats) |
|-------------------------------|------------------------|
| <hr/> | |
| As at 31 December 2010 | |
| Cost | 1 059 |
| Accumulated depreciation | -422 |
| <hr/> | |
| Net book value | 637 |
| <hr/> | |
| As at 31 December 2011 | |
| Cost | 1 146 |
| Accumulated depreciation | -538 |
| <hr/> | |
| Net book value | 608 |
| <hr/> | |

15. OTHER DOMESTIC ASSETS

At the end of 2011 and 2010, other domestic assets consisted of the following items:

| | (in thousands of lats) | |
|---|------------------------|-------|
| | 2011 | 2010 |
| <hr/> | | |
| Intangible assets | 440 | 625 |
| Spot exchange rate contracts with domestic institutions | - | 532 |
| Prepaid expense | 108 | 124 |
| Other | 460 | 438 |
| <hr/> | | |
| Total | 1 008 | 1 719 |
| <hr/> | | |

16. INTANGIBLE ASSETS

The following changes in intangible assets took place in 2011 and 2010:

| | (in thousands of lats) | |
|--|------------------------|------------|
| As at 31 December 2009 | | |
| Cost | | 3 769 |
| Accumulated amortisation | | -3 008 |
| Net book value | | 761 |
| During 2010 | | |
| Additions | | 146 |
| Derecognised assets | | -37 |
| Net change in cost | | 109 |
| Amortisation charge | | -282 |
| Accumulated amortisation on disposals | | 37 |
| Net change in accumulated amortisation | | -245 |
| As at 31 December 2010 | | |
| Cost | | 3 878 |
| Accumulated amortisation | | -3 253 |
| Net book value | | 625 |
| During 2011 | | |
| Additions | | 92 |
| Net change in cost | | 92 |
| Amortisation charge | | -277 |
| Net change in accumulated amortisation | | -277 |
| As at 31 December 2011 | | |
| Cost | | 3 970 |
| Accumulated amortisation | | -3 530 |
| Net book value | | 440 |

17. CONVERTIBLE FOREIGN CURRENCIES

At the end of 2011 convertible foreign currency liabilities mostly consisted of funds on the EC account for settlements in euro, as well as the cash collateral received by the Bank of Latvia for securing transactions in derivative financial instruments. The EC account is used by the EC for the distribution of EU budgetary funds (see also Note 18).

At the end of 2011 and 2010, convertible foreign currency liabilities consisted of the following items:

| | (in thousands of lats) | |
|--------------------|------------------------|--------|
| | 2011 | 2010 |
| EC demand deposits | 5 681 | 13 121 |
| Cash collateral | 3 580 | 503 |
| Other liabilities | 299 | 58 |
| Total | 9 560 | 13 682 |

18. OTHER INTERNATIONAL INSTITUTION DEPOSITS IN LATS

Other international institution deposits in lats mostly consist of funds on the EC account for settlements in lats, which is used for effecting Latvian government payments to the EU budget (see also Note 17).

At the end of 2011 and 2010, the breakdown of deposits of other international institutions in lats was as follows:

| | (in thousands of lats) | |
|--------------------|------------------------|-------|
| | 2011 | 2010 |
| EC demand deposits | 18 024 | 8 258 |
| Other deposits | 247 | 247 |
| Total | 18 271 | 8 505 |

19. OTHER FOREIGN LIABILITIES

At the end of 2011 and 2010, other foreign liabilities consisted of the following items:

| | (in thousands of lats) | |
|--|------------------------|--------|
| | 2011 | 2010 |
| Non-traded financial derivative contracts and spot exchange rate contracts with foreign financial institutions | 43 210 | 19 074 |
| Accrued expense | 272 | 245 |
| Other | 34 | 50 |
| Total | 43 516 | 19 369 |

20. LATS IN CIRCULATION

At the end of 2011 and 2010, the following units of lats (LVL) and santims (s) were in circulation:

| Nominal | Amount | | Number | | Percentage | |
|---------------------------|------------------------|-------------------------|-------------------------|-------------------------|--------------|-------|
| | (in thousands of lats) | (in thousands of units) | (in thousands of units) | (in thousands of units) | (%) | (%) |
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| Banknotes | | | | | | |
| LVL 500 | 94 815 | 72 549 | 190 | 145 | 8.1 | 7.8 |
| LVL 100 | 171 438 | 118 390 | 1 714 | 1 184 | 14.8 | 12.6 |
| LVL 50 | 94 227 | 79 637 | 1 885 | 1 593 | 8.1 | 8.5 |
| LVL 20 | 584 562 | 471 147 | 29 228 | 23 557 | 50.4 | 50.2 |
| LVL 10 | 76 695 | 68 574 | 7 669 | 6 857 | 6.6 | 7.3 |
| LVL 5 | 71 576 | 66 273 | 14 315 | 13 255 | 6.2 | 7.1 |
| Total banknotes | 1 093 313 | 876 570 | x | x | 94.2 | 93.5 |
| Coins | | | | | | |
| LVL 100 | 405 | 405 | 4 | 4 | 0 | 0 |
| LVL 10 | 145 | 145 | 15 | 15 | 0 | 0 |
| LVL 2 | 8 636 | 8 317 | 4 318 | 4 159 | 0.7 | 0.9 |
| LVL 1 | 35 316 | 31 358 | 35 316 | 31 359 | 3.0 | 3.4 |
| 50 s | 8 299 | 7 820 | 16 599 | 15 639 | 0.7 | 0.8 |
| 20 s | 4 757 | 4 481 | 23 785 | 22 405 | 0.5 | 0.5 |
| 10 s | 2 901 | 2 736 | 29 011 | 27 362 | 0.3 | 0.3 |
| 5 s | 2 190 | 2 093 | 43 795 | 41 852 | 0.2 | 0.2 |
| 2 s | 2 417 | 2 268 | 120 828 | 113 417 | 0.2 | 0.2 |
| 1 s | 1 804 | 1 711 | 180 446 | 171 138 | 0.2 | 0.2 |
| Total coins | 66 870 | 61 334 | x | x | 5.8 | 6.5 |
| Total lats in circulation | 1 160 183 | 937 904 | x | x | 100.0 | 100.0 |

At the end of 2011, the total nominal value of gold circulation coins (fineness .999) issued, with the denomination of 100 lats, was 1 989 thousand lats (1 988 thousand lats at the end of 2010). The respective coins in circulation are not included in the balance sheet caption "Lats in circulation", since their nominal value is directly supported by their content of gold (see also principles described in Note 3.22).

As at the end of 2011, collector coins with the total nominal value of 1 556 thousand lats had been issued (1 528 thousand lats at the end of 2010). These coins are not included in the balance sheet caption "Lats in circulation" (see also Note 3.23).

21. BALANCES DUE TO CREDIT INSTITUTIONS

Balances due to credit institutions include balances on the settlement accounts of domestic credit institutions opened with the Bank of Latvia, as well as overnight and 7-day deposits (deposit facility) received from them. The respective credit institutions place their funds with the Bank of Latvia in order to comply with its minimum reserve requirement, as well as to effect interbank and customer payments, and settlements related to the Bank of Latvia's monetary policy operations. At the end of 2011, the overnight deposit facility rate and 7-day deposit facility rate as set by the Bank of Latvia were 0.25% and 0.375% respectively (at the end of 2010, the overnight deposit facility rate and 7-day deposit facility rate were 0.25% and 0.375% respectively).

At the end of 2011 and 2010, balances due to domestic credit institutions consisted of the following items:

| | (in thousands of lats) | |
|----------------------------------|------------------------|------------------|
| | 2011 | 2010 |
| Overnight deposit facility | 2 220 | 800 |
| 7-day deposit facility | 227 000 | 873 000 |
| Current account balances in lats | 824 840 | 796 405 |
| Current account balances in euro | 143 680 | 20 025 |
| Total | 1 197 740 | 1 690 230 |

22. BALANCES DUE TO THE GOVERNMENT

Latvian government deposits consist of the Treasury demand deposits and time deposits in lats and foreign currencies received by the Bank of Latvia acting as the financial agent of the Latvian government.

At the end of 2011 and 2010, the breakdown of Latvian government deposits was as follows:

| | (in thousands of lats) | |
|---------------------------------------|------------------------|------------------|
| | 2011 | 2010 |
| Time deposits in foreign currencies | 259 124 | 789 809 |
| Demand deposits in foreign currencies | 242 523 | 236 674 |
| Demand deposits in lats | 235 441 | 54 527 |
| Total | 737 088 | 1 081 010 |

23. OTHER DOMESTIC LIABILITIES

At the end of 2011 and 2010, other domestic liabilities consisted of the following items:

| | (in thousands of lats) | |
|---|------------------------|--------------|
| | 2011 | 2010 |
| Accrued expense and similar liabilities | 1 571 | 1 598 |
| Tax liabilities | 69 | 80 |
| Accrued interest expense | 63 | 169 |
| Other | 262 | 408 |
| Total | 1 965 | 2 255 |

24. TAX

In 2011 and 2010, the Bank of Latvia calculated and paid the following taxes:

(in thousands of lats)

| | Personal income tax | Compul- sory social security contribu- tions (by employer) | Compul- sory social security contribu- tions (by employee) | Tax on real estate | Value added tax | Other taxes and duties | Total |
|---|---------------------------|---|---|--------------------------|-----------------------|---------------------------------|-----------|
| Claims as at 31 December 2009 | 0 | 0 | 0 | 0 | 18 | 0 | 18 |
| During 2010 | | | | | | | |
| Calculated | 2 294 | 2 449 | 924 | 91 | 359 | 1 | 6 118 |
| Increase in deferred liabilities | 0 | 24 | 0 | 0 | 0 | 0 | 24 |
| Paid | -2 294 | -2 473 | -924 | -91 | -297 | -1 | -6 080 |
| Liabilities as at 31 December 2010 | 0 | 0 | 0 | 0 | 80 | 0 | 80 |
| During 2011 | | | | | | | |
| Calculated | 2 044 | 2 373 | 1 086 | 92 | 427 | 1 | 6 023 |
| Increase in deferred liabilities | 0 | 5 | 0 | 0 | 0 | 0 | 5 |
| Paid | -2 044 | -2 378 | -1 086 | -92 | -438 | -1 | -6 039 |
| Liabilities as at 31 December 2011 | 0 | 0 | 0 | 0 | 69 | 0 | 69 |

In addition to the tax payments indicated herein, the Bank of Latvia transfers 65% of the profit for the reporting year, including the payment for the usage of state capital (15 440 thousand lats in 2011; 48 355 thousand lats in 2010; see also Notes 25 and 35) to the state budget. The Bank of Latvia is not subject to corporate income tax.

25. CAPITAL AND RESERVES

In 2011 and 2010, changes in the Bank of Latvia's capital and reserves were as follows:

| | (in thousands of lats) | | | | |
|---|------------------------|-----------------|-------------------|------------------------------|----------------------|
| | Nominal capital | Reserve capital | Valuation account | Profit of the reporting year | Capital and reserves |
| As at 31 December 2009 | 25 000 | 114 236 | 74 129 | 74 393 | 287 758 |
| During 2010 | | | | | |
| Revaluation, realisation, and write-downs | x | x | 33 484 | x | 33 484 |
| Profit appropriated to the state budget | x | x | x | -48 355 | -48 355 |
| Profit transferred to the reserve capital | x | 26 037 | x | -26 037 | 0 |
| Profit of the reporting year | x | x | x | 23 754 | 23 754 |
| As at 31 December 2010 | 25 000 | 140 273 | 107 613 | 23 754 | 296 640 |
| During 2011 | | | | | |
| Revaluation, realisation, and write-downs | x | x | 13 934 | x | 13 934 |
| Profit appropriated to the state budget | x | x | x | -15 440 | -15 440 |
| Profit transferred to the reserve capital | x | 8 314 | x | -8 314 | 0 |
| Profit of the reporting year | x | x | x | 32 028 | 32 028 |
| As at 31 December 2011 | 25 000 | 148 587 | 121 547 | 32 028 | 327 162 |

The capital of the Bank of Latvia is comprised of the nominal capital, reserve capital and the balance sheet item "Valuation account", as well as the undistributed profit. The Bank of Latvia does not take decisions affecting the formation of the nominal capital, reserve capital, and the profit distribution as they are provided for by the Law "On the Bank of Latvia". The balance sheet item "Valuation account" comprises the positive result on revaluation of the financial instruments and gold. The accounting policy, harmonised with the principal accounting policies established by the legal framework for accounting and financial reporting in the ESCB and described in Note 3, stipulates that the realised gains are recognised in the profit and loss statement only after the disposal of a financial instrument or settlement while unrealised gains are recorded under the balance sheet item "Valuation account", thus facilitating the preservation of the capital under the impact of financial instrument price, interest rate and exchange rate fluctuations.

No external capital adequacy requirements have been stipulated for the Bank of Latvia capital; nevertheless, it should be adequate to promote credibility of the monetary policy implemented by the Bank of Latvia, and to ensure implementation of its operations and financial independence when performing the tasks set forth by the Law "On the Bank of Latvia". The Bank of Latvia does not hedge interest rate risk related to domestic financial assets where a conflict with the monetary policy pursued by it could arise. The implementation of the monetary policy as well as exposure to other financial and operational risks may adversely affect the Bank of Latvia income or cause losses to be covered from the capital of the Bank of Latvia.

The nominal capital of the Bank of Latvia is comprised of the state-allotted resources and the Bank of Latvia's profit allocations. The authorised and paid-up nominal capital of the Bank of Latvia amounts to 25 million lats as prescribed by the Law "On the Bank of Latvia".

The Law "On the Bank of Latvia" establishes that a part of the Bank of Latvia's profit of the reporting year, calculated by applying the same percentage as the tax rate set for resident corporate entities of Latvia by the Law "On Corporate Income Tax", together with a payment in the amount of 50% of the profit of the reporting year for the usage of state capital shall be transferred to the state budget. At the end of 2011 and 2010, the corporate income tax rate applicable to residents of Latvia was 15%. Therefore, 65% of the Bank of Latvia's profit of the reporting year shall be transferred to the state budget within 15 days following the approval of the Annual Report of 2011 by the Council of the Bank of Latvia. In 2012, the Bank of Latvia will transfer 20 818 thousand lats from its profit earned in 2011 to the state budget.

The Bank of Latvia's profit remaining after making the above deductions shall be transferred to the reserve capital as prescribed by the Law "On the Bank of Latvia". The reserve capital shall be formed to cover potential losses.

In 2011 and 2010, changes in the balance sheet caption "Valuation account" were as follows:

| | (in thousands of lats) | | | | | | | | |
|---|------------------------|-------------|-------------|-------------|---------|-------------|-------------|-------------|--------|
| | 2011 | Write-downs | Revaluation | Realisation | 2010 | Write-downs | Revaluation | Realisation | 2009 |
| Initial valuation account | 24 018 | x | x | -75 | 24 093 | x | x | -190 | 24 283 |
| Deferred result on revaluation of foreign currencies and gold | 24 018 | x | x | - | 24 018 | x | x | - | 24 018 |
| Deferred result on revaluation of debt securities | - | x | x | -75 | 75 | x | x | -190 | 265 |
| Revaluation reserve for equity instruments | 17 233 | - | 17 233 | - | - | - | - | - | - |
| Result on revaluation of foreign currencies and gold | 49 582 | 1 651 | 6 068 | -13 761 | 55 624 | 1 356 | 36 680 | -3 889 | 21 477 |
| Result on revaluation of non-traded interest rate swap arrangements | 25 | - | 25 | - | - | - | - | - | - |
| Result on revaluation of debt securities | 30 689 | 14 905 | 4 545 | -16 657 | 27 896 | 11 639 | -1 198 | -10 914 | 28 369 |
| Total | 121 547 | 16 556 | 27 871 | -30 493 | 107 613 | 12 995 | 35 482 | -14 993 | 74 129 |

The initial valuation account was established by transferring thereto the result on revaluation prior to the change in the accounting policy on 1 January 2007. The change in the balance of the initial valuation account in 2011 is related to the recognition of the net profit from the debt securities held by the Bank of Latvia at the end of 2006 and disposed of in the reporting year in the amount of 75 thousand lats (net profit in the amount of 190 thousand lats in 2010).

Revaluation reserve for equity instruments has been established to account for the result on revaluation of the BIS shares.

26. NET INTEREST INCOME

In 2011, the Bank of Latvia's net interest income amounted to 61 309 thousand lats (46 344 thousand lats in 2010). The income was mainly derived from investing foreign currency reserves.

Interest income from foreign operations increased by 16 210 thousand lats in comparison with 2010 while interest expense decreased by 473 thousand lats year-on-year. The interest income grew mostly on account of higher interest rate levels in the euro area in the first half of 2011 as well as the amortisation of the negative revaluation result of debt securities recognised in the profit and loss statement at the end of 2010. Net interest income from financial derivatives used by the Bank of Latvia for hedging currency risk exposure grew by 7.3 million lats as a result of the widening spread between the euro and US dollar short-term interest rates in the first half of 2011.

Interest income from domestic operations fell to 1 thousand lats (a 3 617 thousand lats decline in comparison with 2010) as lending to domestic credit institutions contracted due to the excess lats liquidity in credit institutions.

Interest expense on domestic operations (11 475 thousand lats; 13 362 thousand lats in 2010) was largely comprised of interest on deposits of domestic credit institutions and the Latvian government. Interest expense on credit institution deposits decreased by 5 083 thousand lats. With the credit institution deposits in lats with the Bank of Latvia decreasing and in view the fall in interest rates paid on these deposits at the end of 2010 and lower interest rate levels throughout 2011, interest expense on the credit institution deposits, including remuneration for holding the minimum reserves, decreased accordingly. In 2011, the Bank of Latvia received a lower average amount of Latvian government funds as deposits than in 2010; however, interest rates on deposits in foreign currencies increased, therefore interest expense on government deposits grew by 2 998 thousand lats.

27. REALISED GAINS/LOSSES FROM FINANCIAL OPERATIONS

Realised gains or losses from financial operations comprise the gains and losses from the disposal of debt securities, as well as realised gains and losses on derivative financial instruments and foreign exchange transactions.

Gains from the disposal of debt securities amounted to 11 836 thousand lats, 5 763 thousand lats less than in 2010. Although a larger amount of the positive debt securities revaluation result accumulated on the valuation account in previous reporting years was realised in comparison with 2010, lower gains from the disposal of debt securities mostly resulted from the interest rate rise in the euro area in the first half of 2011.

The realised gains or losses from financial operations were negatively affected by the negative result on derivative financial instruments, despite the fact that it was 8 573 thousand lats smaller than in 2010, mostly on account of the result of interest rate future contracts as well as the result of currency future contracts concluded for the purpose of hedging currency risks. The negative result of the currency future contracts concluded for the purpose of hedging currency risk exposure is offset in equal value by the positive revaluation result of the hedged balance sheet items reported in the balance sheet caption "Valuation account" as well as the realised gains on foreign exchange transactions recognised in the profit and loss account.

28. WRITE-DOWNS OF REVALUATION RESULT ON FINANCIAL ASSETS AND POSITIONS

The revaluation result of several debt securities and foreign currency positions at the end of 2011 and 2010 was negative, and it has been recognised as write-downs on financial assets and positions in the profit and loss statement while the positive result on the revaluation of debt securities and foreign currency positions has been reported in the balance sheet caption "Valuation account" (see also Note 25).

29. INCOME FROM PARTICIPATING INTEREST

Income from participating interest in the amount of 245 thousand lats (611 thousand lats in 2010) comprises the dividends received from the participating interest in the BIS (see also Note 11). In 2011, normal dividends were paid. The increase in dividends paid in 2010 was related to the BIS decision to pay normal dividends as well as supplementary dividends in view of the BIS financial performance results.

30. OTHER OPERATING INCOME

Other operating income in 2011 and 2010 was as follows:

| | (in thousands of lats) | |
|--|------------------------|-------|
| | 2011 | 2010 |
| Income from sale of collector coins | 581 | 702 |
| Income from payment and securities settlement services | 379 | 310 |
| Other | 301 | 266 |
| Total | 1 261 | 1 278 |

31. BANKNOTE PRODUCTION AND COINAGE COSTS

The breakdown of banknote production and coinage costs in 2011 and 2010 was as follows:

| | (in thousands of lats) | |
|------------------------------|------------------------|------|
| | 2011 | 2010 |
| Coinage of circulation coins | -101 | -83 |
| Coinage of collector coins | -481 | -458 |
| Total | -582 | -541 |

32. REMUNERATION AND SOCIAL SECURITY COSTS

Remuneration and social security costs in 2011 and 2010 were as follows:

| | (in thousands of lats) | |
|--|------------------------|---------|
| | 2011 | 2010 |
| Remuneration | | |
| Remuneration of Members of the Council and the Board | -895 | -873 |
| Remuneration of other personnel | -9 007 | -9 405 |
| Total remuneration | -9 902 | -10 278 |
| Social security costs | -2 373 | -2 449 |
| Total remuneration and social security costs | -12 275 | -12 727 |

Remuneration of those Members of the Bank of Latvia's Board who are also Heads of Departments of the Bank of Latvia includes remuneration for performance of operational duties.

The number of employees in 2011 and 2010 was as follows:

| | 2011 | 2010 |
|--|------|------|
| Number of employees at the end of the year | | |
| Members of the Council and the Board | 13 | 13 |
| Other personnel | 543 | 557 |
| Total at the end of the year | 556 | 570 |
| Average number of employees per period | 563 | 605 |

33. OTHER OPERATING EXPENSES

Other operating expenses in 2011 and 2010 were as follows:

| | (in thousands of lats) | |
|--|------------------------|--------|
| | 2011 | 2010 |
| Municipal services | -553 | -577 |
| Maintenance of buildings, territory and equipment | -398 | -328 |
| Risk insurance | -267 | -294 |
| Acquisition of low value office supplies | -227 | -113 |
| Information and public relations | -214 | -180 |
| Business travel | -209 | -192 |
| Telecommunications services and system maintenance | -167 | -189 |
| Personnel training | -139 | -156 |
| Transport provision | -109 | -126 |
| Tax on real estate | -91 | -89 |
| Audit, advisory and legal services | -27 | -34 |
| Disposal of material values | -3 | -255 |
| Other | -294 | -232 |
| Total | -2 698 | -2 765 |

The increase in the expenses for low value office supplies is mostly related to the implementation of a project for improving the organisation of the cash circulation process. The audit, advisory and legal services expenses also comprise the remuneration in the amount of 23 thousand lats paid to Deloitte Audits Latvia SIA for the audit of 2011 financial statements (22 thousand lats in 2010).

34. CASH FLOW STATEMENT

(1) Reconciliation of profit before appropriation to net cash and cash equivalents inflow arising from operating activities

| | (in thousands of lats) | |
|--|------------------------|------------|
| | 2011 | 2010 |
| Profit before appropriation | 32 028 | 23 754 |
| Non-cash transaction adjustments | | |
| Depreciation of fixed assets and amortisation of intangible assets | 2 948 | 3 044 |
| Losses on disposal of fixed assets | 2 | 255 |
| Write-downs of revaluation result on financial assets and positions | 16 556 | 12 995 |
| Net non-cash transaction adjustments | 19 506 | 16 294 |
| Change in balance sheet items | | |
| Net decrease of gold reserves | – | 1 |
| Net increase (–)/decrease in Special Drawing Rights | 22 589 | –1 687 |
| Net increase (–)/decrease in foreign debt securities and other foreign investments | 606 426 | –1 056 008 |
| Net decrease in loans to domestic credit institutions | – | 140 449 |
| Net increase (–)/decrease in other assets | –32 | 419 |
| Net decrease in foreign convertible currency liabilities | –4 122 | –5 324 |
| Net increase/decrease (–) in foreign bank and other international institution deposits in lats | 9 752 | –23 770 |
| Net increase in lats in circulation | 222 279 | 149 749 |
| Net increase/decrease (–) in deposits of domestic credit institutions | –492 490 | 574 553 |
| Net decrease in Latvian government deposits | –343 922 | –210 932 |
| Net increase/decrease (–) in deposits of other financial institutions | –14 023 | 54 790 |
| Net decrease in other liabilities | –279 | –1 185 |
| Net change in balance sheet items | 6 178 | –378 945 |
| Net cash and cash equivalents inflow/outflow (–) arising from operating activities | 57 712 | –338 897 |

(2) Analysis of balances and movements in cash and cash equivalents

(at the end of the year; in thousands of lats)

| | 2011 | Change | 2010 | Change | 2009 |
|--|----------------|---------------|----------------|-----------------|----------------|
| Convertible foreign currencies in cash | 13 611 | -2 102 | 15 713 | -3 630 | 19 343 |
| Demand deposits with foreign credit institutions and other foreign financial institutions | 519 867 | -11 868 | 531 735 | -273 668 | 805 403 |
| Time deposits with foreign credit institutions and other foreign financial institutions with original maturity up to 5 business days | 63 252 | 54 050 | 9 202 | -110 277 | 119 479 |
| Total cash and cash equivalents | 596 730 | 40 080 | 556 650 | -387 575 | 944 225 |

35. TRANSACTIONS WITH THE LATVIAN GOVERNMENT

The Bank of Latvia is wholly owned by the Republic of Latvia and carries out transactions with the Treasury, acting as the financial agent of the Latvian government. Performing this function, the Bank of Latvia services the Treasury's accounts in lats and foreign currency, as well as conducts foreign exchange transactions. The Bank of Latvia conducts government securities transactions in the secondary securities market in order to implement monetary policy (in 2011 and 2010 the Bank of Latvia did not perform such transactions). In the above transactions, the Bank of Latvia is independent in making its own decisions.

The interest rates and foreign exchange rates used in the transactions with the Latvian government are market-based. No commission fees are applied to transactions with the Latvian government.

At the end of 2011 and 2010, the breakdown of the Bank of Latvia liabilities to the Latvian government and the respective interest rates were as follows:

| | Amount (in thousands of lats) | | Interest rate (%) | |
|---------------------------------------|----------------------------------|------------------|----------------------|-----------|
| | 2011 | 2010 | 2011 | 2010 |
| Liabilities | | | | |
| Time deposits in foreign currencies | 259 124 | 789 809 | 0.32–0.51 | 0.22–0.57 |
| Demand deposits in foreign currencies | 242 523 | 236 674 | 0.00–0.22 | 0.01–0.34 |
| Demand deposits in lats | 235 441 | 54 527 | 0.57 | 0.41 |
| Accrued interest expense | 20 | 95 | x | x |
| Tax liabilities | 69 | 80 | x | x |
| Total net liabilities | 737 177 | 1 081 185 | x | x |

In 2011 and 2010, the breakdown of the Bank of Latvia's income and expense related to the Latvian government, as well as the Bank of Latvia's profit of the previous reporting year appropriated to the state budget was as follows (see also Notes 24–26):

| | (in thousands of lats) | |
|---|------------------------|---------------|
| | 2011 | 2010 |
| Expense and the Bank of Latvia's profit appropriated to the state budget | | |
| Interest on government deposits | 7 125 | 4 127 |
| Taxes | 6 023 | 6 118 |
| Profit appropriated to the state budget | 15 440 | 48 355 |
| Total expense and the Bank of Latvia's profit appropriated to the state budget | 28 588 | 58 600 |

36. PLEDGED ASSETS

Securities and other financial instruments with the market value of 23 720 thousand lats, as at the end of 2011 (18 968 thousand lats at the end of 2010), have been pledged to provide collateral for interest rate and currency future contracts. These financial instruments are included in the balance sheet asset caption "Convertible foreign currencies".

37. SECURITIES LENDING

On behalf of the Bank of Latvia its agents conclude securities lending transactions, as part of an automatic securities lending programme, where Bank of Latvia's securities are lent against cash or other securities collateral. Securities lending transactions provide additional income without any material impact on foreign currency reserve liquidity as the securities lent are readily available to the Bank of Latvia. The Bank of Latvia's agent administers the securities lending programme and monitors the securities lending and related collateral.

At the end of 2011, the fair value of Bank of Latvia's securities lent was 278 577 thousand lats (474 421 thousand lats at the end of 2010).

At the end of 2011 and 2010, the fair value of collateral provided in securities lending transactions was as follows:

| | (in thousands of lats) | |
|---|------------------------|---------|
| | 2011 | 2010 |
| Foreign currency cash | 241 602 | 323 344 |
| Debt securities of foreign governments, financial institutions and non-financial corporations | 41 987 | 158 698 |
| Total | 283 589 | 482 042 |

Foreign currency cash or securities provided as collateral in securities lending transactions is not recognised in the Bank of Latvia's balance sheet (see also principles described in Note 3.13).

38. DERIVATIVE FINANCIAL INSTRUMENTS AND SPOT EXCHANGE RATE CONTRACTS

The Bank of Latvia enters into forward and spot exchange rate contracts, currency and interest rate swap arrangements and interest rate and currency future contracts in order to manage interest rate and currency risks associated with the Bank of Latvia's foreign reserves. As part of its monetary policy, the Bank of Latvia also engages in spot exchange rate contracts and currency swap arrangements.

At the end of 2011 and 2010, the breakdown of the Bank of Latvia's derivative financial instruments and spot exchange rate contracts was as follows:

| | (in thousands of lats) | | | | | |
|---|--------------------------------|-----------|---------------|-------|---------------|--------|
| | Contract or notional amount | | Book value | | | |
| | | | Assets | | Liabilities | |
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| Non-traded financial derivative and spot exchange rate contracts with foreign financial institutions | | | | | | |
| Forward exchange rate contracts and currency swap arrangements | 1 775 002 | 1 803 979 | 12 211 | 1 292 | 43 026 | 18 542 |
| Spot exchange rate contracts | 114 643 | 54 523 | 347 | 1 152 | 37 | 6 |
| Forward transactions in securities | 152 949 | 202 350 | 560 | 381 | 147 | 526 |
| Interest rate swap arrangements | 870 | – | 25 | – | – | – |
| Total | x | x | 13 143 | 2 825 | 43 210 | 19 074 |
| Spot exchange rate contracts with domestic institutions | | | | | | |
| Spot exchange rate contracts | – | 53 448 | – | 532 | – | – |
| Total | x | x | – | 532 | – | – |
| Traded financial derivative contracts with foreign financial institutions | | | | | | |
| Interest rate future contracts | 1 189 194 | 2 336 784 | x | x | x | x |
| Currency future contracts | 151 365 | 319 217 | x | x | x | x |

The book value of the non-traded financial derivative contracts and spot exchange rate contracts is reported in the respective balance sheet captions of other assets or other liabilities (see also Notes 12, 15 and 19). Since settlement has been made for the change in the fair value of future contracts, it is reported as demand deposits in the balance sheet asset caption "Convertible foreign currencies".

At the end of 2011 and 2010, the book value and the fair value of non-traded contracts concluded by the Bank of Latvia and not reported at their fair value, were not materially different. The reconciliation of the book value and net fair value of these instruments at the end of 2011 and 2010 was as follows:

| | (in thousands of lats) | | | | | |
|---|------------------------|---------|----------------|---------|-------------|------|
| | Net fair value | | Net book value | | Difference | |
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| Non-traded financial derivative contracts with foreign financial institutions and spot exchange rate contracts | | | | | | |
| Forward exchange rate contracts and currency swap arrangements | –31 290 | –17 388 | –30 815 | –17 250 | –475 | –138 |
| Spot exchange rate contracts | 311 | 1 146 | 310 | 1 146 | 1 | 0 |
| Total | –30 979 | –16 242 | –30 505 | –16 104 | –474 | –138 |
| Spot exchange rate contracts with domestic credit institutions | | | | | | |
| Spot exchange rate contracts | – | 532 | – | 532 | – | 0 |
| Total | – | 532 | – | 532 | – | 0 |

39. CONTINGENT LIABILITIES AND COMMITMENTS

In 2005, the liquidator of the bankrupt JSC *Banka Baltija* filed a claim against the Bank of Latvia on behalf of the creditors of JSC *Banka Baltija* in the Riga Regional Court for the recovery of losses; in February 2010, the amount of the claim was increased from 185.6 million lats to 238.3 million lats. The claimant alleges that the Bank of Latvia, as the institution in charge of banking supervision at that time, is responsible for losses arising from the bankruptcy of JSC *Banka Baltija* in 1995. On 12 October 2010, the Civil Court Collegium of Riga District Court as the court of first instance ruled as follows: to satisfy the claim against the Bank of Latvia in part, collecting 60 million lats from the Bank of Latvia for the benefit of the JSC *Banka Baltija* undergoing liquidation for the purpose of reimbursing losses, and 32 thousand lats as stamp duty for the benefit of the State. The Bank of Latvia appealed the judgement of the court of first instance, thus it did not take effect. On 21 February 2012, the Chamber of Civil Court of the Supreme Court announced a condensed judgement whereby the court ruled that the claim against the Bank of Latvia be completely rejected and court expenses in the amount of 16 thousand lats and legal services in the amount of 150 thousand lats be collected from the JSC *Banka Baltija* undergoing liquidation. The claimant may appeal the judgement under cassation procedure to the Senate of the Supreme Court within 30 days of the date of producing a complete judgement. The Bank of Latvia is confident that the claim is without merits; therefore no provisions are recognised in the financial statements. In case of cassation claim is submitted, the final ruling on the case is expected no earlier than in 2014.

The Bank of Latvia has not paid up 96.25% of the Bank of Latvia's share in the ECB subscribed capital, which is payable following the decision of the General Council of the ECB. At the end of 2011 and 2010, the Bank of Latvia's unpaid share in the ECB subscribed capital was 29 383 thousand euro (20 651 thousand lats; see also Note 10).

The Bank of Latvia's uncalled portion of the BIS shares is 75% of their nominal value. These shares are callable following the decision of the BIS Board. At the end of 2011, the uncalled portion of the BIS share holding was 4 013 thousand SDR (3 367 thousand lats; 4 013 thousand SDR or 3 291 thousand lats at the end of 2010; see also Note 11).

At the end of 2011, the Bank of Latvia had issued collector coins in the nominal value of 1 556 thousand lats (1 528 thousand lats at the end of 2010) and gold circulation coins with a nominal value of 1 989 thousand lats (1 988 thousand lats at the end of 2010). These coins may be represented to the Bank of Latvia in exchange for lats at a nominal value. In the opinion of management of the Bank of Latvia, the probability that the Bank of Latvia will be required to repurchase these coins from their holders is considered low and no provisions have been made.

40. CURRENCY PROFILE

At the end of 2011 and 2010, the currency profile of the Bank of Latvia's assets, liabilities and off-balance sheet accounts was as follows:¹

| | (in thousands of lats) | | | | | | |
|--|------------------------|------------------|------------------|----------------|----------------|---------------|------------------|
| | LVL | EUR | USD | JPY | Gold | Other | Total |
| As at 31 December 2011 | | | | | | | |
| Assets | | | | | | | |
| Foreign assets | 13 312 | 1 851 498 | 1 176 038 | 238 913 | 210 066 | 17 715 | 3 507 542 |
| Domestic assets | 31 648 | 30 | – | – | – | 5 | 31 683 |
| TOTAL ASSETS | 44 960 | 1 851 528 | 1 176 038 | 238 913 | 210 066 | 17 720 | 3 539 225 |
| Liabilities | | | | | | | |
| Foreign liabilities | 61 916 | 5 910 | 4 442 | 33 | – | 71 | 72 372 |
| Lats in circulation | 1 160 183 | – | – | – | – | – | 1 160 183 |
| Domestic liabilities | 1 334 073 | 590 939 | 35 143 | 8 131 | – | 11 222 | 1 979 508 |
| TOTAL LIABILITIES | 2 556 172 | 596 849 | 39 585 | 8 164 | – | 11 293 | 3 212 063 |
| Net position on balance sheet | –2 511 212 | 1 254 679 | 1 136 453 | 230 749 | 210 066 | 6 427 | 327 162 |
| Net position on financial instruments' off-balance sheet accounts | – | 1 542 642 | –1 131 368 | –227 796 | –210 314 | –3 231 | –30 067 |
| Net position on balance sheet and off-balance sheet accounts | –2 511 212 | 2 797 321 | 5 085 | 2 953 | –248 | 3 196 | 297 095 |
| Profile of the net position on balance sheet and off-balance sheet accounts (%) | x | 99.6 | 0.2 | 0.1 | 0 | 0.1 | 100.0 |
| Benchmark currency structure (%) | x | 100.0 | 0 | 0 | 0 | 0 | 100.0 |
| As at 31 December 2010 | | | | | | | |
| TOTAL ASSETS | 35 406 | 2 236 908 | 1 355 399 | 272 023 | 187 179 | 20 418 | 4 107 333 |
| TOTAL LIABILITIES | 2 749 097 | 848 059 | 173 601 | 20 357 | – | 19 579 | 3 810 693 |
| Net position on balance sheet | –2 713 691 | 1 388 849 | 1 181 798 | 251 666 | 187 179 | 839 | 296 640 |
| Net position on financial instruments' off-balance sheet accounts | 53 980 | 1 552 017 | –1 185 852 | –252 006 | –187 400 | 1 167 | –18 094 |
| Net position on balance sheet and off-balance sheet accounts | –2 659 711 | 2 940 866 | –4 054 | –340 | –221 | 2 006 | 278 546 |
| Profile of the net position on balance sheet and off-balance sheet accounts (%) | x | 100.1 | –0.2 | 0 | 0 | 0.1 | 100.0 |
| Benchmark currency structure (%) | x | 100.0 | 0 | 0 | 0 | 0 | 100.0 |

¹ The assets, liabilities and off-balance sheet accounts as well as liabilities to the IMF (313 thousand lats) denominated in SDR and exposed to the SDR currency risk are reported as per the SDR basket of currencies.

41. REPRICING MATURITY AND TRACKING ERROR

The table below reflects the sensitivity of the Bank of Latvia's assets, liabilities and off-balance sheet accounts to a change in interest rates. Items reported in this table are stated at carrying amounts, except for interest rate and currency future contracts and forward transactions in securities that are stated at notional amounts and included in off-balance sheet accounts. A nearest contractual interest repricing or residual maturity date to 31 December of the reporting year is used for categorising items reported in this table.

| | (in thousands of lats) | | | | | | Total |
|--|------------------------|---------------|---------------|------------------|----------------|----------------------|------------------|
| | Interest bearing | | | | | Non-interest bearing | |
| | Up to 3 months | 3–6 months | 6–12 months | 1–3 years | Over 3 years | | |
| As at 31 December 2011 | | | | | | | |
| Foreign assets | | | | | | | |
| Gold | – | – | – | – | – | 210 066 | 210 066 |
| Special Drawing Rights | 79 069 | – | – | – | – | – | 79 069 |
| Convertible foreign currencies | 1 272 248 | 12 221 | 84 090 | 1 089 024 | 710 297 | 17 040 | 3 184 920 |
| Participating interest in the European Central Bank | – | – | – | – | – | 750 | 750 |
| Participating interest in the Bank for International Settlements | – | – | – | – | – | 18 997 | 18 997 |
| Other foreign assets | 22 | – | – | – | – | 13 718 | 13 740 |
| Domestic assets | | | | | | | |
| Fixed assets | – | – | – | – | – | 30 675 | 30 675 |
| Other domestic assets | – | – | – | – | – | 1 008 | 1 008 |
| TOTAL ASSETS | 1 351 339 | 12 221 | 84 090 | 1 089 024 | 710 297 | 292 254 | 3 539 225 |
| Foreign liabilities | | | | | | | |
| Convertible foreign currencies | 3 879 | – | – | – | – | 5 681 | 9 560 |
| International Monetary Fund | – | – | – | – | – | 313 | 313 |
| Other international institution deposits in lats | – | – | – | – | – | 18 271 | 18 271 |
| Foreign bank deposits in lats | – | – | – | – | – | 712 | 712 |
| Other foreign liabilities | – | – | – | – | – | 43 516 | 43 516 |
| Lats in circulation | – | – | – | – | – | 1 160 183 | 1 160 183 |
| Domestic liabilities | | | | | | | |
| Balances due to credit institutions | 1 029 688 | – | – | – | – | 168 052 | 1 197 740 |
| Balances due to the government | 655 637 | – | – | – | – | 81 451 | 737 088 |
| Balances due to other financial institutions | 41 027 | – | – | – | – | 1 688 | 42 715 |
| Other domestic liabilities | 27 | – | – | – | – | 1 938 | 1 965 |
| TOTAL LIABILITIES | 1 730 258 | – | – | – | – | 1 481 805 | 3 212 063 |

(cont.)

(in thousands of lats)

| | Interest bearing | | | | | Non-interest bearing | Total |
|---|------------------|---------------|---------------|------------------|----------------|----------------------|-----------|
| | Up to 3 months | 3–6 months | 6–12 months | 1–3 years | Over 3 years | | |
| Net position on balance sheet | -378 919 | 12 221 | 84 090 | 1 089 024 | 710 297 | x | x |
| Assets on financial instruments' off-balance sheet accounts | 2 637 476 | 1 088 | 3 264 | 566 165 | 146 078 | x | x |
| Liabilities on financial instruments' off-balance sheet accounts | 2 753 163 | 865 | 3 264 | 376 752 | 250 094 | x | x |
| Net position on balance sheet and off-balance sheet accounts | -494 606 | 12 444 | 84 090 | 1 278 437 | 606 281 | x | x |
| As at 31 December 2010 | | | | | | | |
| TOTAL ASSETS | 1 853 158 | 102 874 | 144 036 | 904 889 | 857 959 | 244 417 | 4 107 333 |
| TOTAL LIABILITIES | 2 706 588 | – | – | – | – | 1 104 105 | 3 810 693 |
| Net position on balance sheet | -853 430 | 102 874 | 144 036 | 904 889 | 857 959 | x | x |
| Assets on financial instruments' off-balance sheet accounts | 3 548 301 | – | – | 913 397 | 293 321 | x | x |
| Liabilities on financial instruments' off-balance sheet accounts | 3 414 636 | – | – | 1 072 461 | 283 494 | x | x |
| Net position on balance sheet and off-balance sheet accounts | -719 765 | 102 874 | 144 036 | 745 825 | 867 786 | x | x |

The exposure to aggregate market risk and credit risk of foreign reserves, included in portfolios managed against multi-currency fixed income securities benchmark and asset-backed securities benchmark is characterised by the tracking error, which is measured as the expected annualised standard deviation of the difference in return between the investment portfolio and a respective benchmark (see also risk management principles described in Note 2.1). In 2011 and 2010, the actual (*ex-post*) tracking errors of the portfolios managed against multi-currency fixed income securities benchmark were 54 basis points and 65 basis points respectively, whereas the tracking errors of the portfolios managed against asset-backed securities benchmark were 84 basis points and 81 basis points respectively.

The expected (*ex-ante*) tracking error lay within the following basis point intervals during the year:

| | Book value (at the end of the year; in thousands of lats) | Expected tracking error (number of business days) | | | |
|---|---|---|-------|-------|---------|
| | | 10–39 | 40–69 | 70–99 | 100–110 |
| During 2011 | | | | | |
| Portfolios managed against multi-currency fixed income securities benchmark | 2 388 804 | – | 253 | – | – |
| Portfolios managed against asset-backed securities benchmark | 175 883 | – | 171 | 76 | 6 |
| During 2010 | | | | | |
| Portfolios managed against multi-currency fixed income securities benchmark | 2 602 693 | – | 219 | 30 | – |
| Portfolios managed against asset-backed securities benchmark | 165 090 | – | 231 | 18 | – |

42. LIQUIDITY PROFILE

At the end of 2011 and 2010, the liquidity profile of the Bank of Latvia's assets and liabilities was as follows:

(in thousands of lats)

| | 2011 | | | 2010 | | |
|-------------------------------|-------------------|----------------------|------------------|-------------------|----------------------|------------------|
| | Up to 3 months | No fixed maturity | Total | Up to 3 months | No fixed maturity | Total |
| Assets | | | | | | |
| Foreign assets | 3 487 257 | 20 285 | 3 507 542 | 4 071 606 | 3 005 | 4 074 611 |
| Domestic assets | 376 | 31 307 | 31 683 | 690 | 32 032 | 32 722 |
| TOTAL ASSETS | 3 487 633 | 51 592 | 3 539 225 | 4 072 296 | 35 037 | 4 107 333 |
| Liabilities | | | | | | |
| Foreign liabilities | 72 339 | 33 | 72 372 | 42 522 | 34 | 42 556 |
| Lats in circulation | – | 1 160 183 | 1 160 183 | – | 937 904 | 937 904 |
| Domestic liabilities | 1 979 508 | – | 1 979 508 | 2 830 233 | – | 2 830 233 |
| TOTAL LIABILITIES | 2 051 847 | 1 160 216 | 3 212 063 | 2 872 755 | 937 938 | 3 810 693 |
| Net position on balance sheet | 1 435 786 | –1 108 624 | x | 1 199 541 | –902 901 | x |

In the Note, asset items are reported on the basis of the Bank of Latvia's capability to convert them into cash. Liabilities items are reported by their expected settlement date.

43. SECTORAL PROFILE OF ASSETS

The sectoral profile of the Bank of Latvia's assets at the end of 2011 and 2010 was as follows:

| | Amount (in thousands of lats) | | Percentage (%) | |
|---|----------------------------------|------------------|-------------------|--------------|
| | 2011 | 2010 | 2011 | 2010 |
| Foreign central governments and other governmental institutions | 1 104 267 | 1 234 527 | 31.2 | 30.1 |
| Foreign local governments | 51 437 | 64 268 | 1.5 | 1.6 |
| Foreign central banks and credit institutions | 1 493 624 | 1 809 206 | 42.2 | 44.0 |
| Other foreign financial institutions | 668 356 | 704 888 | 18.9 | 17.2 |
| Foreign non-financial corporations | 78 127 | 65 687 | 2.2 | 1.6 |
| International institutions | 110 837 | 196 395 | 3.1 | 4.8 |
| Domestic credit institutions | 53 | 584 | 0 | 0 |
| Unclassified assets | 32 524 | 31 778 | 0.9 | 0.7 |
| Total | 3 539 225 | 4 107 333 | 100.0 | 100.0 |

44. FOREIGN ASSETS BY THEIR LOCATION OR THE COUNTERPARTY'S DOMICILE

At the end of 2011 and 2010, the Bank of Latvia's foreign assets broken down by their location or the counterparty's domicile were as follows:

| | Amount (in thousands of lats) | | Percentage (%) | |
|--|----------------------------------|-----------|-------------------|-------|
| | 2011 | 2010 | 2011 | 2010 |
| Euro area countries | 1 526 724 | 1 910 391 | 43.5 | 46.9 |
| Other EU countries | 725 868 | 697 914 | 20.7 | 17.1 |
| US | 519 974 | 594 517 | 14.8 | 14.6 |
| Japan | 231 590 | 256 361 | 6.6 | 6.3 |
| Other countries and international institutions | 503 386 | 615 428 | 14.4 | 15.1 |
| Total | 3 507 542 | 4 074 611 | 100.0 | 100.0 |

45. ASSETS BY CREDIT RATINGS ASSIGNED TO THE COUNTERPARTY

At the end of 2011 and 2010, the Bank of Latvia's assets broken down by categories of credit ratings assigned to the counterparty were as follows:

| | Credit rating | Amount (in thousands of lats) | | Percentage (%) | |
|--|--|----------------------------------|----------------|-------------------|-------------|
| | | 2011 | 2010 | 2011 | 2010 |
| FOREIGN ASSETS | | | | | |
| Gold | AAA | 210 066 | 187 179 | 5.9 | 4.6 |
| Special Drawing Rights | AAA | 79 069 | 99 356 | 2.2 | 2.4 |
| Foreign debt securities | AAA | 838 391 | 1 814 171 | 23.8 | 44.1 |
| | AA+ | 361 359 | 78 814 | 10.2 | 1.9 |
| | AA | 149 536 | 154 700 | 4.2 | 3.8 |
| | AA- | 475 843 | 483 514 | 13.5 | 11.8 |
| | A+ | 238 576 | 129 596 | 6.8 | 3.2 |
| | A | 350 477 | 24 238 | 9.9 | 0.6 |
| | A- | 6 662 | 3 646 | 0.2 | 0.1 |
| | BBB+ | 806 | 733 | 0 | 0 |
| | BBB- | 373 | - | 0 | - |
| | BB+ | 20 686 | - | 0.6 | - |
| | Deposits with foreign financial institutions | AAA | 438 969 | 518 452 | 12.4 |
| AA+ | | 31 985 | 2 454 | 0.9 | 0.1 |
| AA | | 25 867 | 59 918 | 0.7 | 1.5 |
| AA- | | 45 396 | 133 053 | 1.3 | 3.2 |
| A+ | | 129 163 | 190 607 | 3.7 | 4.6 |
| A | | 57 220 | 144 444 | 1.6 | 3.5 |
| A- | | - | 28 114 | - | 0.7 |
| Foreign currency in cash | AAA | 13 607 | 15 713 | 0.4 | 0.4 |
| | AA+ | 4 | - | 0 | - |
| Participating interest in the European Central Bank | AAA | 750 | 750 | 0 | 0 |
| Participating interest in the Bank for International Settlements | AAA | 18 997 | 1 763 | 0.5 | 0 |
| Derivative financial instruments | AAA | 560 | 385 | 0 | 0 |
| | AA | - | 115 | - | 0 |
| | AA- | 82 | 470 | 0 | 0 |
| | A+ | 7 791 | 1 503 | 0.2 | 0 |
| | A | 4 609 | 315 | 0.1 | 0 |
| | A- | 101 | 37 | 0 | 0 |
| Accrued interest income | Different | 59 | 79 | 0 | 0 |
| Other foreign assets | Different | 538 | 492 | 0 | 0 |
| DOMESTIC ASSETS | Different | 31 683 | 32 722 | 0.9 | 0.8 |
| TOTAL | | 3 539 225 | 4 107 333 | 100.0 | 100.0 |

At the end of 2011 and 2010, the Bank of Latvia's foreign assets broken down by major categories of credit ratings assigned to the counterparty were as follows:

| | Credit rating category | Amount (in thousands of lats) | | Percentage (%) | |
|----------------|------------------------|-------------------------------|-----------|----------------|-------|
| | | 2011 | 2010 | 2011 | 2010 |
| Foreign assets | AAA | 1 600 409 | 2 637 769 | 45.6 | 64.8 |
| | AA | 1 090 072 | 913 038 | 31.1 | 22.4 |
| | A | 794 599 | 522 500 | 22.7 | 12.8 |
| | BBB | 1 179 | 733 | 0 | 0 |
| | BB | 20 686 | – | 0.6 | – |
| | Different | 597 | 571 | 0 | 0 |
| Total | | 3 507 542 | 4 074 611 | 100.0 | 100.0 |

Based on Standard & Poor's credit ratings or other equivalent credit ratings assigned by other international credit rating agency to the counterparty, the above tables show the breakdown of the Bank of Latvia's assets as at the end of the reporting period. The rating "AAA" is the highest possible long-term creditworthiness rating, which indicates an extremely strong capacity of the counterparty to meet its financial commitments. The rating "AA" confirms the counterparty's very strong capacity and the rating "A" – the counterparty's strong capacity to meet its financial commitments in the long term. "BBB" is a medium grade considered to be the lowest level of investment-grade rating, while "BB" is a rating below investment grade implying that the counterparty's long-term creditworthiness is risky. Ratings below "AAA" are modified by marks "+" or "-" to show the relative standing within the major categories of credit ratings of an international credit rating agency.

INDEPENDENT AUDITORS' REPORT

TO THE COUNCIL OF THE BANK OF LATVIA

We have audited the accompanying financial statements of the Bank of Latvia ("the Bank") set out on pages 3 to 45, which comprise the balance sheet as at 31 December 2011, and the related statements of profit and loss, total recognised gains and losses and cash flows for the year then ended, and a summary of principal accounting policies and other explanatory notes.

Board's Responsibility for the Financial Statements

The Board of the Bank is responsible for the preparation and fair presentation of these financial statements in accordance with the "Financial Accounting Policy of the Bank of Latvia" approved by the Council of the Bank, and the law "On the Bank of Latvia", and for such internal control as the Board of the Bank determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement.

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

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

Opinion

In our opinion, the financial statements of the Bank give a true and fair view of the financial position of the Bank as at 31 December 2011, and of its financial performance and its cash flows for the year then ended in accordance with the "Financial Accounting Policy of the Bank of Latvia" approved by the Council of the Bank, and the law "On the Bank of Latvia".

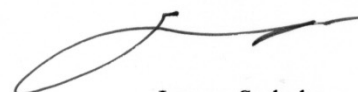
Deloitte Audits Latvia SIA
Licence No. 43



Inguna Stasa
Member of the Board

Riga, Latvia
13 March 2012

The State Audit Office
of the Republic of Latvia



Inguna Sudraba
Auditor General

Riga, Latvia
15 March 2012