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**The Republic of Latvia: Financial System Stability Assessment, including Reports on  
Observance of Standards and Codes on the following topics: Banking Supervision;  
Payment Systems; Securities Regulation; Insurance Regulation; Corporate  
Governance; and Monetary and Financial Policy Transparency**

This Financial System Stability Assessment on the **Republic of Latvia** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **December 28, 2001**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the **Republic of Latvia** or the Executive Board of the IMF.

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## REPUBLIC OF LATVIA

### Financial System Stability Assessment

Prepared by the Monetary and Exchange Affairs and the European II Departments

Approved by V. Sundararajan and John Odling-Smee

December 28, 2001

- The Financial System Stability Assessment report is based on the joint IMF-World Bank mission that visited Latvia during February 14–28 and October 22–26, 2001 as part of the Financial Sector Assessment Program (FSAP). The mission met with the Bank of Latvia (BoL), the Financial and Capital Markets Commission (FCMC), the Securities Market Commission, the Ministry of Finance, the Insurance Supervision Inspectorate, and representatives of the private sector. The FSAP findings were discussed with the authorities during the Article IV consultation mission in October 2001.
- The mission was comprised of Alexander Fleming (Head, World Bank), Sami Geadah (Deputy Head, IMF), Peter Kyle, Donald McIsaac, Barbara Mondestin (Team Assistant), Melinda Roth, Susan Rutledge (all World Bank), Christian Beddies, Li Cui, Jodi Scarlata (all IMF), Krzysztof Senderowicz (National Bank of Poland), Laszlo Seregdi (Hungarian Financial Supervisory Authority), and Maria Westerberg (Swedish Financial Supervisory Authority). A number of World Bank/IFC local staff participated in the work of the mission including Ilze Berzina (IFC, Riga), Roger Handberg (Technical Unit, Riga), Andrejs Jakobsons (World Bank, Riga), and Eva Ernstreite (Program Assistant, World Bank, Riga). Vedat Milor (consultant, World Bank Programmatic Adjustment Loan) also assisted the mission. The IMF Resident Representative, Adalbert Knöbl, participated in some of the meetings with the Latvian authorities.
- The banking system is well capitalized, profitable, and liquid following its recovery from the effects of the Russian crisis in 1998. A notable feature of the financial system is the significant share of nonresident deposits and foreign equity in the banking system and nonresident investment in the securities market. The banking system is fairly resilient to different shocks: the risks associated with an increase in interest rates, rapid credit expansion, and a possible withdrawal of nonresident deposits seem to be well-managed by banks, but the supervisory authorities and banks need to continue to closely monitor these areas. Other parts of the financial sector are starting to emerge, and pose no systemic vulnerabilities. The present supervisory and regulatory framework is robust, and has a high degree of observance of relevant international standards and codes. There has been a smooth transition to the FCMC, which unified the previous three supervisory agencies in July 2001.
- The report is divided into two sections. The first section presents the main findings and overall stability assessments while the second section provides summary assessments of standards and codes in the areas of banking supervision, securities, insurance, payment systems, corporate governance, and monetary and financial policy transparency, as inputs into the overall assessment. The FSAP report, on which this report is based, includes the detailed background analysis and covers developmental issues.

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## SECTION I. STAFF REPORT ON FINANCIAL SECTOR ISSUES

### I. OVERALL STABILITY ASSESSMENT

1. **Macroeconomic conditions are favorable for a sustained and balanced evolution of the financial sector, following a strong recovery from the slowdown triggered by the Russian crisis.** Latvia is well advanced in the transition process and many of the economic and financial issues that it confronts are those typical of a small and open economy. Most of the problems associated with the early stages of transition—the prevalence of the state in banking business, the persistence of state enterprises as a source of inefficiency, bad loans, and a weak credit culture—are no longer pertinent to Latvia. Although a number of major privatizations still remain to be carried out, the enterprise sector is in an advanced stage of restructuring and there is now a firmer foundation upon which the relationship with the financial sector can be built. The banking sector—which is the largest component of the financial system—has been greatly strengthened by the entry of foreign strategic investors.

2. **Notwithstanding the generally favorable macroeconomic situation, there has been an increase in domestic interest rates (as well as in the differential with the SDR basket rate) during 2001.** Should domestic interest rates increase further, borrowers could be adversely affected given the short-term maturity of most lending. Interest rate movements are a consequence of the exchange rate peg, but also reflect the thinness of domestic money markets. Likewise, the effect of the **movement of key exchange rates** for Latvia must be carefully monitored, as downward movements in the euro against the U.S. dollar can impact adversely on exporters, who may experience difficulties in repaying their dollar debts to banks; about one-half of banks' lending to enterprises and to households is in foreign currencies.

3. **The banking system is well capitalized, liquid, and profitable. While no major sources of vulnerability have been identified, some areas will require close monitoring and a willingness to act quickly if deterioration is perceived.** A potential source of risk is associated with the **rapid credit expansion** that was observed during 2000 and the first nine months of 2001. Banks are competing for customers and undercutting each other in terms of rates offered or services provided. There is a question as to whether this will lead to deterioration in the quality of credit. Of course, lending is developing off a very low base and some of it is going to new sectors that have previously had little access to the banks. While the growth in lending is welcome from a developmental perspective, a persistence of the current strong rates of lending growth could become a source of concern.

4. **Latvia's banking system has a large proportion of nonresident deposits.** The associated risk relates mainly to the prospect that these deposits may be withdrawn rapidly (if, for instance, there was a sudden sharp fall in confidence in Latvian banks). This could impinge on the larger banks that operate in both the domestic and CIS markets, and lead to systemic implications, should their profit prospects deteriorate significantly. A related concern is the implication of a serious loss of reputation in the event that some nonresident deposits were found to come from suspicious sources. While nonresident deposits are usually

invested in highly liquid OECD paper or redeposited abroad with little maturity mismatch, the loss of these could lead to a significant deterioration in profits. Latvia has in place appropriate anti-money laundering supervisory and reporting arrangements. However, the January 2001 report of the European Committee on Crime Problems and the OECD Financial Action Task Force (FATF) raised questions regarding the enforcement of anti-money laundering measures, and in particular with the speed of the legal process, the standards of proof, the confiscation regime, and information sharing.

5. The BoL has used two-year **foreign exchange swaps** to help develop the domestic financial markets. While acknowledging the positive impact this has had to generate long-term lending in lats, the use of long-term foreign exchange swaps potentially impacts the level of usable reserves and, as such, should be monitored closely. The BoL reduced the monthly issue volume of long-term swaps from LVL 10 million to LVL 5 million in April 2001, and eliminated them in December 2001.

6. In order to gauge the significance of the above-risk factors for the banking sector, **stress tests** were performed on a set of the larger banks. The results of these tests suggest that a sharp increase in interest rates or a movement of the euro/U.S. dollar exchange rate would have a relatively small effect on bank solvency. A significant increase in nonperforming loans would also have a limited effect on solvency, as only two out of eight banks in the sample would fall below the 10 percent capital adequacy ratio threshold. The banks are not vulnerable to stock market movements since they currently invest relatively small amounts. However, bank profitability was found to be generally vulnerable to significant declines in fee income.

7. **Nonbank financial institutions are beginning to emerge, and do not pose potential systemic risks at present.** The insurance and pension fund sectors are likely to become increasingly important players with the onset of pension reform. Leasing is growing at a fast pace and is proving to be a useful vehicle for financing small and medium enterprises in particular. Potential systemic risks emanating from nonbank financial activities are small at present. This reflects the relatively small volume of activity and the lack of strong linkage with the banks. Nevertheless, the growth of business and banking connectivity should be closely monitored.

8. **The securities market is also small and lacks liquidity and investor confidence.** The bond market consists of government bonds and newly issued mortgage bonds, but there are no public corporate or municipal issues. Closer cooperation among the Baltic countries and with other Western European stock exchanges will facilitate market broadening and Latvian companies may attract portfolio investments more easily.

9. **The move to a unified regulatory agency—the Financial and Capital Markets Commission (FCMC)—holds out the prospect of a more efficient supervisory framework that will ensure a coordinated approach to the supervision of the array of emerging financial institutions.** The three constituent agencies had different supervisory cultures and techniques, as well as different staffing and levels of remuneration. The merger was conducted smoothly and the costs associated with the restructuring seem to have been

minimized. The staffing; internal organizational form; decision-making processes; collaboration on policy and regulatory objectives; information sharing with the BoL; and public relations aspects were dealt with expeditiously. The transition to the FCMC has not weakened supervision, and it has already strengthened the supervision of insurance companies. The FCMC is currently working on the re-approval of existing legislation and regulations on financial market supervision, the harmonization of legislation with the EU and among sectors, and the establishment of a unified database. Additional emphasis could be placed on developing a risk-based supervisory approach, introducing a rating system for financial institutions before 2003, and developing an on-site examination manual for insurance companies.

10. **Arrangements for the regulation and supervision of the financial system are adequate.** Latvia was found to be largely conforming to the Basel Committee Core Principles for Effective Banking Supervision. The finding is similar for the insurance sector where supervision is adequate and Latvia is largely observant of the IAIS Core Principles and is in almost complete compliance with EU Insurance Directives. The principles for securities regulation issued by IOSCO are also largely implemented, although efforts could be made to strengthen penalties on insider trading and market manipulation. The legal framework for banking is particularly robust. Latvia exhibits a high degree of policy transparency in virtually all of the areas in which it has been assessed (banking, insurance and securities regulation, and in the spheres of monetary policy and the payment system oversight). The legal framework for corporate bankruptcy, loan recovery, and creditor rights is sound.

11. **The payment system is modern and functioning relatively well.** The procedures largely observe the Basel Committee on Payment and Settlement Systems Core Principles. There were some legal uncertainties with regard to the finality of settlements and netting enforceability, as well as to the rights of holders of collateral securities in the event of the insolvency of the providers of the collateral, but these have been addressed by legislative changes that were approved by parliament in October 2001.

12. **Systemic liquidity and safety net arrangements appear adequate.** The BoL manages liquidity—mostly through foreign exchange intervention, short-term foreign exchange swaps, and repo operations—with the peg to the SDR as the monetary policy anchor. The BoL provides temporary liquidity support through a wide range of facilities, while imposing a good degree of discipline in the market as banking licenses have been revoked and lender-of-last-resort loans are rare. The assets of the Deposit Guarantee Fund (DGF) are currently the equivalent of 50 percent of insured deposits, and the DGF can access government resources in the event of need. Banks' liquidity management seems to be reasonably efficient, and banks are generally liquid, in part given thin financial markets.



## II. THE FINANCIAL SYSTEM AND THE MACROECONOMY

### A. The Financial Sector

13. **The Latvian financial system is relatively small.** It is dominated by the banking sector, with assets the equivalent of about 60 percent of GDP at end-2000 (Table 1). A notable feature of the financial system is the significant share of nonresident deposits and foreign equity in the banking system and of nonresident investment in the securities market. About 50 percent of banks' assets and deposits are foreign, with the bulk of foreign assets held in convertible currencies (Table 2). Foreign ownership accounts for approximately 70 percent of total banking capital in Latvia, a significant part of it from Sweden and Germany. Domestic credit constitutes only 45 percent of total bank assets with the bulk of credits concentrated in the enterprise sector. State ownership of the banking system is relatively minor (3 percent of banking system assets), and consists of the full ownership of the Mortgage and Land Bank and a 32-percent stake in Krajbanka.

14. The nonbank financial sector comprises the stock market, insurance companies, and a handful of private pension funds, brokerage houses, leasing companies and investment funds. Insurance premiums amounted to 2¼ percent of GDP in 2000. This penetration rate for Latvia is the highest among the Baltic States but ranks below Poland at 3 percent and the Czech Republic at 3½ percent of their respective GDPs. Ratios for EU countries generally range higher. Premiums written during 2000 amounted to LVL 96 million (2¼ percent of GDP); life insurance represents only just over 3 percent of the total market volume. Insurance companies invest conservatively. Over 90 percent of investments are made in Latvian assets, 46 percent of assets are held in cash or bank deposits, 18 percent in fixed interest securities (mainly governments), 13 percent in stocks, and 13 percent in real estate.

15. **The capital market is small,** and market capitalization sharply decreased from LVL 513 million in 1999 to LVL 348 million at end-2000 (8 percent of GDP). Several delistings occurred as companies were acquired by strategic investors, including that of Unibanka, which accounted for almost 50 percent of turnover in the equity market. Virtually all equity trading is in a handful of companies on the official list of top tier issuers. Turnover on the Riga Stock Exchange (RSE) grew significantly in 2000 to reach LVL 556 million from LVL 29 million in 1999 as a result of the listing of treasury bonds on the RSE.

16. **There has been significant consolidation in the financial sector.** Larger banks created cross-Baltic banking groups, which have been facilitated mainly by investments from Sweden and Germany. However, there has been less movement towards consolidation among smaller banks, despite the increase in minimum capital requirements, which may be related to the importance of niche banks. Latvia raised the minimum capital requirement to euro 5 million at the beginning of 2000. As of December 2000, Latvia had 21 banks, more than its other two Baltic neighbors combined. The 10 largest banks account for about 80 percent of banking system assets. The smaller niche banks deal primarily with nonresident transactions, and nonresident deposits amount to as much as 90 percent of their deposits. In 2001, the BoL approved the licenses for two additional banks.

Table 1. Latvia: Structure of the Financial System at End-2000

Financial Institutions	Number	Assets	
		(millions of lats)	(percent of GDP)
Banks	21	2,485	57.4
Credit unions	17	1	--
Insurance companies	25	115	2.7
Brokers	22	...	...
Pension funds (third pillar)	4	6	0.1
Investment funds	3	...	...
Leasing companies 1/	5	140	3.2

Source: Bank of Latvia, Insurance Supervision Inspectorate, and Securities Market Commission.

1/ Five companies undertake the bulk of the leasing, three of which are subsidiaries of Latvian banks. Their assets are deducted from banks' assets (first row of the table). In addition, four banks undertake leasing activities in the order of LVL 85 million directly.

Table 2. Latvia: Aggregate Balance Sheet of Commercial Banks, End-September 2001  
(In percent of total assets-liabilities)

Assets		Liabilities	
Foreign	47.7	Foreign	49.3
Convertible	44.8	Convertible	47.5
Nonconvertible	2.9	Nonconvertible	1.8
Currency	1.7	Deposits	36.6
Domestic Credit	45.3	Bank of Latvia	1.8
Bank of Latvia	1.8	Credit Institutions	2.4
Credit Institutions	2.4	Enterprises	14.6
Enterprises	28.7	Households	15.4
Households	6.3	Capital	6.5
Government	6.0	Of which: Foreign	4.3
Other	5.2	Reserves	0.2
		Other	7.3
<b>Total</b>	<b>100</b>	<b>Total</b>	<b>100</b>

Source: Bank of Latvia.

17. In the insurance market, the number of companies operating in Latvia fell from 42 in 1994 to 25 companies in 2000 (17 nonlife and 8 life insurance companies). Higher levels of minimum capital to be maintained by the companies have spurred the consolidation process. Life insurance companies must have at least LVL 2 million of base capital whereas nonlife companies must have at least LVL 1 million. The Insurance Supervision Inspectorate managed the consolidation in an orderly manner. There have been no insolvencies that have resulted in losses for policyholders.

## B. Monetary Policy and Systemic Liquidity

18. **Monetary policy is based on an exchange rate peg to the SDR**, with intervention in the foreign exchange market aimed at maintaining the rate within a band of  $\pm 1$  percent. There is an unofficial policy of keeping foreign reserves at greater than, or equal to, narrow money; and the BoL targets net domestic lending within that objective. The BoL primarily influences liquidity through foreign exchange operations. It also uses indirect instruments, usually the repo and reverse repo facilities. It prefers not to use outright purchases and sales in the secondary market because of their strong impact on the market.

19. **Domestic financial markets are thin.** At end-2000, government securities outstanding totaled LVL 226 million (about  $5\frac{1}{4}$  percent of GDP). The lats interbank market is also shallow. The market is concentrated in about five banks, and one bank accounts for about 25 percent to 30 percent of the market, a large enough percentage to potentially move the market. In contrast, the interbank market for foreign exchange is significantly deeper. Commercial banks have access to lines of credit abroad, as approximately 70 percent of bank capital is foreign-owned. A result of these thin markets is volatility in money market interest rates. Commercial banks' liquidity forecasting is short-term with forecasts typically made for 3 to 6 month periods.

20. **The shallow domestic lats market is compensated by the banks' ability to access the BoL's lending facilities.** While the interbank market is the primary means of satisfying day-to-day liquidity needs, the BoL provides additional liquidity support. Such support amounted to an average credit of approximately LVL 41 million during 2000. While the BoL's foreign exchange swap facility is the predominant means of obtaining liquidity, the repo facility has played an increasing role in supplying lats liquidity, and the Lombard facility was increasingly accessed by banks in 2001 as a result of tight liquidity (Box 1). The lender-of-last-resort facility has been resorted to only twice. In each case, the terms were based on the refinancing rate of the BoL with illiquid collateral as guarantee. A rehabilitation plan for Riga Komercbank in 1999 was the most recent occasion, involving a loan of LVL 18 million to be repaid by December 15, 2001.

21. **The BoL has used two-year foreign exchange swaps to help develop the domestic financial markets.** This has helped to promote long term lending in lats given that banks' sources of long term funds tended to be in foreign currencies rather than in lats. However, the use of long-term foreign exchange swaps also potentially impacts the level of usable reserves. Since March 2001, the share of short- and long-term swaps was about one-quarter of net international reserves and, as such, should be monitored closely.<sup>1</sup> While acknowledging the positive impact this has had in generating long-term lending in lats, the markets are now introducing longer-term instruments, as exhibited in the growth of mortgage

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<sup>1</sup>The swaps also provide a sizeable quasi-fiscal subsidization of financial market operators given the differential between foreign and domestic interest rates and the implicit medium-term exchange rate guarantee.

lending (now available for up to 25 years, and on a fixed-rate basis for up to 5 years). Recent issues of five-year treasury bonds will help to broaden the range of long-term financial instruments, paving the way for corporate bond issues, commercial paper, and other private debt instruments. The BoL reduced the monthly issue volume of long-term swaps from LVL 10 million to LVL 5 million in April, and eliminated them in December 2001.

#### Box 1. Latvia: Main Monetary Policy Instruments

##### *Reserve requirements*

The reserve requirement is applied to average funds received over the month, regardless of maturity and currency, and excludes liabilities to other credit institutions, the state budget, or funds received from foreign branches of Latvian banks. The average vault cash balance that can be used to meet the reserve ratio has been lowered from 50 to 40 percent of the requirement. In order to gradually attain levels set by the ECB, the BoL reduced the reserve requirement for credit institutions to 6 percent on December 1, 2000, and plans to decrease the reserve requirement by one percentage point per year over the next four years to reach the two percent of the ECB. In addition, the cash component requirement will be reduced to 10 percent per year over the same period until eliminated.

##### *Treasury bill and bond auctions*

The BoL primarily acts as the technical agent of the government, organizing sales of government securities through primary auctions. The BoL is not permitted to purchase securities in the primary market, but can participate in the secondary market for government securities. Treasury bills are in 3-, 6-, 9-, and 12-month maturities, and treasury bonds in 2-, 3-, and 5-year maturities.

##### *Repos and reverse repos*

The BoL auctions repurchase agreements of government securities in maturities of 7-, 28-, and 91-days. Reverse report auctions are also available; however, only one tender of reverse repos has been organized in early July 2000, in 7-day maturities.

##### *Currency swap auctions*

The BoL holds regular currency swap auctions, providing banks with funds in lats. Currency swaps are of 7-, 28-, and 91-day maturities in any of the SDR basket currencies. Long-term currency swap arrangements were introduced in May 2000 in two-year maturities, and were conducted once a month. No new swaps were issued after December 2001.

22. **The Deposit Guarantee Fund (DGF) is well funded and appears to provide adequate coverage of deposits.** The DGF is funded by quarterly (non-risk adjusted) payments by commercial banks and initial single payments by the BoL and the MoF of LVL 500,000 each. DGF assets are currently equivalent to 50 percent of covered deposits, and the DGF can access government resources in the event of need. The amount of the guaranteed compensation to a depositor is generous and has been established on an increasing scale through 2008 to LVL 13,000 per depositor per bank.

#### C. Macroeconomic and Financial Sector Vulnerabilities

23. **The macroeconomic environment provides a favorable backdrop for sustained and balanced growth in the financial sector.** Latvia has recovered strongly from the slowdown triggered by the Russian crisis. Real GDP grew by about 6½ percent in 2000 and by 8¼ percent during the first half of 2001 driven by exports and investment with manufacturing, forestry, and services showing strong gains. Inflation has remained subdued

with the CPI rising by about 3¼ percent in the 12 months through October 2001. Latvia has also made good progress in its accession negotiations with the EU.

24. **Notwithstanding the recovery of the economy in general, and the banking system in particular, the latter remains susceptible to an array of potential shocks.** None of these shocks seems to pose significant risks at this point. The most important of these relate to the rapid growth in lending and associated competition among banks, the possible perception of money laundering, a possible increase in domestic interest rates, and the potential for exchange rate movements. The potential effects of these vulnerabilities are quantified in the section on stress testing.

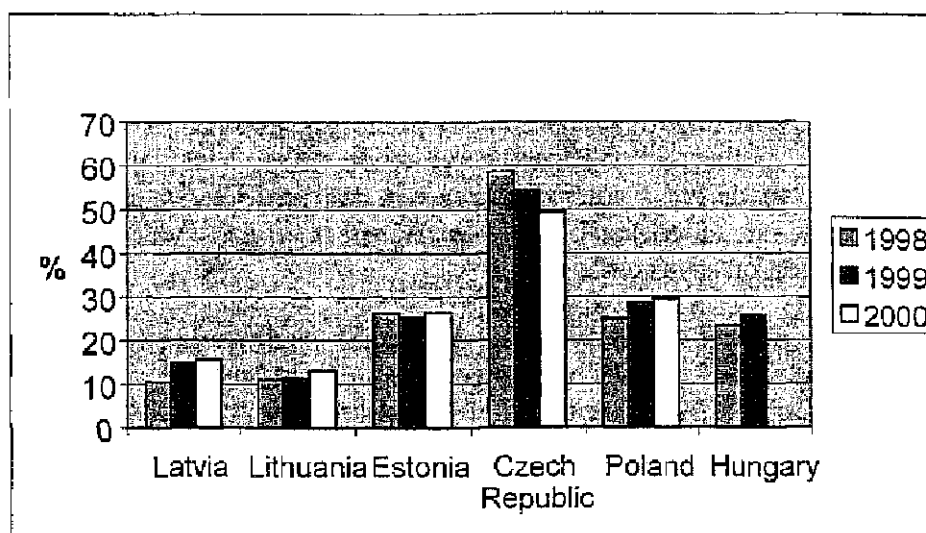
25. **A potential source of risk is related to the rapid credit expansion,** notwithstanding low monetization (M2 was 29 percent of GDP at end-2000) and relatively low levels of credit to the private sector (19½ percent of GDP).<sup>2</sup> Credit to the nongovernment sector increased rapidly—at a rate of 37 percent in 2000—of which credit to households increased by 69 percent. The rapid increase in credit could be a source of vulnerability, although lending to the private sector could be expected to increase further (Figure 1). Competition among banks is leading to pressure on margins, and this could result into a temptation to move into riskier types of lending (Table 3). On the other hand, the growth in credit is benefiting a wider group of borrowers than in the past. Overall, these developments suggest there are potential vulnerabilities emanating from increased credit risk, especially should the current strong rate of lending growth continue.

26. **A further source of vulnerability may be associated with the large fraction of nonresident deposits with Latvian banks.** Overall, these deposits accounted for one-half of total deposits in the Latvian banking system in 2001. About one-half of nonresident deposits are from the U.S., reportedly from Delaware-registered companies. Restrictive regulations in neighboring CIS countries are a factor in the attractiveness of Latvian banks for the nonresident businesses. Hence, there is a risk that both improved regulations and increased financial confidence in these countries may lead to a deposit outflow from Latvia, which may hamper the business prospects of those banks that are largely operating in CIS markets. While these deposits are usually invested in highly liquid OECD paper or redeposited abroad—with little maturity mismatch—the loss of this business could lead to a significant deterioration in profits with possible systemic implications.

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<sup>2</sup>At end-2000, bank credit to the private sector was 27 percent of GDP in Estonia, and 13 percent of GDP in Lithuania.

Figure 1. Latvia: Credit to the Private Sector/GDP



Sources: International Financial Statistics, World Economic Outlook

Table 3. Latvia: Interest Rate Spreads in Selected Countries 1/

	1996	1997	1998	1999	2000	June 2001
Estonia	7.6	13.6	8.6	4.5	3.9	2.5
Latvia	14.1	9.4	9.0	9.2	7.5	6.3
Lithuania	7.6	6.5	6.2	8.2	8.3	8.5
Poland	6.1	5.6	6.3	5.8	5.8	5.8
Slovenia	7.5	6.8	5.6	5.1	5.7	5.7

Source: IMF, International Financial Statistics, and staff estimates.

1/ Based on average deposit and lending rates.

27. **There could also be a serious loss in reputation should it become apparent that some nonresident deposits were to come from suspicious sources.** A loss of reputation could negatively affect investors' perceptions of Latvia as a place in which to do business.<sup>3</sup> Reputational effects may also lead to a decline in nondebt creating inflows that currently finance the current account deficit to a large extent. Furthermore, bona fide businesses from the CIS may redirect their banking needs to other countries to avoid reputational implications for themselves. Confidence in the banking system may also be negatively affected, which could affect the domestic deposit base. Latvia has appropriate anti-money laundering

<sup>3</sup>A number of bank officials indicated their concern about the potential loss of reputation that may arise in the context of possible money-laundering allegations.

supervisory and reporting arrangements in place. Banks are required to report suspicious transactions to the Money Laundering Board (MLB), and the FCMC has imposed steep fines on institutions for failure to report these transactions. Moreover, Latvia has been quick to revise legislation—to encompass funds related to terrorism—following the September 11 events. However, the January 2001 report of the European Committee on Crime Problems and the OECD Financial Action Task Force (FATF) indicated that while Latvia had made significant progress in combating money-laundering activities, additional efforts were needed in enforcement especially with respect to the speed of the legal process, the standards of proof, the confiscation regime, and information sharing.

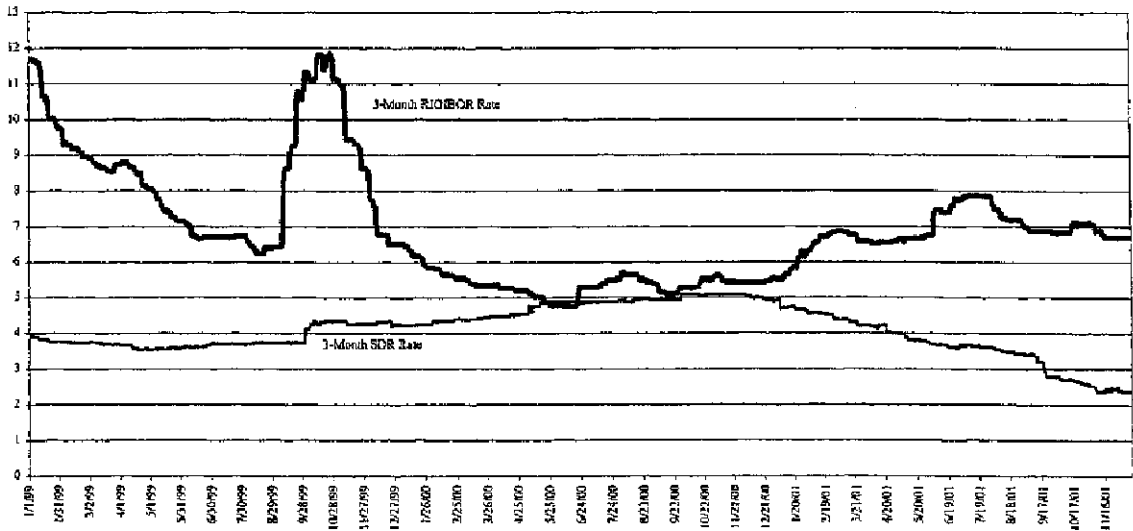
28. **Latvian short-term interest rates have increased in 2001, which can have an adverse impact on borrowers given the short maturity of bank lending.** The market's view of the commitment to the exchange rate peg is reflected in the behavior of interest rate spreads relative to the anchor currency basket; the interest rate differential could also reflect the thinness of domestic money markets. After convergence in late 2000, lats and SDR money market rates diverged steadily to about 400 basis points during the first three quarters of 2001 (Figure 2). Short-term interest rates increased in 2001, related primarily to issues of government securities.<sup>4</sup> The BoL attributed the divergence to the decline in SDR rates while domestic liquidity conditions remained tight. While changes in interest rates are expected to have a manageable first-round effect on banks—given that banks generally match the maturities of their assets and liabilities—it is not clear that their borrowers could easily withstand sharp increases in interest rates, which could affect the quality of bank loan portfolios negatively.

29. **Exchange rate movements between the euro and the dollar also affect commercial banks and their borrowers.** Bank limits on single currency open positions of no more than 10 percent of capital—20 percent for all currencies combined—contain the direct effect of exchange rate movements. However, there may be potent indirect effects, should the euro depreciate significantly relative to the U.S. dollar. Exporters reported in 2000 that their profits suffered severely (when the euro weakened relative to the U.S. dollar). Should such a development recur, export companies dealing primarily in the euro market may experience difficulties in repaying their debts to banks, thus increasing the need to provision for potential or actual loan losses. A significant proportion of loans is in foreign currencies—52 percent of loans to enterprises and 45 percent of loans to households at end-September 2001. Nonetheless, while banks were reported to base their lending decisions on the currency composition of the income of their customers and to offer their customers foreign exchange hedging instruments, lending in foreign exchange to unhedged borrowers—including for residential mortgages—could be a potential vulnerability.

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<sup>4</sup>The government issued LVL 60 million in five-year treasury bonds in January 2001. In contrast to previous issues, the BoL did not accommodate the resulting liquidity absorption.

Figure 2. Latvia: Three-Month Money Market Rates (LVL-SDR), 1999–2001  
(In percent)



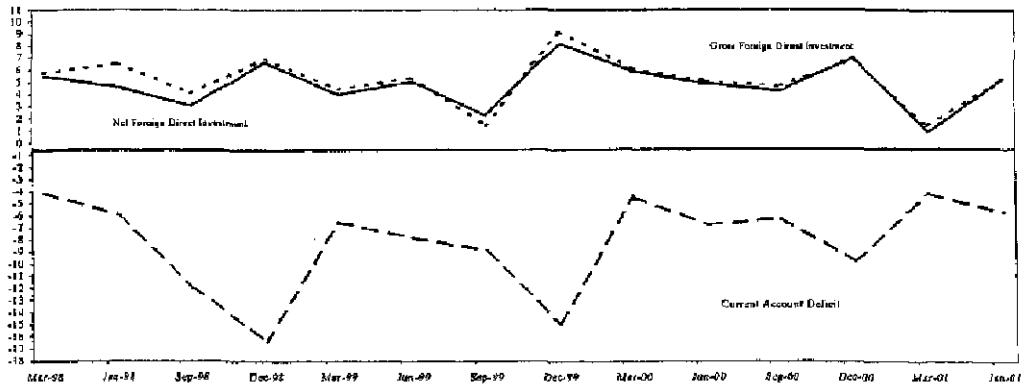
Source: Bank of Latvia, and staff estimates.

30. While the external position and outlook have improved, the current account and its financing remain a source of potential risk in the longer term. The current account deficit fell from close to 10 percent of GDP in 1998 and 1999 to about 7 percent of GDP in 2000, despite an appreciation of the lats against the euro and the sharp rise in oil prices. The share of the deficit financed by foreign direct investment rose from just over half in 1999 to about 81 percent in 2000 as the result of an increase in investment flows and a decline in the deficit (Figure 3). More than one-half of foreign direct investment flows are in the form of equity; this has helped to maintain low external debt to GDP ratios and to reduce the yield spread on Latvia's euro bond relative to the German benchmark bond.<sup>5</sup> The diversification in the composition of exports and markets, moderate growth in real wages, and a decline in unit labor costs indicate that Latvia remains competitive on international markets. An analysis of the sustainability of Latvia's current account deficit is covered in the staff report for the Article IV consultation.

<sup>5</sup>Latvia's (long-term sovereign foreign currency) risk rating is BBB (Standard and Poor's).



Figure 3. Latvia: Current Account and Foreign Direct Investment, 1998–2001.  
(In percent of GDP)



Source: Bank of Latvia and staff estimates.

### III. SOUNDNESS OF FINANCIAL INSTITUTIONS AND MARKETS

#### A. Banks

31. **The banking sector appears to be well capitalized, liquid, and profitable.** Asset quality is high, as evidenced by the low ratio of nonperforming loans, and provisions are adequate. At end-2000, the average risk-weighted capital adequacy ratio was reported at 14 percent. For the period 1996–2000, the funding volatility ratio<sup>6</sup> for commercial banks remained constant at zero, signifying that banks maintained just sufficient liquid assets to cover volatile liabilities. However, the aggregate commercial bank liquidity ratio has declined from 44 percent to 30 percent during 2001 with the rapid increase in domestic credit. The aggregate return on equity at end-2000 was reported at 19 percent, ranging from 13 percent to 40 percent for the major banks (Table 4). Profits have come from a combination of traditional banking operations, trading and investments in financial assets, and the activities of their subsidiaries (predominantly insurance and leasing). Lending operations have represented an important source of income. Banks pay minimal interest on demand deposits, which have consistently represented a high share of total deposits (65 percent at end-2000). The returns on their financial asset portfolios and the performance of their subsidiaries have been variable, resulting in significant losses during the Russian crisis. The high rates of return on equity in 1995, 1996, and 1997—in excess of 26 percent—were followed by significant losses in 1998, due to the substantial losses on trading CIS

<sup>6</sup>The funding volatility ratio was measured as (borrowed funds-liquid assets)/(total assets-liquid assets). Borrowed funds were used as the proxy for volatile liabilities and include liabilities of interbank borrowings; notes; bills; bonds; certificates of deposit; and other debt instruments plus other borrowings regardless of maturity.

financial instruments. Since then, the ratio of nonconvertible foreign currency assets to total assets has been reduced from 37 percent to about 3 percent as banks have significantly strengthened their risk-management practices.

32. **The potential vulnerabilities of the banking system were gauged through stress tests on the eight largest banks**, which account for 75 percent of total banking system assets and 80 percent of total banking system deposits. The results indicate that these banks can absorb the likely effect of the vulnerabilities discussed above without undermining their solvency. An interest rate increase of 5 percentage points—which corresponds to the maximum change over 30 days of the one-month RIGIBOR rate during 1999–2000—and a 10-percent change in the lats value of the foreign currency position of banks—were considered. The CAR of the eight banks decreased only marginally in the two scenarios since banks generally match the maturity of their lats assets and liabilities, and banks' net open positions are fairly small. However, the potential second-round effects, through deterioration in the quality of loans, had more significant—although easily manageable—implications on the CAR. Assuming increases in nonperforming loans in the range of 30 percent to 60 percent (and a provisioning rate of 50 percent), the banks' CARs would fall by only 1 to 2 percentage points. It is important to note that nonperforming loans are fairly small at present, thus even a 60-percent increase would drive one bank only below the prescribed 10-percent CAR.

33. Likewise, the risks associated with the rapid credit expansion should a significant portion of the new credits become nonperforming were found to be small. Assuming a 20-percent increase in the loan portfolio, of which 30 percent become nonperforming, all banks but two would remain above the 10-percent CAR—assuming again that bad loans have to be provisioned for at 50 percent.<sup>7</sup> With a 40-percent increase in loans, of which 30 percent go bad, 4 out of the 8 banks would have CARs below 10 percent.

34. Finally, the effects on profitability of a decline in interest margins and fee income were considered. Fee income could fall should there be a loss of the nonresident business, while interest margins could narrow as a result of competition among banks. A decline in interest income of 50 percent (as a result of smaller margins) would decrease banks' ROA by up to 2 percentage points; the average ROA for the banking system was 2 percent in 2000. Banks that primarily operate in the domestic market would suffer the highest losses, since a large fraction of their income relates to traditional banking services. Conversely, a 50-percent decrease in fee income for banks that deal with CIS markets would reduce their ROA by 1 to 1½ percentage points. As expected, banks that are heavily involved in the nonresident business would suffer more than those banks that primarily operate in the domestic market.

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<sup>7</sup>Some of the banks indicated that they were aiming at a 20-percent loan increase in 2001, while others indicated that they would aim for a 40-percent increase in their loan portfolio.

Table 4. Latvia: Selected Financial Sector Indicators, 1995–2001.  
(In percent, unless otherwise indicated)

	1995	1996	1997	1998	1999	2000	9/2001
Capital adequacy							
Capital adequacy—risk-weighted average	22.9	24.5	21.0	17.0	16.0	14.0	15.0
Capital and reserves (in millions of lats)	103	149	220	196	193	228	266
Liquidity							
Liquidity ratio 1/	63.6	69.7	77.0	36.6	42.9	44.2	30.1
Total reserves/total deposits	14.5	15.8	16.3	16.1	18.9	16.3	14.5
Excess reserves/total reserves	20.6	15.9	18.8	19.3	19.8	7.5	1.2
Asset quality							
Nonperforming loans (in millions of lats)	...	...	51	50	58	54	45
Nonperforming loans (in percent of total loans)	19.0	21.0	10.0	6.0	6.0	4.6	3.1
Loan-loss provisioning/gross loans	23.7	25.1	7.4	4.3	4.0	3.0	1.7
Earnings							
Return on equity 2/	34.0	24.0	26.0	-12.9	11.0	19.0	16.0
Return on assets	1.0	3.0	3.0	...	1.0	2.0	1.3
Income from fees/total income	20.2	20.1	23.9	22.8	23.5	26.2	22.1
Loans and deposits							
Loans/deposits	49.2	40.2	46.4	70.3	65.9	58.3	66.5
Loans/total assets	29.7	23.7	29.7	43.4	43.4	40.3	44.7
Credit to nongovernment/GDP	7.6	6.6	9.8	14.8	15.8	19.6	...
Nonresident deposits/total deposits	27.0	41.4	42.3	37.1	46.9	51.3	48.5
Market risk							
Net foreign exchange position/capital	...	11.4	10.4	15.3	6.7	4.8	...

Source: Bank of Latvia and staff estimates.

1/ The liquidity ratio is defined as: (cash + claims on the central bank + claims on other credit institutions + fixed-income government bonds - liabilities to the central bank - liabilities to other credit institutions) / deposits.  
2/ Return on equity is defined as the ratio of profits to the value of bank-issued equity.

## B. Nonbank Financial Intermediaries

35. **Insurance companies are well capitalized and profitable.** Total capital and surplus maintained by the industry as a whole is approximately 3.5 times the amount required. All companies are in compliance with the minimum standards, and the authorities have adopted the solvency margin formula prescribed for the member countries of the EU. In 1999, profits for the industry as a whole represented 10 percent of average equity, 3½ percent of average total assets, and 2¾ percent of total premiums. The combined ratio of claims and expenses to premiums for nonlife companies amounted to 67 percent in 2000. The insurance market has not reached a size or connectivity with the banks that represents a potential systemic risk to the financial system at large.

36. **Stress tests were undertaken on six large nonlife insurance companies** (which accounted for 57 percent of the assets of the nonlife insurance market in 2000). The tests considered the effect of sharp deteriorations in the stock market, real estate market, liquidity conditions associated with a banking crisis, and the solvency of the banks. The results suggest that the insurance sector is reasonably stable when exposed to these risks. Three (out of six) companies maintained positive capital and were able to meet the required solvency

margin (RSM) under all four scenarios. Under a crisis scenario where insurance companies do not have access to their deposits, three companies would lack the necessary capital to satisfy the RSM, and one company would have negative capital. A marked deterioration in the stock market or in real estate values would leave one company not meeting the RSM, given regulatory limits on investments into equities and real estate. An unexpected increase in claims resulting from liquidity problems would leave three companies not meeting the RSM requirements, and one company would have negative capital. However, these scenarios ignore the potential coverage of claims through reinsurance, although access to reinsurance facilities may take more time to develop.

37. **There are very few pension funds**, and these do not represent a potential source of systemic risk at present. Latvians have traditionally relied upon the state social insurance system to provide income support in retirement. Due to a number of factors such as increased longevity, early retirement ages, an aging workforce, and significant increases in living costs, the state system is no longer capable of providing the expected support.

38. **At present, there are unlikely to be systemic risks from activities in the Latvian securities market.** The market is small and illiquid, and the emergence of domestic institutional investors is at a fledgling stage. However, the lack of more active securities market limits the private sector's borrowing options and concentrates funding risks with the banking sector.

### C. Corporate Linkage with the Financial Sector

39. **Links between enterprises and the banking sector are relatively weak.** About 10 percent of the liabilities of enterprises are credits from commercial banks (Table 5); about 70 percent of bank credits to enterprises are long-term (more than a year). Despite the growth of bank credit and the advanced stage of enterprise restructuring, nonbank flows (such as leasing and borrowing from other enterprises and private persons) remain the most important sources of funds.<sup>8</sup>

40. **The debt-equity ratios of Latvian enterprises are generally low.** Since 1997, the debt/equity ratio of Latvian enterprises has been around 100. This level is comparable with other advanced transition countries (88 percent in Czech Republic in 1999), and low compared with Korea and Thailand (450 percent and 200 percent, respectively) before the 1997 crisis. The debt/equity ratios are significantly higher in the privately owned enterprises, reaching 176 at the end of 1999 and vary significantly across sectors. It was the highest in wholesale and retail trade (311 percent). The sectors with relatively high debt/equity ratios are profitable, so there are no immediate concerns that lending to these enterprises is risky.

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<sup>8</sup>The privatization program has been almost completed (except for several large enterprises) and the share of the private sector in GDP is estimated at about 70 percent in 2000.

Table 5. Latvia: Liability Structure of the Enterprise Sector, 1997–2000  
(In percent, end-of-period)

	1997	1998	1999	2000
Equity capital	51.4	50.3	48.3	49.5
Liabilities	48.6	49.7	51.7	50.5
LT liabilities (nonbank)	11.2	9.6	11.2	11.9
ST liabilities (nonbank)	32.0	29.7	29.7	27.8
Of which: trade credit	12.3	12.5	12.7	12.4
Bank credits	7.6	9.2	9.5	10.1
Of which: LT bank credit	5.4	5.5	5.8	7.3
Of which: ST bank credit	2.1	3.6	3.7	2.8
Debt to equity ratio	94.6	98.8	107.2	101.9

Source: Central Statistical Bureau of Latvia.

#### IV. FINANCIAL SECTOR SUPERVISORY FRAMEWORK

41. **Responsibility for the supervision of the financial sector has been vested in a newly created authority, the Financial and Capital Markets Commission (FCMC), since July 2001.** The FCMC merged the operations that had been undertaken by the Banking Supervision Department of the BoL, the Insurance Supervision Inspectorate in the Ministry of Finance, and the Securities Market Commission. The creation of the FCMC aims at enhancing the stability and safety of the financial markets.

42. **There has been a smooth transition from the three supervisory agencies to the FCMC.** A high priority was accorded to staffing issues (including the appointment of members of the Board), the change management process, internal organizational form, and decision-making processes, public relations, and the relationship between the FCMC and the BoL. The members of the Board of the FCMC were appointed in a timely manner (including representation from the insurance and securities sectors), and an MoU was signed with the BoL regarding the broad objectives of the FCMC and the exchange of information between the two institutions. The transition to the FCMC did not weaken supervision, and has already strengthened the supervision of insurance companies. However, there are no plans to address a few minor issues, notably relating to the law on the appointment and removal of the Chairman and Deputy Chairman, which raises some concerns regarding the likely independence of the FCMC from improper influences.

43. **The FCMC plans to focus on the revision and approval of the regulations of the merged supervisory institutions during the remainder of 2001.** In 2002, it plans to harmonize the financial sector legislation on banking, insurance, and securities, and to bring it into line with EU Directives; and to introduce a unified database for financial sector reporting that would provide for the exchange of information among market participants. The FCMC could place increased emphasis on developing its risk-based supervisory approach (in addition to the emphasis on compliance with legislative requirements), introducing a rating system before 2003, and developing an on-site examination manual for insurance supervisors.

## A. Banking System

44. **The legislative framework governing the supervision and regulation of Latvia's financial sector is sound and comprehensive.** Over the last decade the laws governing the regulation and supervision of the financial sector have undergone significant reform and are now generally consistent with international best practices and EU Directives. The key components of this framework are the Law on the Bank of Latvia (1999), the Credit Institutions Law (1998)—which have been amended to keep pace with the country's rapidly developing banking sector—and the Law on the Financial and Capital Markets Commission (2000). The prudential standards compare quite well to international best practices in all areas (Table 6).

45. **Latvia largely conforms to the Basel Committee Core Principles for Effective Banking Supervision.** Shortcomings are relatively few. One challenge for Latvia's banking supervision is related to the rapid transition of the Latvian economy and its financial sector. Bank structures and activities are changing quickly and laws, regulations, and supervisory implementation do not always keep pace. Staff involved in bank supervision is skilled but they will need to increase those skills in parallel with developments in the financial sector. Latvia is largely compliant with the Basel Committee Rules for the Prevention of Money Laundering, but questions have been raised with regard to the enforcement of anti-money laundering regulations. Measures to address most of the few shortfalls from full compliance are under way. Efforts in recent years have focused on the strengthening of consolidated supervision and the capital charge for market risk. In October 2001, amendments to the Law on Credit Institutions were submitted to parliament that include provisions to (i) terminate banks' close links with third parties and affiliated companies, as well as transactions with such parties, (ii) stop any activity of a bank that may endanger the soundness and safety of that bank, and (iii) conduct (global) consolidated supervision. Additionally, the amendments aimed at enhancing the so-called know your customer rules by requiring banks to have stronger internal controls and stronger monitoring of clients.

Table 6. Latvia: Key Prudential Standards

Standard	Latvian Requirement	International Best Practice
Capital Adequacy: Tier 1	5% of risk-weighted assets, including off-balance sheet items	Minimum 4% higher warranted for transition economies
Capital Adequacy: Total	10% of risk-weighted assets, including off-balance sheet items	Minimum 8% higher warranted for transition economies
Liquidity	30% of liabilities	...
Single large exposure	25% of own funds	Maximum of 25 percent of own funds
Related parties exposure	15% of own funds	Maximum of 20% of own funds
Total large exposure	800% of own funds	Maximum of 800% of own funds
Open foreign exchange position limits	Sum of net short and long positions in each currency limited to 20% of own funds; single currency exposure 10%.	Within limits recommended by BIS Committee.
Country exposure limit	50% of own funds for Estonia and Lithuania; 25% for other non OECD countries	...

Source: Bank of Latvia.

## B. Insurance and Pensions

46. **Latvia largely observes the LAIS Core Principles for Insurance Supervision**, with identified shortcomings limited to the implementation of good corporate governance practices by insurance companies and in respect of reinsurance. The regulatory system for insurance companies is in almost complete compliance with the EU Insurance Directives, and financial reporting follows the EU Directive for insurance companies. The regulations for investments include rules that limit the concentration of assets used to support technical provisions as a function of types of investment and use of a single counter-party. Insurance companies all possess substantial "own resources" implying amounts in excess of those required to cover technical provisions. The statutory requirements place few restrictions on how these own resources are invested and this flexibility has led some to conclude that the insurance investment rules are more lenient than those applicable to pension funds.

47. **The legislation that governs the operation of private pension funds is considered to be restrictive by their managers even though funds have considerable opportunity to diversify their investments.** Pension funds must retain 85 percent of investments within Latvia. In practice, while 15 percent of the assets may be in securities of foreign issuers, those securities must be listed on stock exchanges operating in Latvia. As a result, pension funds confine their investments to government securities and deposits in banks. However, some pension funds arranged asset management side agreements with local banks, whereby the funds deposited are invested in assets and currencies with the investment results credited to the pension fund. Pension fund supervision could develop a prudent management approach

that relies more on prudent investment policies by the directors of pension funds and less on prescriptive rules.

### **C. Securities Market**

48. **The Principles and Objectives of Securities Regulation issued by the International Organization of Securities Commissions (IOSCO) are largely implemented.** The establishment of the FCMC increased the operational independence of supervisors and provided additional resources for supervision. Arrangements for information sharing and cooperation among the domestic financial supervisory also improved.

49. **Some improvements to securities markets regulation could be initiated.** Most regulation occurs through licensing, as the removal of the license (temporary or permanent) is the only effective sanction as fines on market participants have been small and rarely imposed.<sup>9</sup> There are no securities infractions that are criminal in nature, and the authorities should consider making insider trading and market manipulation a criminal violation. Additional measures consist of giving domestic financial sector supervisors indemnity against any actions arising from the normal discharge of their duties; requiring the disclosure of all (legal) insider buying and selling; moving toward a system of electronic filing and reporting for all market participants and issuers; improving internet surveillance; allowing FCMC staff to buy or sell securities for their personal accounts only after receiving a waiver (instead of reporting the transaction ex post); and pursuing investor education efforts.

### **D. Payment Systems**

50. **Cash is the major payment instrument in Latvia (particularly among individuals).** However, banks have introduced advanced payment instruments. Electronic credit transfers, electronic banking, internet banking, and payment cards are widely used, particularly among legal entities. The predominance of credit transfers is a distinguishing feature of the payment systems in Latvia. The most important payment systems are the Interbank Automated Payment System (SAMS) a real time gross settlement system mostly used for interbank high-value transfers, and the Electronic Clearing System (EKS), which is used for retail payments. In 2000 these two systems processed 12½ million payments (99 percent in EKS) with a total value of LVL 22 billion (70 percent in SAMS).

51. **The payment systems are generally efficient. SAMS and EKS, the systemically important systems, operate in accordance with the Committee on Payment and Settlement Systems (CPSS) Core Principles.** The payment and settlement systems have undergone substantial reforms over the last years. EKS was fully implemented in 1999 and the SAMS was established in 2000. These systems use modern means of data processing and have high security standards. SAMS and EKS systems are owned, operated and managed by

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<sup>9</sup>Total fines imposed on brokerage companies and issuers in 2000 were LVL 3,000 or less than US\$5,000.



the BoL. Currently only banks participate in these systems. The areas that need to be addressed to bring Latvia into full observance of the CPSS Core Principles relate to the finality of settlements and netting enforceability in the event of the insolvency of a participant in the system, and to the legal uncertainties concerning the rights of holders of collateral securities in the event of the insolvency of the provider. Amendments to deal with these issues were approved by parliament in October 2001; these amendments brought payment system oversight in accordance with the statutes of the European System of Central Banks.

52. **The two securities settlement systems—the VNS and the LCD—broadly observe the recommendations established by the joint work of CPSS and IOSCO.** The VNS is operated and supervised by the BoL, and it processes operations with government securities in the primary and secondary (OTC) market. The BoL uses VNS to settle its open market operations and register operations with collateral. Participants are domestic and foreign banks and international financial institutions that have a lats settlement account with the BoL (i.e., cash account). VNS settles securities either DVP or on a free-of-payment basis (interbank transactions or pledging of securities). LCD participants are banks, brokerage companies, investors, and securities issuers; banks and brokerages can also operate as intermediaries for third parties. Both systems have an online link to the cash payment systems (settlement of fixed income payments or the cash leg of a securities transaction). Shortcomings relate to legal framework for settlement finality and to the rights of a holder of collateral securities in the event of insolvency of the collateral provider. The VNS does currently not account for confirmation of trades between direct market participants and does not have a securities lending facility.

### **E. Transparency**

53. **The BoL displays a high degree of transparency in its monetary policy.** The predominant vehicle for maintaining transparency and ensuring accountability is through the publication of the monthly Monetary Bulletin, the quarterly Monetary Review, the Annual Report, and the BoL's website ([www.bank.lv](http://www.bank.lv)). Furthermore, decisions by the Board of governors and the executive board are disclosed and explained shortly after respective meetings. The governor reports in monthly press conferences on the conduct of monetary policy, explains the policy objectives of the institution, and describes the BoL's performance in achieving its objectives. One area that could be addressed in order to strengthen the transparency framework is related to the disclosure of the composition of credits to banks. Currently only the Annual Report discloses banks' use of the BoL's repo, Lombard, or refinancing facility, the latter being the emergency financing facility. The BoL indicated that this information would be provided monthly starting in 2002.

54. **The BoL's transparency practices in the areas of banking supervision and payment systems oversight are of a high order.**<sup>10</sup> In banking supervision, a periodic special report and the Annual Report disclose major developments in the banking sector. While the report as well as the major laws are published on the BoL's website, some more specific regulations and guidelines are available upon request. Areas of particular importance are the relationship and information sharing arrangements between the various supervisory agencies and overseas. The BoL has also signed MoUs with other countries' supervisory agencies to facilitate and enhance consolidated supervision. Systemically important payment systems in Latvia are operated and managed by the BoL. In practice, the BoL oversees these systems as the owner and supervisor of banks. However, the BoL Law is very general in terms of the oversight role—it does not specifically give the BoL the oversight authority.

55. **Transparency practices in the capital market sector are also of a high order.** Both the SMC and the RSE maintain excellent websites, which contain English and Latvian versions of recent developments, statistics, legislation (both laws and implementing regulations), licensed intermediaries and useful financial links. The Latvian Central Depository also maintains a similarly professional site. The Enterprise Register provides, through a private company, online access to company financial statements and other key particulars relating to company incorporation. In addition to the domestic agreements to share information, and MoUs have been signed with the other Baltic Securities Commissions, as well as with Denmark and Sweden, on information sharing.

56. **The ISI has made a concerted effort to ensure transparency in its operations.** All legislation and regulations applicable to insurance companies are available through a website. In addition, the website contains copies of quarterly and annual reports issued by the ISI. These reports are also distributed in hard copy form and senior officials of the agency appear at press conferences at the time of each such distribution. Changes in regulations affecting insurance companies are discussed extensively with industry officials and the trade associations in advance of their adoption. Greater transparency in the accounting for assessments collected from insurance companies is recommended.

57. **Overall, the DGF is open and transparent in most of its operations.** The roles, responsibilities and objectives of the DGF are well specified in legislation. Policies and financial reports of the DGF are made public in assorted media, including government publications and newspapers. Areas of particular concern are in the public disclosure of the relationship and information sharing arrangements between financial agencies, areas of information disclosure, particularly with regard to aggregate data and a public information service, and the requirements to appear before a public body and to disclose internal governance procedures.

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<sup>10</sup>The assessments of transparency in the area of banking, securities markets, insurance, and deposit insurance supervision were based on the separate treatment of these functions. On July 1, 2001, these functions were unified under the umbrella of the FCMC.

## V. LEGAL FRAMEWORK

58. **The government has taken a number of steps to develop the commercial sector.** A new market-oriented Commercial Law will be introduced in January 2002. This comprehensive law will improve administrative and corporate governance procedures, simplify the process of registration of new enterprises, and generally bring commercial regulation in line with EC requirements. The types of legal entrepreneurial entities have been reduced from 17 to 5 and, after a transition period, the existing laws on joint stock companies, limited liability companies, partnerships and other such entities will be repealed. Latvia's experience with commercial law issues is still limited and it is likely that the Commercial Law will need further strengthening particularly in the area of supervisory board responsibility as the corporate sector continues to mature. Considerable progress has also been made in computerizing the Commercial Register. The commercial community expressed a high level of satisfaction with the time taken to register new enterprises and with the operation of the new business law framework. However, about 110,000 companies will need to be re-registered, requiring additional investment in staff and computer systems. Sufficient funding should be made available to complete the registration as a matter of priority in order to ensure full and prompt compliance with the Commercial Code.

59. **Latvia's corporate bankruptcy procedures appear to be sound although the process tends to be protracted and the backlog of cases is increasing.** In 2000, the Riga Regional Court records indicated that 665 bankruptcy cases were outstanding at the beginning of the year, 414 new cases were filed, and 272 were completed. The authorities need to review this situation and take steps to appoint sufficient judges to handle the backlog. General enterprise bankruptcies are governed by the Law on Insolvency of Enterprises and Entrepreneurial Associations (1996), which provides comprehensively for amicable settlements and debtor workouts. Creditors rights appear to be satisfactorily protected. Secured creditors' claims take priority after administration costs. Bankruptcy is still a relatively new concept in Latvia but experience to date has been generally positive. The quality and integrity of bankruptcy administrators is of a high level and general satisfaction was expressed with the quality and oversight exercised by the bankruptcy judges. The law has been amended several times in light of experience.

60. **The bank crisis of 1995 and the Russian crisis of 1998 resulted in the bankruptcy of several banks.** Revised procedures to cope with the upsurge in bank bankruptcies have been incorporated in the Credit Institutions Law (1995) and these have been amended on several occasions since that time. Several banks have been successfully rehabilitated and the provisions of the law seem to work well in practice. The quality of those selected to serve as administrators by the courts has been high and the overseeing judges have taken pains to ensure that issues that arise in the course of bank bankruptcies are dealt with on a timely and efficient basis.

61. **Although commercial bank experience with the taking and enforcing of security is still quite limited, the applicable procedures are sound and reasonably well understood by banks, debtors and judges.** Companies may use virtually any of their assets, including intangibles, securities and enterprises registered in Latvia as going concerns, as

part of their collateral. The Law on Commercial Guarantees of 1998 governs security in respect of commercial pledges and, where appropriate, the general provisions concerning pledge rights as set forth in the Civil Code. Anecdotal evidence confirms that the system of taking security works well although enforcement of judgments can often be quite time consuming. Information on the commercial guarantees register is readily available on line. Most bank loans are secured over real estate and, in this case, the applicable law is the Law on Registration of Real Estate with the Land Books of 1997. Virtually all land in Latvia has been registered in the country's Land Books. Land and buildings are registered on the same title certificate and transactions involving sale and registration of transfers of land are uncomplicated. No particular weaknesses were identified with the operation of the Land Book Register. Enforcement of charges over immovable property can be time consuming but the system appears to work reasonably well.

**62. The functioning of the judicial system has improved considerably over the last few years but much remains to be done.** The creation of a division for legal methodology within the Ministry of Justice has already led to improvements in the quality of law drafting. Recent amendments to the Law on the Prosecutor's Office should also lead to improvements in the operation of that office. However, legislation to transform court bailiffs into an independent legal profession has yet to be adopted. The coordination between court bailiffs and the court system needs to be improved in order to ensure the proper enforcement of court decisions, which continues to be a serious problem.

**63. Some criticism of the operation of the courts and of the judges is justified but overall the judicial sector in Latvia compares favorably with that of other transition economies.** Considerable improvements have been made in the areas of judicial training, caseload management, computerization and remuneration of judges. However, at the regional court level, the backlog of cases is high and increasing despite the adoption in 1998 of a new Law on Civil Procedure, which provided the legal basis for shortening the duration of proceedings. There is a need for more judges and further improvements in the infrastructure and security of court buildings. Court procedures can always be improved but overall, the Latvian judicial sector operates efficiently and does not constitute a serious constraint on the country's financial sector development.

## SECTION II. SUMMARY ASSESSMENT OF OBSERVANCE OF STANDARDS AND CODES

- This part contains the summary assessments of the standards and codes that were carried out as part of the FSAP. These assessments were undertaken in February 2001, before the establishment of the Financial and Capital Markets Commission in July 2001 that unified the supervisory authorities for banking, insurance, and securities. The standards that were assessed are (1) the IMF's *Code of Good Practices on Transparency in Monetary and Financial Policies (MFP Transparency Code)*; (2) the *Basel Core Principles for Effective Banking Supervision (BCP)*; (3) *IAIS Core Principles for Insurance Supervision (ICP)*; (4) *IOSCO Objectives and Principles of Securities Regulation (SCP)*; (5) *Committee on Payment and Settlement Systems Core Principles for Systemically Important Payment Systems (CPSIPS)*; and (6) *OECD Principles for Corporate Governance (OCG)*. These assessments provided input in formulating the overall assessment of financial stability in the macroeconomic context, identifying areas for improvement, and an action plan in areas of non-observance.
- *The assessments were prepared by Maria Westerberg (Swedish Financial Supervisory Authority) on the Basel Core Principles for Effective Supervision, Donald McIsaac (World Bank) on the IAIS Insurance Supervisory Principles, Melinda Roth (World Bank) on the IOSCO Objectives and Principles of Securities Regulation, Krzysztof Senderowicz (National Bank of Poland) on the Draft Code Principles for Systemically Important Payment Systems, Susan Rutledge on the OECD Principles for Corporate Governance, and Christian Beddies (IMF) on the Code of Good Practices on Transparency in Monetary Policies. The assessments were prepared on the basis of information provided by the Latvian authorities, discussions with relevant officials, and research by the mission.*
- *Latvia has made significant progress in strengthening financial system supervision and regulation. In general, the assessments show a high degree of observance of all the standards that have been covered in this report. The few deficiencies that have been identified are relatively minor, and the authorities are generally taking measures to address them.*

### VI. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

64. The assessment of the Latvian Banking Sector compliance with the *Basel Core Principles for Effective Banking Supervision (BCP)* was conducted as part of the FSAP for Latvia. The assessment was prepared by Maria Westerberg, analyst, Finansinspektionen (the Swedish Financial Supervisory Authority). It updates previous assessments, namely the assessment conducted by the IMF in September 1998, an update of that assessment in October 1999, and BoL's self-assessment in July 2000. The present assessment takes into account recent developments in the legal framework and it is based on extensive discussions with the Banking Supervisory Department of the BoL. The BoL cooperated fully with the assessment and provided all the necessary clarification and documents.

65. This assessment evaluates compliance with the BCP using the Core Principles Methodology Document (October 1999). It should be noted that the assessment examined the status of the Banking Supervision Department in February 2001. The Banking Supervision Department was subsequently unified with the Securities Market Commission and with the Insurance Supervision Inspectorate on July 1, 2001. The newly created Financial and Capital Markets Commission changed the institutional framework on which this assessment is based.

### **Institutional and macroprudential setting, market structure—overview**

66. Latvia's financial sector is based on the universal banking model, with banks owning approximately half of the domestic non-bank financial institutions. In February 2001, there were 21 banks of which 1 bank was state-owned and 12 banks were foreign-owned. Subsidiaries of Estonian, Finnish, Swedish, German, and Russian banks as well as a branch of a Finnish bank operate in Latvia. The state-controlled bank accounts for about 3 percent of the sector's assets, but it is dominant in certain activities, notably mortgage lending and taking small deposits. Seventeen small credit unions operate in Latvia, but their effect on the financial system is marginal.

67. The BoL was responsible for banking supervision and regulation. Enforcement was strengthened in the wake of the 1995 crisis, which led to a sharp fall in the number of banks, including the closure of the largest commercial bank. Supervisory regulations are in some aspects more stringent than the minimum standards set out by the Basel Committee. The BoL closely tracks a range of prudential ratios and conducts regular on-site examinations of banks. The LCI requires that a bank that fails to maintain a minimum risk-weighted capital adequacy ratio of 10 percent be placed under intensified supervision, which gives supervisors wide-ranging powers to intervene in the bank's operations. The aggregate risk-weighted capital ratio declined from about 25 percent at the end-1996 to 14 percent at end-2000. Nonperforming loans declined from 10 percent of total loans at the end of 1997 to 4½ percent at the end-2000.

### **Preconditions for effective banking supervision**

68. The legal framework for banking is provided by the Law on the Bank of Latvia, the Law on Credit Institutions, and numerous prudential regulations and guidelines issued by the BoL. The BoL issues operating licenses to credit institutions and is entitled to revoke these licenses in the event of noncompliance with the procedures for conducting operations stated by the BoL. The BoL is also entitled to issue other requirements regulating activities of credit institutions to reduce risk in credit institutions' activities and to protect creditors' interests. Credit institutions are required to submit all BoL-required information to them.

69. The BoL requires that an auditor it authorized audit the annual accounts of banks. Credit institutions choose the auditor from a list of auditing firms approved by the BoL (only internationally recognized auditing firms have been on the list up to now).

### **Main findings**

70. The regulation and supervision of the Latvian Banking Sector has improved in recent years, and laws and regulations have been harmonized with EU legislation. Latvia was assessed as having a high degree of compliance with the Core Principles, and most of the Core Principles were assessed as "compliant." The banking supervision responsibilities and objectives of the BoL are outlined in the laws and regulations, and the BoL is operationally independent and has adequate resources for the task. The legal framework for banking supervision includes adequate provisions relating to the authorization of banking

establishments and their supervision; powers to address compliance with laws; safety and soundness concerns; legal protection for supervisors; arrangements for sharing information between supervisors; and for protecting the confidentiality of such information. Permissible activities of licensed institutions are clearly defined, and the BoL sets criteria and rejects applications for establishments that do not meet the standards test. Bank supervisors have the authority to review and reject proposals to transfer significant ownership or controlling interests, and establish criteria for reviewing major acquisitions and investments by banks.

71. Prudential limits are compliant with the Core Principles. Minimum capital adequacy requirements are more stringent than those established in the Basel Capital Accord. The BoL evaluates banks' credit policies, has limits on large exposures, connected lending, country risk, market risk, and internal audit and control systems in line with the Core Principles. Amendments to the Law "On Credit Institutions" that are expected to be approved by parliament by the end of 2001 will ensure full compliance with the CP on investment criteria. These amendments will entitle the BoL to request any bank to terminate close links with third parties (including affiliated companies) or prevent transactions with them if such links may endanger the bank's stability or hinder the BoL in effecting supervisory functions. More explicit regulations—which are planned to be developed—on interest rate risk in the whole banking portfolio would further increase compliance.

72. Rules for the prevention of money laundering are in line with international standards. The law on the prevention of laundering of proceeds derived from criminal activity became effective on June 1, 1998, and the guidelines for developing procedures for identifying suspicious financial transactions were implemented on January 1, 2001. The regulations require the mandatory reporting by financial institutions of cash transactions larger than LVL 40,000. According to the law, financial institutions are obliged to report without delay any unusual or suspicious transactions. However, while unusual transactions are explicitly specified, suspicious transactions are not explicitly specified, and credit institutions decide on whether a transaction is suspicious based on internal rules and procedures. Moreover, the minimum "suspicious amount" is relatively high. The number of reported cases was 4,014 in 2000, of which 40 cases were forwarded to the Prosecutor's Office.

73. The Latvian banking supervision system consists of on-site and off-site supervision, and bank supervisors have regular contacts with bank management and a thorough understanding of bank operations. Bank supervisors collect, review, and analyze banks' prudential reports and statistical returns on a solo and consolidated basis, and use on-site examinations and auditor reports to validate supervisory information. Supervision is conducted on a consolidated basis, accounting standards are satisfactory, host-country supervision, and supervision over foreign banks, is compliant with the relevant Core Principles. The expected amendments to the Law on Credit Institutions noted above will also ensure compliance with Core Principles related to corrective action and to overseas supervision. One challenge to Latvia's banking supervision is related to the very rapid transition of the Latvian economy and its financial sector. Bank structures and activities are changing quickly and laws, regulation, and supervisory implementation do not always keep pace. Banking supervision is skilled, but could maintain skills in line with developments in the financial sector.

Table 7. Latvia: Basel Core Principles for Effective Banking Supervision—Main Findings

CPs Main Categories	Main Findings
Objectives, Autonomy, Powers, and Resources	<p>The BoL's supervisory objectives and responsibilities are defined clearly in the laws and regulations. The BoL has operational independence and adequate resources. The legal framework for banking supervision is suitable, including for the authorization of banking establishments and their ongoing supervision, and compliance with the laws and as well as soundness and safety concerns, and legal protection for supervisors.</p> <p>An amendment to the Law "On Credit Institutions" that will state explicitly that the BoL and its employees are not responsible for losses incurred to the credit institution or third parties, if they carry out their duties professionally and in good faith, would further improve compliance. This regulation is expected by end-2001.</p>
Licensing and Structure	<p>The Law "On Credit Institutions" provides an explicit definition of a credit institution and its permissible activities; licensing criteria and procedures are adequate; and bank supervisors have effective authority to review and reject significant transfers or controlling interest in banks.</p> <p>The amendments to the Law "On Credit Institutions" that entitles the BoL to request any bank to terminate close links with third parties (including affiliated companies) will strengthen compliance with the BCP. This amendment is expected by the end of 2001.</p>
Prudential Regulations and Requirements	<p>The BoL has effective supervision and regulation of credit institutions' investment criteria, capital adequacy, credit policies, loan evaluation and loan loss provisioning, large exposure limits, connected lending, country risk, market risks, other risks, and internal control and audit.</p> <p>More explicit regulations on interest rate risk in the whole banking portfolio would further improve compliance.</p> <p>Rules for the prevention of money laundering are in line with international standards, but their enforcement could be further strengthened.</p>
Methods of Ongoing Supervision	<p>The BoL conducts effective on-site and off-site supervision. BoL supervisors maintain regular contact with bank management, supervise banks on a consolidated basis, and have means for independent validation of supervisory information.</p>
Information Requirements	<p>The laws and regulations governing accounting standards and practices enable supervisors to obtain a true and fair view of the financial conditions of banks.</p>
Formal Powers of Supervisors	<p>While supervisory measures are generally adequate, amendments to the Law "On Credit Institutions" regarding the BoL's ability to stop bank activities that endanger, or may endanger, safety and soundness would further improve compliance.</p>
Cross-border Banking	<p>Rules and regulations are generally satisfactory. Compliance will be strengthened further by an amendment to the Law "On Credit Institutions" that entitles the BoL to request any bank to terminate close links with third parties (including affiliated companies) or prevent transactions with them if such links may endanger the bank's stability or hinder the BoL in effecting supervisory functions will strengthen compliance. This amendment is expected by the end of 2001.</p>



## **Recommended action plan and authorities' response**

74. The authorities disagreed with the "largely compliant" assessment of the principle related to money laundering; the BoL's self-assessment rates the BoL as compliant with that principle. The authorities indicated that all rules related to the prevention of money laundering that have to be observed by credit institutions are adequately enforced by the supervision department. There were no disagreements on other issues.

## **VII. CPSS CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT PAYMENT SYSTEMS**

75. The assessment of the Latvian payment and settlement systems was performed as part of the FSAP for the Republic of Latvia. The main objective of the assessment was to determine the level of observance with the Basel Committee on Payment and Settlement Systems (CPSS) Core Principles for Systemically Important Payment Systems; with the draft recommendations for securities settlement systems being established by the joint work of CPSS and IOSCO; and to suggest areas where further development may be appropriate.

76. Krzysztof Senderowicz, deputy director, Payment Systems Department of the National Bank of Poland, prepared the assessment. The assessment was based on a review of the legal framework and extensive discussions with the BoL and the Latvian Central Depository officials.

### **Institutional and macroprudential setting, market structure—overview**

77. As of December 31, 2000, there were 21 banks and 1 branch of a foreign bank operating in Latvia. While banks provide most of the payment services to the general public, the BoL plays the principal role in establishing and operating the interbank clearing and settlement systems. The BoL operates SAMS—Interbank Automated Payment System (an RTGS system) and EKS—Electronic Clearing System (retail net payment system). Currently, only banks are participating in these systems. The central bank provides deposit accounts, which banks use for the settlement of all payment transactions between them. These accounts are also used for maintaining banks' compulsory reserves.

78. As in other countries there are close links in Latvia between the payment system and the securities settlement systems. There are two such systems in Latvia. One of these systems (called VNS) is operated by the BoL and one by the Latvian Central Depository (LCD). The Securities Market Commission supervises the LCD.

79. Foreign exchange transactions are based on correspondent relations. Payment and settlement systems in Latvia operate only in domestic currency.

80. The BoL has explicit legal responsibility for the Latvian payment system. The basic approach of the BoL to payment system policy is that it should develop and run the most important payment systems.

## **General preconditions for effective payment systems**

81. Payment systems are critical to the effective functioning of the financial system. They are the major channels by which disruptions are transmitted, and sometimes they themselves can be the potential source of instability in the financial system. Development of a sound and effective payment system, compliant with internationally accepted standards and practices, should be one of the basic goals of any institution involved in payment systems policy definition.

## **Main findings**

82. Payment systems in Latvia are generally efficient, and SAMS and EKS largely observe the CPSS Core Principles. SAMS and EKS systems are owned, operated, and managed by the BoL. Currently, only banks participate in these systems. The few areas that could be addressed to bring Latvia to full observance of the CPSS Core Principles are the following:

- The existing law should be amended to improve the recognition of the finality of settlements and netting enforceability in the event of the insolvency of a participant in the system. According to BoL officials, this uncertainty is a theoretical rather than practical problem. The decision to suspend the operations of a bank is always taken by the BoL before such a bank is being declared bankrupt. There is therefore no problem to the systems operated by the central bank. Nevertheless, the provisions of existing law are not formulated clearly enough to ensure the settlement finality and netting enforceability, and could be a potential source of risk for the systems' stability and functioning.
- There is legal uncertainty concerning the rights of holders of collateral securities in the event of the insolvency of the provider. According to the Civil Code (Article 132): If the pledgor and the pledgee have reached a particular agreement that in the case of failure to pay, the pledged asset is to be sold immediately, then the former shall not be responsible for reminding or notifying in advance the latter on his intention to sell the asset. However, the "Law on Credit Institutions" (which establishes procedures for supervision, insolvency, bankruptcy, and liquidation of credit institutions) does not explicitly exclude any claims against the pledgee, especially if there is no particular agreement. The BoL has recognized these uncertainties, and appropriate amendments to the Law on the Bank of Latvia, to the Law on Credit Institutions and to the Law on Securities have been prepared. It is expected that amendments will come into force in 2001.
- With regard to the responsibility of the central bank in applying the Core Principles, the BoL has not publicly disclosed its payment system roles and the major policies it will follow to achieve its objectives for systemically important payment systems. The BoL also has no clearly defined oversight role over the payment system. The "Act on the Bank of Latvia" makes the central bank responsible for the payment system, but does not explicitly detail instruments to carry out an oversight.

Table 8. Latvia: Observance of CPSS Core Principles for Payment Systems—Main Findings

Subject	Main Findings
Well-founded legal basis in all relevant jurisdictions	There is legal uncertainty concerning the finality of settlements and netting enforceability, as well as the rights of holders of collateral securities, in the event of the insolvency of the provider.
Understanding of the system's impact on risks and procedures for the management of risks	The system's rules and procedures are clear and allow participants to understand the system's impact on each of the financial risks they incur through participation in it. The procedures for the management of credit risks and liquidity risks are defined clearly and specify the respective responsibilities of the system operator and the participants.
Final settlement, inability to settle by the participant with the largest single settlement obligations	SAMS is an RTGS system fulfilling this principle under normal circumstances. There is legal uncertainty concerning netting and settlement finality in retail payment system.
Assets for settlement	Assets used for settlement are claims on the central bank.
Security and operational reliability and contingency arrangements	SAMS and EKS ensure a high degree of security and operational reliability.
Practical for the markets and efficient for the economy	SAMS and EKS seem to be efficient for participants and the economy. They provide a sophisticated, low risk payment facilities for banks and, indirectly, for all users of payment system.
Objective and publicly disclosed criteria for participation	The objective criteria for being a participant in SAMS and EKS are defined in the "Regulation for Interbank Settlements Effected by the BoL. The regulation is publicly available in paper form and on the BoL's web site.
Governance of the system should be effective, transparent and accountable	SAMS and EKS are owned and managed by the BoL. Management of the BoL approves all changes concerning payment system and relevant regulations. In 1997, the BoL signed an agreement with leading Latvian commercial banks on the establishment of the National Payment Consultative Council.
Responsibilities of the Central Bank in applying the Core Principles	Major policies with respect to the payment system oversight were not publicly disclosed. The ability to carry out the oversight responsibility is not clear.

### Recommended next steps and authorities' response

83. The authorities noted that banks participating in the payment system could pledge securities as collateral. Each bank has signed an agreement with the BoL, which includes the BoL's right to sell collateral immediately in the case of a bank's failure to repay a loan. Therefore, a bank's insolvency cannot prevent either the system or the central bank from freely disposing of pledged assets. Nevertheless, amendments to existing law have been prepared in order to eliminate legal uncertainty concerning settlement finality and netting enforceability, as well as about the rights of collateral securities' holders in the event of the insolvency of the provider. These amendments were passed by Parliament in October 2001, and are expected to be in force as of January 2002.

## VIII. IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

84. This assessment covers the Latvian securities sector for which regulation and supervision were largely the responsibility of the Securities Market Commission (SMC) until end-June 2000. The main objectives of the assessment were to determine levels of observance of the International Organization of Securities Commissions (IOSCO) principles and to suggest areas where further development may be appropriate. This assessment was undertaken as part of a FSAP report on Latvia.

85. The assessment was conducted by Melinda Roth, Senior Financial Sector Specialist, Financial Sector Development Department of the World Bank. The assessment is based on the recently completed Latvian IOSCO self-assessment; as well as a review of the securities laws; SMC annual report; internet site and other documents; Riga Stock Exchange (RSE) annual report; documents and internet site; information from the Latvian Central Depository (LCD); Latvian market research information from investment banks; and other publicly available information. Extensive discussions were held with the SMC, including the heads of most of the relevant departments. In addition, meetings with market participants, the RSE, LCD, and the new Financial and Capital Markets Commission also provided input.

86. The assessment is based on the Principles of Securities Regulation adopted by IOSCO in September 1998. There were no adaptations made for specific country circumstances to the IOSCO Principles, as Latvia is a full member of IOSCO and has an established securities regulator. There is no established methodology for the assessment, but the principles themselves contain detailed explanations and specific areas, which should be observed under each principle. It should be further noted that the assessment was based on the status of the Securities Market Commission in February 2001. The SMC merged as of July 1, 2001, into a unified financial sector regulator along with banking supervision and the insurance agency.

### **Institutional and market structure**

87. The SMC was established in 1995 through the implementation of the Law on Securities. This Law, along with the Regulations on the Securities Market Commission (1997), is the main normative act that regulates the operations of the Securities Market Commission. Since July 1, 2001 the new Financial and Capital Markets Commission has had responsibility for regulation and supervision of the securities sector.

88. *Riga Stock Exchange:* The Riga Stock Exchange (RSE) trades stocks and treasury bonds. Currently, the RSE has 15 members out of which the majority are banks and the rest are brokerage firms. The RSE was established in 1993 and trading began in July 1995. Since 1997, the RSE implemented continuous trading at variable prices. All securities are dematerialized. Further improvements to trading were made in 1999 primarily in order to deal with block trades for debt securities. In 2000, the RSE became the first exchange in the region to offer investors direct access to trading through the internet.

89. Securities trade on an official list, a secondary list, and a free market. Total market capitalization was 8 percent of GDP at end-2000 (LVL 348 million or approximately US\$580 million). Total turnover increased sharply in 2000 (to LVL 556 million or approximately US\$926 million) following the listing of treasury instruments. In 2000, 63 companies were traded on the RSE (8 on the official list; 14 on the second list, and 41 on the free list). Residents accounted for 52 percent of turnover. There is also an over-the-counter (OTC) market for financial instruments. In 2000, the OTC market for shares was 20 percent of the total market turnover.

90. *Market intermediaries:* There are 22 licensed brokerages in Latvia, most of whom are banks. Five investment companies are licensed to operate investment funds, but currently only three funds are operational, which focus on money market instruments. Four third-pillar private pension funds exist, though they manage in total only LVL 6 million (and the majority of this is managed by the telecom company-related pension fund). Two brokerage firms (both major Latvian banks) each accounted for slightly more than 20 percent of RSE turnover; six other brokerages each accounted for between 8–12 percent in 2000.

91. *Debt markets:* Turnover in the debt market on the RSE was equivalent to 4 percent of GDP. The nominal value of government securities in 2000 was LVL 255 million (approximately US\$425 million), while the value of other debt securities was LVL 29 million (approximately US\$48 million). These non-government bond issues include mortgage bonds and two foreign lat-denominated issues (both bilateral Scandinavian institutions). Corporate bond offerings, if any, are arranged privately through the banks. Neither commercial paper nor municipal bond markets exist. There is no regulated public derivative market in Latvia.

92. *Market infrastructure:* The Central Depository (LCD) offers clearing and settlement, and acts as a central depository. It complies with most of the G-30 international standards. Securities are held in book-entry form (dematerialized), and the computerized systems enable fully automated trade processing. Trades settle on (T+3), according to the delivery versus payment (DVP) principle. The RSE uses a direct link to transmit information on concluded trades to the LCD on a daily basis. A mutual guarantee mechanism enforces joint responsibility for all LCD members to ensure full settlement of all trades.

### **Preconditions for securities regulation**

93. The preconditions for effective securities supervision are numerous, but perhaps most critically include sound and sustainable macroeconomic policies conducive to investment and savings; enforceable property rights; a supportive political environment free from corruption; well developed infrastructure (such as legal and accounting practices, clearing and settlement systems, payments system); and an effective judicial system. Corporate governance and insolvency mechanisms are also necessary. These appear to be largely in place in Latvia, with only a few noted exceptions regarding investment and tax regulations.

94. IOSCO also lists several attributes necessary for effective regulation: no unnecessary barriers to entry and exit from markets; markets should be open to the widest range of participants who meet specified entry criteria; regulators should consider the impact of requirements when developing policy; and all who make financial commitments or promises must bear an equal regulatory burden. These preconditions appear to be met in Latvia.

### **Main findings**

95. The Financial and Capital Markets Commission (FCMC) will be responsible for regulation and supervision of the securities sector since July 2001. This consolidation of domestic regulators should serve the securities regulator well, as it should provide greater independence, more resources, and stronger institutional capacity.

96. Both SMC and the RSE continue to adapt to the dynamic situation that exists in all securities markets. The Securities Law was amended several times, mainly to comply with EU Directives. Other changes in the legal and regulatory are proposed, including (1) changes to the capital adequacy requirements for intermediaries; (2) details relating to the EU settlement finality directive; and (3) establishment of an investment guarantee scheme.

97. Other areas still require improvement, such as coordination between domestic financial sector regulators. This should happen once the FCMC is fully established, as it will help the Latvian financial sector supervisors to better understand the risks that market intermediaries are taking. Another improvement would be the ability for SMC to impose criminal sanctions for market manipulation. Indemnity for supervisors is also needed. Disclosure on proper insider buying and selling should be instituted.

98. Several minor areas of improvement are also suggested, such as (1) establishing an ex ante system of SMC/FCMC personal security transaction reporting; (2) restrictions on SMC/FCMC/RSE/LCD staff from participating on security market participants boards or other bodies; (3) electronic filing of required reports; (4) licensing of investment advisors; and (5) developing exposure limits for brokerages.

### ***Principles relating to the regulator***

99. The responsibilities of the SMC are stated in the following laws: Law on Securities (1995); Law on Securities Market Commission (1995); and Law on Investment Companies (1998). The Securities Market Commission Law and the subsequent regulations adopted by the Cabinet of Ministers in 1997 regulate the operations of the SMC. These acts establish the SMC and state its function to protect the interests of the public when investing in securities.

100. Reliance on the state budget and supervision by the Ministry of Finance decrease the operational independence of the SMC. However, the new Law on the Financial and Capital Markets Commission will change the structure of the SMC, and these principles should become fully implemented, given the independence of the new commission and its stable source of financing through levies on market participants.

101. While the new FCMC should have the necessary resources and capacity to carry out effective supervision of the Latvian market, the capital markets are changing rapidly through both globalization and new technology, and it will be important for the FCMC to maintain both resources and capacity to ensure continued successful supervision.

### *Principles of self-regulation*

102. The SMC grants a license to and supervises the Riga Stock Exchange (RSE) and also supervises the Latvian Central Depository (LCD). Both are nonprofit joint stock companies that are considered as Self-Regulatory Organizations. They both issue their own rules and regulations, as well as rights and responsibilities of their members. However, the SMC must approve of all of these regulations and by-laws.

103. As of February 2001, the RSE has 15 members, including 13 banks and 2 brokerages. The RSE is responsible for establishing and enforcing standards of conduct for its members. In particular, the RSE is responsible for rulemaking in regard to trading practices, fair and orderly operation of trading facilities, and financial responsibility of their members. The RSE is also responsible for enforcing the listing rules for the three organized markets. The SMC has a direct on-line connection to the RSE.

104. The LCD organizes clearing and settlement for trades concluded both on the stock exchange and the OTC market. As LCD participants have corresponding securities accounts with the LCD, the LCD settles securities positions. Cash positions are cleared in the BoL according to the instructions of the LCD. The LCD will debit/credit a participant's corresponding cash accounts with the BoL for settlement of securities trades. In addition, the LCD engages in some supervision of its participants, and informs the SMC of any problems.

### *Principles for the enforcement of securities regulation*

105. Supervision is conducted through both regular reporting requirements of all market participants as well as limited inspections of licensed participants, as a result of a suspected irregularity. Reliance on small fines or revocation of licenses for enforcement is a weakness in the enforcement powers of the SMC. Moreover, the lack of criminal sanctions and the limitation on fines severely constrains the SMC's abilities.

106. Staffing that supports SMC's enforcement area appears adequate, although with the increasing allure of the internet as an investment and information dissemination tool (including for fraudulent activities), the FCMC may need to strengthen the areas of inspection, investigation, and surveillance.

### *Principles for cooperation in regulation*

107. The Securities Market Commission, the BoL, and the Insurance Agency have signed an agreement for mutual cooperation. Domestic supervisory authorities are obliged to inform each other of any irregularity uncovered during the supervisory procedure if such irregularities are relevant to the work of other supervisory authority. To date, the SMC has

signed MOUs with Denmark, Estonia, Lithuania, and Sweden. Other MOUs are currently in process with Iceland, Luxembourg, and Norway.

108. The SMC meets quarterly with other Baltic commissions, as all three are trying to harmonize their regulatory framework with EU Directives.

### *Principles for issuers*

109. The prospectus for public offering presents information with the purpose to enable investors to make an assessment with regard to the issuer's legal status, its financial standing, prospects, and the rights attaching to the securities. In addition, public corporations are also subject to continuous obligations. Corporations must disclose information on matters or events that would be expected to have material effects on the price or value of the securities traded on the exchange, including the acquisition of a 10-percent interest in any listed company or any transaction completed by an interested party (including insider buying and selling). Any acquisition of 10 percent of a listed company must be reported to the issuer and the SMC within seven days from the time the event has occurred. This seven-day lag is unfair to the market and should be disclosed immediately to all market participants. Legitimate insider buying and selling are not mandated to be disclosed at all.

110. All shareholders must be treated equally. In the case of takeovers, all the shareholders of the target company must be treated equally. If, for example, the bidder changes the price of securities during the offer, shareholders who already accepted the offer may withdraw from the previous offer and accept the new, better one. Once 50 percent of the shares of a company are acquired, the acquirer must launch a takeover for the remainder of the shares.

111. Latvian accounting standards follow the concept of international accounting standards (IAS) as well as European Union Directives. Amendments to existing legislation have been prepared to harmonize the Latvian framework with IAS. All public companies have to engage a certified auditor to audit their annual financial statements.

### *Principles for collective investment schemes*

112. The Law on Investment Companies (1998) defines the conditions and processes of licensing for investment funds. This law complies with the relevant EU Directive in the field of investment funds and investment companies (mostly with the UCITS Directive). Investment funds are not a legal entity, but rather the pool of assets belonging to investors in the fund, managed by an investment company and held by a custodian bank. The SMC grants permits to investment funds to publish their prospectuses and offer their units for sale to the public. Supervision of mutual funds is accomplished through semiannual reports to the SMC and annual audited reports.



113. The SMC, once merged into the FCMC, will also be responsible to license and supervise second pillar pension funds. However, the treasury will manage these funds from July 1, 2001 through end-2002 during the transition period, while private asset managers are licensed. Resources will likely need to be increased to handle the activities associated with pension fund supervision.

#### *Principles for market intermediaries*

114. The Law on Securities (Chapter VI) and the Law on Investment Companies and related regulations define entry criteria, capital and prudential requirements, supervision, and other relevant standards for market intermediaries. The SMC licenses both mutual funds as well as pension funds, and sets minimum entry requirements.

115. The segregation of assets is an integral part of each Latvian intermediary's responsibilities. The custodian bank maintains an individual account for each client and then has a corresponding account with LCD.

116. The SMC has drafted an investment protection guarantee scheme, which would comply with EU Directives. This law is currently awaiting government approval and is expected to be sent to parliament shortly.

117. Whether or not prudential requirements and margin levels are set appropriately are only known ex post. The relationship between the banks and their financial intermediary subsidiaries, off-balance sheet affiliates, and related parties renders this principle difficult to assess. However, regulation cannot remove risk from the marketplace, but only ensure that proper management of that risk occurs.

#### *Principles for the secondary market*

118. According to the Law on Securities, the SMC supervises the fair and orderly operation of the RSE. Article 30 of the law states that the SMC must license the RSE. The SMC also approves all of the rules and regulations of the RSE. Stock exchange transactions may only be conducted by RSE members. Trading is based on the automated processing of orders entered into the system. All securities are included in the daily continuous trading at varying prices and, as the price of different orders matches, a trade is automatically concluded (unless a single price or continuous trading at a fixed price is utilized). The trading system also allows an audit trail of all member-trading actions.

119. Insider trading should be made a criminal act and the fines allowable by law should be increased to permit the SMC to disgorge illegal profits gained from market manipulation.

120. The recently passed capital adequacy regulations (effective as of July 1, 2001) have detailed descriptions of risk ratings for various securities and required capital for market intermediaries. Banking legislation mandates exposures of banks; however, there are no regulations for large exposures for brokerages.

121. LCD offers clearing, settlement and custody services, and acts as a central securities depository. Multilateral netting in LCD, the pledge of securities in both LCD, and the BoL system creates legal uncertainty, since finality settlement and the rights of holder of collateral securities in the event of insolvency are unclear. Amendments to comply with the EU Directives regarding the finality settlement are proposed.

Table 9. Latvia: Observance of IOSCO Objectives and Principles of Securities Regulation—Main Findings

Subject	Main Findings
Principles relating to the regulator	Independence will improve under the newly created FCMC.
Principles of self-regulation	The RSE operates efficiently.
Principles for the enforcement of securities regulation	Lack of criminal sanctions and the limitation on fines severely constrains the SMC's enforcement abilities.
Principles for cooperation in regulation	Domestic coordination should improve under the newly created FCMC.
Principles for issuers	Disclosure requirements appear comprehensive, except the seven day lag to report acquisitions of over 10% could be shortened dramatically and disclosure of legitimate insider buying and selling should be mandatory.
Principles for collective investment schemes	The Law on Investment complies with the relevant EU Directive.
Principles for market intermediaries	The relationship between the banks and their financial intermediary subsidiaries, off balance sheet affiliates and related parties renders these principles difficult to assess.
Principles for the secondary market	Insider trading should be made a criminal act and the fines allowable by law should be increased to permit the SMC to disgorge illegal profits gained from market manipulation.

### Recommended next steps and authorities' response

122. The few weaknesses should be eliminated with the merger of the SMC into the FCMC, as most of the remaining issues involve financial accountability (the SMC is currently a budgetary organization). The methods of appointment, financial independence (and introduction of fees to market participants), greater cooperation between domestic financial regulators, and political accountability should all improve.

123. Remaining issues include (1) indemnity for supervisors acting in good faith in the normal discharge of their duties, and (2) staff investment policy so that the current ex post system is abolished in favor of one in which staff must obtain a waiver to make personal investments.

## IX. IAIS CORE PRINCIPLES

124. The assessment of the Latvian Insurance Sector was performed as part of the FSAP for Latvia. The main objectives of the assessment are to determine the levels of observance with the International Association of Insurance Supervisor (IAIS) principles, and to suggest areas where further development may be appropriate.

125. The assessments were prepared by Donald McIsaac, lead insurance specialist, Financial Sector Department of the World Bank. The assessment was based on a review of the legal framework, and extensive discussions with the supervisory authorities and market participants. The legal framework for the Latvian Insurance Sector is based on the Law on Insurance Companies and Their Supervision (1998 with subsequent amendments) and the Law on Insurance Contract (1998 with subsequent amendments). Relevant sections of the Law on Joint Stock Companies also apply to the insurance sector. Supervision of the sector was performed by the ISI, an independent public administration institution operating under the supervision of the Ministry of Finance until end-June 2001. The ISI was unified with the Banking Supervision Department and the Securities Market Commission on July 1, 2001. The newly created Financial and Capital Markets Commission changed the institutional framework on which this assessment is based.

126. The supervisory staff of ISI cooperated extensively in the assessment, by providing answers to an extensive questionnaire, preparing a self-assessment against IAIS Core Principles and making them available to meet with mission members at every opportunity.

127. In addition to the information and statistics provided by ISI, a report containing industry statistics was obtained from the association of Latvian insurance companies. This was supplemented by details provided by individual insurance companies. Useful meetings were also conducted with the Association of Insurance Brokers and the Association of Actuaries. The assistance provided by all these organizations is gratefully acknowledged.

128. This assessment was based on the Core Principles Methodology Document that was adopted by the IAIS at its annual meeting in October 2000. Consideration was also given to the Supervisory Standard on Solvency Assessment.

### **Institutional and macroprudential setting, market structure**

129. As of end-2000, there were 25 licensed insurance companies operating in Latvia, all incorporated locally. Ownership of companies is not restricted and foreign shareholders control 9 companies. There are two mutual insurance companies. Linkages with local banks are not common although two companies are affiliated with banking groups. There are 8 life insurance companies and 17 nonlife companies. Composites are not permitted in Latvia.

130. Total premiums received by Latvian insurance companies during 2000 amounted to an estimated 95.7 million lats, of which 3.8 million (4 percent) was for life insurance and 91.9 million for nonlife insurance. Total premium income is estimated to represent 2.2 percent of GDP. An insurance penetration of these proportions ranks Latvia as a leader in

the Baltic region, although it ranks behind Poland and the Czech Republic and considerably below the levels prevailing in the European Union. Total assets for Latvian insurance companies as at end-2000 amounted to an estimated 115.2 million lats or approximately 2.7 percent of GDP.

131. The Republic of Latvia has adopted the European Union formula for minimum solvency of insurance companies. As at the end of 2000, most companies had solvency positions that exceeded minimum requirements by a comfortable margin. For example, the average solvency margin for nonlife companies was 3.5 times average requirements. The ISI reports that only one joint stock nonlife company with market share of 1.09 percent that failed to meet the minimum margin as of October 1, 2000. This company was identified as a subsidiary of a foreign insurer.

132. Major changes were implemented in 2001 with the creation of a new financial supervisory agency. This assessment was prepared considering only the situation prevailing prior to the transfer of those responsibilities and makes no attempt to assess the effectiveness of insurance supervision after July 2001.

133. The regulatory system for insurance companies has evolved steadily. The Law on Insurance Companies and Their Supervision, and the Law on Insurance Contracts were both adopted in 1998. There have been two sets of revisions to these laws since that time, implying that a serious effort is made to keep the legislation up-to-date. The latest revisions move the Latvian regulatory system into almost complete compliance with the EU Insurance Directives. Financial reporting now follows the EU Directive for insurance companies. The regulations for investments include rules that limit the concentration of assets used to support technical provisions as a function of types of investment and use of a single counterparty. Insurance companies all possess substantial "own resources" implying amounts in excess of those required to cover technical provisions. The statutory requirements place few restrictions on how these own resources are invested but it should be noted that, currently, insurance companies invest conservatively. Over 90 percent of investments are made in Latvian assets; 46 percent of assets are held in cash or bank deposits, 18 percent in fixed interest securities, mainly governments, 13 percent in stocks, and 13 percent in real estate.

#### **General preconditions for effective insurance supervision**

134. The legal system in the Republic of Latvia is similar to that which prevails in Germany. Companies are incorporated according to the Law on Joint Stock Companies, although this is soon to be replaced by a new commercial law. The Law on the Insurance Contract provides rules that govern the construction of an insurance policy and governs the relationship between insurance policyholders and their companies to some extent. This would supplement consumer protection measures available under the older Civil Law. The legal framework for insurance is somewhat lacking in the area of corporate governance. Existing corporate law for general-purpose corporations in Latvia does not follow modern best practices in this area, which affects the situation of insurance companies, although the Law on Insurance Companies and Their Supervision contains several clauses that are designed to clearly establish the governance responsibilities of the board of directors. However the

provisions do not go far enough in protecting the interests of policyholders and accountholders in financial institutions.

135. According to the provisions of the Law on Insurance Companies and Their Supervision, the system of supervision that prevails in Latvia is based upon solvency monitoring and the setting of tariffs is left to the discretion of the companies, except in compulsory lines of business. Authorities have made a determined effort to conform legislation and other statutory instruments, such as Cabinet of Ministers Regulations to the regulatory/supervisory system prescribed for member countries of the European Union through the various directives issued by the latter.

136. Accounting and auditing rules are also relevant for the performance of the insurance sector. Accounting for insurance companies is prescribed through a special Cabinet of Ministers Regulation that implements essentially the same accounting rules as are prescribed for companies in the EU. Local accounting experts have advised that the accounting standards in use conform reasonably well to emerging international best practices for insurance company accounting. Annual statements of insurance companies must be audited by an external sworn auditor, authorized by ISI. The legislation specifies that the auditor is to inform the supervisor of any breach of the law, or of a developing situation that could impair the ability of the company to meet its obligations.

### **Main findings**

137. The regulation and supervision of the Latvian insurance sector has developed to a high degree since transition with considerable improvement in recent years, including adoption of a more modern insurance law that is more harmonized with EU legislation, and that, *inter alia*, introduces EU solvency criteria. During many years in the 1990s, the ISI was provided with technical assistance by experts in insurance supervision from EU member countries, particularly Denmark and Germany. The ISI has established a regular program of training for its supervisory staff.

138. The head of ISI has considerable independence from political or other influences and can issue or withdraw licenses on his own authority. Officials have expressed the view that they lack 'financial independence' since the budget is subject to approval by both the ministry and parliament. Levies are collected from companies at a rate specified by the cabinet of ministers. However, if ISI's expenses do not consume the entire levy, the government has the right to use the surplus for other purposes, although it has done so on only one occasion at the end of 1999. The development of the supervisory function would benefit from greater independence and more adequate resources for staffing and training.

139. Major changes are contemplated for the year 2001. Plans call for the creation of a new financial supervisory agency in Latvia and the existing insurance supervisory operations will be transferred into that agency. This assessment was prepared considering only the situation prevailing prior to the transfer of those responsibilities and makes no attempt to assess the effectiveness of insurance supervision after July 2001.

### *Licensing and changes in control*

140. A comprehensive licensing review process has been established. Shareholders, officers, and managers are subject to “fit-and-proper” tests. The process would be strengthened if it included an assessment of the capacity of the shareholder to augment the capital, as that is dictated by future growth or changing circumstances. The ISI is to be complimented for the fact that it has established criteria that it will use to assess the suitability of the new shareholders when changes in control occur. The objective is to ensure that parties acquiring shares are subject to similar review, as would be applied to an applicant seeking to start a new company.

### *Corporate governance and internal controls*

141. Corporate governance practices are not well established in Latvian Commercial Law; however, there are several references in the insurance legislation that impose specific responsibilities on the board of an insurance company. Further progress in this area will depend on further development of corporate governance in Latvian law and business practice. The ISI has distributed guidance material indicating to insurance companies its expectations in the area of internal control. Inspectors review such matters during on-site inspection.

### *Prudential rules*

142. Latvian authorities have done an excellent job in establishing rules for establishment of liabilities, capital adequacy, and solvency measures. The mission recommended that the supervisor should direct all companies to establish risk management policies, although it has to be mentioned that investment portfolios in place at present consist mainly of loans to government and deposits in banks. The ISI is planning to issue a binding decree in the current year that will prescribe the necessary policies to be adopted by companies.

### *Market conduct*

143. There is a provision for the establishment of a guaranteed fund that will serve as a kind of deposit insurance to cover losses suffered by policyholders in the event of the failure of an insurance company. This fund will be in operation as of July 1, 2001. The ISI does not play the role of ombudsman and this concept does not exist elsewhere in Latvia; neither does it have the authority to compel companies to establish formal policies on fair treatment of their clients nor does it oblige companies to establish procedures to deal with conflicts of interest.

### *Monitoring, inspection and sanctions*

144. The authorities have adopted financial reporting rules that conform to those specified for member companies of the EU by community directives. Further development of the risk-based approach to on-site inspection work is recommended. Comments from company

officials suggest that inspections focus mainly on compliance checking and verification of data. The authorities are provided with an impressive range of sanctions for dealing with problems of noncompliance or financial stress.

*Cross-border operations and supervisory coordination and cooperation, and confidentiality*

145. At present, the ISI does not permit the licensing of foreign companies on a branch basis. All companies operating in Latvia at present are established as domestic corporations. The Law on Insurance Companies and Their Supervision specifies that all employees of ISI are forbidden to disclose any information acquired while working for the inspectorate. However, the Law does authorize ISI to enter into a Memoranda of Understanding with supervisors in other jurisdictions that provide for the exchange of confidential information.

**Recommended next steps and authorities' response**

146. Notwithstanding the significant progress in insurance regulation and supervision, the ISI could further strengthen its observance of IAIS Core Principles if it were to be provided with greater financial independence and immunity for staff in respect of legitimate actions taken in the conduct of their duties by (1) enhancing its ability to refuse licenses based on evidence of illegal transactions or improper connections; (2) amending the general commercial law to strengthen corporate governance and internal controls; (3) promoting the use of modern risk management procedures, asset liability management, (4) strengthening procedures for review of reinsurance arrangements; (5) clarifying the ISI's role in consumer protection and issuing specific instructions in this regard; (6) developing a risk-based approach to inspections; and (7) refusing to license insurance companies if their structure impedes proper supervision.

147. The insurance supervisory authorities were generally pleased with the assessment, and they pointed to a series of legislative and regulatory adjustments that are contemplated to be introduced within the 12 months following the assessment mission:

- The launch of the Finance and Capital Markets Commission will be the most important change. This Commission will unite the supervisors of banking, insurance, and securities markets.
- Proposed amendments to the Law on Insurance Supervision will enable FCMC to refuse to issue licenses when there is concern about an applicant's close relationships with persons of improper connections.
- Before the end of the first quarter of 2002, an order will be issued specifying the expectations for internal audits among insurance companies.
- A similar order to govern investments by insurance companies, including risk management considerations, will also appear by the first quarter of 2002.

- With respect to market conduct, amendments to the insurance law are planned for end-2001, which will require each insurer to develop written internal procedures for fair treatment of policyholders. It is expected that the new FCMC will establish more comprehensive measures for consumer protection, which will apply across the financial sector.

Table 10. Latvia: Observance of the IAIS Insurance Supervisory Principles—Main Findings

Subject	Main Findings
Organization of an Insurance Supervisor	The ISI is independent of political influence from an operational point of view. However, while resources appear to be adequate, the budget approval process suggests that the agency does not have financial independence. Staff should be granted immunity from legal actions.
Licensing and Changes in Control	The licensing review process would be strengthened if it included an assessment of the capacity of the shareholder to augment the capital as that is dictated by future growth or changing circumstances. The ISI has established criteria that it will use in making the assessment of suitability of the new shareholders.
Corporate Governance and Internal Controls	Corporate governance practices are not well established in Latvian Commercial Law. However there are several references in the insurance legislation that impose specific responsibilities on the Board of an insurance company and ISI has distributed guidance material indicating to insurance companies its expectations in the area of internal control.
Prudential Rules	The ISI has adopted the solvency margin rules applicable in the member countries of the European Union. Investment rules as well as rules for the establishment of liabilities are closely harmonized with those in the EU and are prescribed through the legislation and a supporting series of regulations and decrees.
Market Conduct	Guarantee fund will soon be issued to cover policyholders' losses in the event of company insolvency. The ISI responds to complaints and inquiries from the public concerning insurance matters. It attempts to resolve disputes by providing clarification and by establishing proper communication between company and client. The ISI does not play a role of ombudsman and this concept does not exist elsewhere in Latvia.
Monitoring, Inspection and Sanctions	The authorities have adopted financial reporting rules that conform to those specified for member companies of the EU by Community Directives. Further development of the risk-based approach to on-site inspection work is recommended
Cross-Border Business Operations; Supervisory Coordination and Confidentiality	All companies operating in Latvia at present are established as domestic corporations.



## X. OBSERVANCE OF OECD CORPORATE GOVERNANCE PRINCIPLES

148. The assessment of the quality of corporate governance in Latvia was performed as part of an FSAP, conducted February 14–28, 2001 in Riga. The assessment was conducted by determining the levels of observance with the OECD Principles for Effective Corporate Governance (the “OECD Principles”). The assessment also identifies areas where further development may be appropriate.

149. Susan Rutledge, Senior Private Sector Development Specialist of the Europe and Central Asia Region of the World Bank prepared the assessment. Peter Kyle, Senior Counsel of the World Bank assisted her with issues related to the functioning of the court system. The assessment was based on a review of several pieces of legislation and extensive discussions with government officials, financial supervisors, and numerous segments of the private sector. In particular, the assessment reflects extensive technical discussions with the Securities Market Commission, the Riga Stock Exchange, the BoL, the State Insurance Inspectorate, the Latvian Privatization Agency, the Latvian Central Depository, the Enterprise Register, a member of parliament, and professional services firms. The review is also based upon two self-assessment questionnaires completed by the Securities Market Commission for the purposes of an assessment of the corporate governance principles of the Organization for Economic Co-operation and Development (OECD) and of the Objectives and Principles of Securities Regulation of International Organization of Securities Market Commissions (IOSCO). Excellent cooperation was received from all agencies and, in particular, from the Securities Market Commission.

### Background

150. For the purposes of the OECD Principles, corporate governance is “that structure of relationships and corresponding responsibilities among a core group consisting of shareholders, board members, and managers designed to best foster the competitive performance required to achieve the corporation’s primary objective.” (*A Report to the OECD by the Business Sector Advisory Group on Corporate Governance*, April 1998).

151. In recent years, Latvia has made substantial and sustainable improvements in governance of the corporate sector. In particular, the 1999 amendments to the Joint Stock Company Act provided a strong basis for improved shareholder rights, including the introduction of cumulative voting for members of the supervisory boards. In April 2000, a new Commercial Code was approved that further developed shareholder rights for both joint stock companies and companies with limited liability. In addition, the Code consolidated several pieces of commercial legislation and strengthen shareholder rights in three key ways:

- The supervisory boards will have the authority to request whatever information is needed for them to fulfill their duties;
- The boards will be formally responsible for hiring and firing the executive management board; and

- The members of the supervisory board will have fiduciary responsibility. They will have liability for acts of “maliciousness” or “negligence”—liability that cannot be summarily waived, as was permitted under the Joint Stock Company Law.

152. Implementation of the Commercial Code now awaits approval of transition legislation that will define the transition period. The key issue is a technical one—the need to re-register some 110,000 enterprises with revised company by-laws. However, with sufficient resources, the Enterprise Register is expected to be able to re-register the enterprises within a relatively short period of time.

153. Of the 110,000 enterprises in Latvia, about 3,000 are joint stock companies. Another 60,000 are limited liability companies and the balance is largely small businesses. Sixty-three companies are listed on the Riga Stock Exchange, although over 90 percent of trading is conducted for the six to eight companies on the top-tier official list of companies. At under 10 percent of 1999’s GDP, Latvia’s stock market capitalization remains relatively low even for an emerging market transition economy.

154. One of the key issues for the immediate period will be the consolidation of the regulatory agencies for the financial sector under the Financial and Capital Markets Commission. The Commission will absorb the existing Securities Market Commission into the consolidated agency. Other reports related to the FSAP discuss the implications of the new agency in its regulatory function. However, it is clear that further development and deepening of the securities market in Latvia will depend on the capability of the new agency to act as an effective regulator of the securities market—and to institute improved levels of corporate governance and market-place behavior. The report provides a summary of the key issues in corporate governance in Latvia and summarizes recommendations on measures to further improve governance of the corporate sector.

155. It must be pointed out that in most countries, banks and insurance companies are typically subject to specific and stricter governance rules, relative to those applied to all other financial and nonfinancial companies. This includes, for example, the duty of boards to implement and monitor systems of risk management and internal controls. This difference is justified due to the nature of the business and the critical importance of minimum capital requirements in these industries. The assessment of corporate governance does not comprise an analysis of specific governance rules for banks and insurance companies. This analysis is done in the specific assessments for banks and insurance companies.

### **Main findings**

156. Sound corporate governance requires a convergence of market practices, laws, and regulatory oversight. An effective court system is also required, to resolve the meaning and application of key legal requirements, to provide enforceable remedies in civil litigation and to penalize those who breach the criminal law.

157. The corporate governance framework for Latvia either fully observes or largely observes the OECD Principles of Corporate Governance, with the exception of detailed measures to ensure that supervisory boards provide strategic guidance for the company and effective monitoring of company management. Progress has been substantial, particularly in the completion of core laws and regulations, and in strengthening key institutions, such as the court system. Most of the principles of corporate governance were considered to be observed or observed with minor qualifications. Some technical issues remain regarding full disclosure of beneficial ownership and the general lack of understanding in the investment community of the disclosure requirements of the Law on Concerns, which requires disclosure of both direct and indirect holdings. Other technical problems relate to the practice of publicly traded companies issuing closed (private) share subscriptions, where the company maintains the share register and the information is not made available to the central depository and cannot be verified. Additionally, the shares from the private subscriptions cannot be freely traded.

158. Of still greater importance are two key areas in need of development:  
(1) strengthening the capacity of the Securities Market Commission (and its successor) to investigate and review cases of possible insider-trading and market manipulation; and  
(2) establishing detailed guidelines (or legal minimum requirements) for supervisory boards.

159. Development of the securities market regulator is becoming a key issue in the transition economies, particularly those moving rapidly towards accession to the European Union. As Edward Glaesser, Simon Johnson, and Andrei Shleifer have pointed out in their study of the regulation of financial markets in Poland and the Czech Republic in the 1990s, strict enforcement of the securities laws by an effective regulatory agency in Poland was associated with a rapidly developing stock market. By contrast, in the Czech Republic after the initial flurry of privatizations on the stock market, less strict enforcement was associated with weak development of the stock market. (*Coase versus the Coasians*, Harvard, NBER, and Massachusetts Institute of Technology (MIT), forthcoming).

160. In particular, care needs to be taken to change the common perception of a stock market being controlled by company insiders. To date, several cases of insider trading and market manipulation have been opened but the Commission lacks sufficient resources to adequately address the complex issues of investigating insider trading.

161. The second key issue relates to the supervisory boards. The Commercial Code establishes strong liability for malicious or negligent acts by members of the supervisory board against which the practices of a careful and honest manager are to be judged. However, the absence of any existing guidelines or industry standards will make it difficult for any judge to determine where malicious or negligent acts have occurred.

162. It is therefore important that the securities industry in Latvia develop such standards for members of supervisory boards. Based on international best practices, at a minimum the standards should cover (a) definition of the roles, authorities, and responsibilities of the supervisory boards, (b) description of the minimum professional qualifications for supervisory board members, and (c) structure of the committees within the supervisory boards, including committees for audits and financial accounts, nomination of board

members and a compensation review committee. In addition, companies should be required to prepare—and publish—their internal guidelines on defining the roles and responsibilities of members of the supervisory boards.

163. The guidelines can be set by law (for example, as is the case in Sweden) or established as a set of guidelines against which listed companies must disclose their degree of compliance (as is used on the London Stock Exchange). Certainly the move towards joining the Nordic Exchange will assist in development board guidelines compatible with the Scandinavian countries. In particular, the experience of Sweden may be a helpful example.

164. In addition, consideration could be given to creating a formal body responsible for overseeing and promoting appropriate standards of corporate governance. Alternatively, the authorities might wish to encourage bodies such as the Chamber of Commerce, or the Riga Stock Exchange, to develop such standards.

165. It may also be helpful to consider developing training programs for members of supervisory boards. Training could be developed by an institute or university, or through a newly created institute for supervisory board members. In this respect, the Swedish model set of training programs for directors might also be particularly helpful.

#### **Response to the assessment and recommended action plan**

166. The Securities Market Commission has provided technical comments, which have been included in the revised assessment.

167. To strengthen the quality of corporate governance further, the regulatory authorities should consider the following measures:

- Develop guidelines on the roles, responsibilities, operations, and structure of supervisory boards;
- Establishing training programs for members of supervisory boards;
- Require that companies disclose their internal governance mechanisms;
- Strengthen the Latvian auditing professional capacity and increase the maximum liability for auditors;
- Ensure that the business community is familiar with the disclosure requirements discussed under the Law on Concerns—and complies with the requirements—perhaps through the development of notes on implementation of the law;
- Ensure that the Securities Market Commission (and its successor) have sufficient resources to fully investigate and review cases of possible insider trading; and
- Ensure that the Enterprise Register has sufficient funding to re-register enterprises and thus allow for rapid implementation of the new Commercial Code.

## XI. TRANSPARENCY OF MONETARY AND FINANCIAL POLICIES

### A. Monetary Policy

#### Legal framework, institutions, and market structure—overview

168. The BoL introduced a fixed exchange rate regime in February 1994, pegging the lats to the SDR. Since then it has demonstrated a large degree of independence, and a proactive approach towards disclosure and transparency in its conduct of monetary policy. The public has been acquainted with monetary developments, and with the implementation of monetary policy through monthly, quarterly, and annual reports, as well as monthly press conferences. The BoL's website is very informative in all areas of monetary policy.

169. Monetary policy in Latvia is based on achieving price stability through maintaining the exchange rate peg. The BoL's policy is based on the principle of facilitating free competition, effective allocation, and circulation of assets; and the stability, coordination, and supervision of the financial system.<sup>11</sup> Within the exchange rate arrangement, the BoL is entitled to set the official exchange rate of the lats against foreign currencies, and to perform foreign exchange operations at its discretion. The exchange rate peg is defined as a narrow band of +/-1 percent with an automatic intervention mechanism. In the longer term, and in the context of EU accession, the authorities will consider replacing the SDR peg with a euro peg.

170. According to the Law on the Bank of Latvia (BoL Law) 1999, the BoL is accountable to Saeima, the Latvian Parliament. While the minister of finance is entitled by law to participate in meetings of the board of governors of the BoL, such participation does not include any voting rights. Contrary to practices in some other countries, the BoL is not required by law to report regularly to Saeima on the monetary policy stance—an *Annual Report*, including audited financial statements, is required by the BoL Law. The BoL maintains an excellent website, which contains—apart from monetary data relevant laws and regulations—speeches and special notes by the governor, who also reports monthly on the overall economic situation and the monetary stance in a press conference.

171. The responsibilities of the BoL in all matters relating to monetary policy are outlined in the BoL Law, the Law on Credit Institutions (1998), and various regulations. The Constitution (1998) does not make any reference to the central bank in general or to the central bank as the responsible entity to conduct monetary policy.

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<sup>11</sup>The BoL's supervisory functions—the supervision of banks—were taken over by a new unified agency, the Financial and Capital Markets Commission, in July 2001. Since then the supervisory functions, as referred to above, have been covered by the Law on Financial and Capital Markets Commission (FCMC) and the Law on Credit Institutions.

172. The BoL uses an array of instruments for monetary policy purposes: including reserve requirements, open market operations, foreign exchange operations, deposit facilities, and refinancing facilities. Among the refinancing facilities, presently, the only standing facility is the Lombard facility, which constitutes the upper bound of BoL interest rates. The deposit rate is the lower bound of BoL interest rates. Repo, reverse repo, and foreign exchange swap operations are conducted through auctions. Beginning 2001, reserve requirements were reduced from 7 percent to 6 percent; the cash fraction that can be counted toward meeting the minimum reserve requirement was reduced from 50 percent to 40 percent. It is envisaged that reserve requirements will be brought in line with ECB practice in four years.

173. The supreme managing body of the BoL is the board of governors. The board determines the general monetary policy; sets interest rates for the BoL's asset and liability operations; and makes all necessary decisions to ensure the implementation of monetary policy in accordance with the BoL Law. The executive board of the BoL is responsible for the implementation of board directives and the practical activities of the bank. Within the BoL, the monetary policy department is responsible for analyzing macroeconomic and, in particular, monetary trends, forecasting monetary and macroeconomic conditions, and drafting monetary policy proposals for consideration by the board.

### **Main findings**

174. The BoL displays a high degree of transparency in its monetary policy. The predominant vehicle for warranting transparency and ensuring accountability is through the publication of the monthly *Monetary Bulletin*, the quarterly *Monetary Review*, the *Annual Report*, and the BoL's website ([www.bank.lv](http://www.bank.lv)). Furthermore, decisions by the board of governors and the executive board are disclosed and explained shortly after scheduled or extraordinary meetings. The governor reports in monthly press conferences on the conduct of monetary policy, explains the policy objectives of the institution, and describes the BoL's performance in achieving its objectives. It also allows for the exchange of views on the state of the economy and the financial system.

175. The responsibilities of the BoL for formulating and implementing monetary policy, as well as the authority to use monetary instruments, are clearly defined in legislation and publicly disclosed. The relationship between the BoL and the government, and the broad modalities of accountability of the BoL are specified in legislation. Framework, targets, and instruments of monetary policy are conveyed to the public through various means of disclosure. The BoL further discloses comprehensive information on the macroeconomic situation and its implications for monetary policy in a timely fashion. The BoL Law ensures accountability to the Saeima. Annual financial reports, as well as quarterly and monthly financial statements, are regularly and timely disclosed to the public.

176. To further strengthen the transparency framework, the main areas where the BoL's existing practices could be improved are described below:

***Clarity of roles, responsibilities, and objectives***

177. The BoL Law broadly defines the bank's main objective to implement monetary policy by controlling the amount of money in circulation with the aim to maintain price stability in the state. The exchange rate peg to the SDR is not specified in any legislation or regulation but widely known to the public.

***Open process for formulating and reporting decisions***

178. The conduct of monetary policy and the principles on which it is based are very open and transparent. Decisions of the board, as well as the underlying economic considerations of monetary policy decisions, are timely disclosed through various means.

***Public availability of information on monetary policy***

179. The BoL provides a wide range of information and publications, and subscribes to the IMF's Special Data Dissemination Standard (SDDS). However, some key elements relating to the BoL's market operations, such as information on the aggregate market transactions, the amounts and the terms of refinance facilities other than swaps or repos, are only disclosed to the public through the *Annual Report*.

180. The BoL's balance sheet contains information on the aggregate amount of financing facilities, including the Lombard facility. However, no details are published regarding the composition of credit to banks, i.e., the split between demand Lombard, overnight Lombard, repo, refinancing (which is the emergency facility), and other facilities on a frequent basis. This information is only available through the *Annual Report*.

181. The BoL indicated that both of these issues are going to be addressed, and such information will be made available to the public on a monthly basis from 2002 onwards.

***Accountability and assurances of integrity***

182. A high degree of transparency also exists with respect to the BoL's public accountability, including the preparation of the *Annual Report*, audited financial statements, and regular appearances before the media. While the BoL has detailed internal governance procedures, stated in various internal regulations, these are not published through the website or by other means. However, if requested, the BoL would provide such information to interested parties.

183. There are no officially stated legal protections for officials and staff of the BoL. However, in practice, staff are protected by insurance, as such the transparency practice related to this issue is not applicable. However, since Article 33, BoL Law states that BoL employees will be responsible for any violation of the laws established by the Republic of Latvia, which may arise in the course of their official duties, uncertainties may exist as to the practical consequences of such potential violations.

## Recommended next steps and authorities' response

184. The authorities did not disagree with any part of the assessment. All factual corrections and additional information provided by the authorities have been reflected in the text.

Table 11. Latvia: Observance of MFP Transparency Code—Monetary Policy; Main Findings

Subject	Main Findings
I. Clarity of roles, responsibilities and objectives of central banks for monetary policy	Both the responsibilities of the BoL for formulating and implementing monetary policies as well as its authority to utilize monetary instruments for that purpose are clearly defined in legislation and disclosed to the public. The broad modalities of accountability of the BoL and the relationship between monetary and fiscal operations are specified in legislation.
II. Open process for formulating and reporting monetary policy decisions	The monetary policy framework, instruments, and targets of monetary policy are conveyed to the public through multiple means of disclosure.
III. Public availability of information on monetary policy	<p>The BoL maintains a widespread publications program and an excellent website.</p> <p>Some minor weaknesses, however, remain in the following areas: (i) key elements relating to the BoL's market operations, such as information on some of the aggregate market transactions—e.g. Lombard transactions and transactions related to the deposit facility—are only disclosed to the public through the <i>Annual Report</i>; (ii) only the BoL's annual financial statements contain details regarding the composition of credit to banks, i.e. the split between demand Lombard, overnight Lombard, repo, refinancing (which is the emergency facility), and other facilities, thus aggregate information on emergency financial support, is disclosed annually only.</p> <p>These areas are currently being addressed and the BoL indicated that such information would be provided on a monthly basis from 2002 onwards.</p>
IV. Accountability and assurance of integrity by the central bank	The BoL Law assures the BoL's accountability to Saeima, the Latvian Parliament. Annual financial statements and monthly summary balance sheets are published regular and in a timely manner. While the BoL has detailed internal governance procedures, stated in various internal regulations, these are not published through the website or other means. However, if requested, the BoL would provide such information to interested parties.



## **B. Banking Supervision**

185. The assessment of the banking supervision department's observance of good transparency practices was performed as part of the FSAP for the Republic of Latvia. The assessment was done by Maria Westerberg, Analyst, Finansinspektionen (The Swedish Financial Supervisory Authority), and was based on a pre-FSAP questionnaire response, relevant legislation and discussions with BoL officials, and commercial banks. The assessment was based on the IMF Code of Good Practices on Transparency in Monetary and Financial Policies (MFP Transparency Code).

186. The BoL cooperated fully with the assessment and provided all the necessary clarification and documents.

187. It should be further noted that the assessment was based on the status of the banking supervision department in February 2001. However, the banking supervision department merged with the Securities Market Commission and the Insurance Supervision Inspectorate into a unified financial sector regulator on July 1, 2001. This newly created Financial and Capital Markets Commission changed the institutional framework.

### **Institutional and market structure-overview**

#### ***Supervisory framework***

188. The legal framework for banking is based on the Law on the Bank of Latvia (BoL Law), the Law on Credit Institutions (LCI), and numerous prudential regulations and guidelines issued by the BoL. The BoL issues operating licenses to credit institutions and is entitled to revoke these licenses in case of noncompliance with procedures for conducting operations as stated by the BoL. The BoL is also entitled to issue other requirements regulating activities of credit institutions to reduce risk inherent in credit institutions activities and protect creditors' interests. Credit institutions are under obligation to submit to the BoL all information required by the BoL.

189. An auditor authorized by the BoL shall audit the annual accounts. In practice the BoL approves the list of auditing firms (up to now only internationally recognized auditing firms have been on the list), which are authorized to audit annual financial statements of credit institutions, while credit institutions choose the auditor from the approved list.

#### ***Market structure***

190. Latvia's financial sector centers around the universal banking model with banks owning approximately half of the domestic non-banking financial institutions. Currently, there are 21 banks, of which 1 is state-owned and 12 are foreign-owned. Subsidiaries of Estonian, Finnish, German, Russian and Swedish banks, as well as a branch of a Finnish bank, also operate in Latvia; about 70 percent of bank assets are foreign-owned. State-controlled banks account for about 3 percent of the sector's assets, but are dominant in certain activities, notably mortgage lending and the taking of small deposits. Seventeen small

credit unions operate in Latvia, but their material impact on the financial system is marginal at best.

### Main findings

191. The banking supervision department displays a high degree of transparency. The BoL publishes an annual report in which the banking supervision department is presented and a website which, among other things, contains legislation and reports in both Latvian and English. The Banking Supervision Department publishes quarterly and annual reports. Legislation and regulation are also available in a database with legal documents (although access is needed). New regulations and amendments to regulations are published in a government journal.

192. The BoL is the only authority supervising credit institutions in Latvia. Although transactions in securities effected by credit institutions are supervised by the Securities Market Commission. The BoL has signed an MoU with the Securities Market Commission concerning the scope and procedures for cooperation and information sharing. The MoU is not publicly disclosed.

Table 12. Latvia: Observance of MFP Transparency Code—Banking Supervision: Main Findings

Subject	Main Findings
V. Clarity of roles, responsibilities and objectives of banking supervisory agencies	The clarity of roles, responsibilities and objectives of the banking Supervision Department are clearly defined in legislation and disclosed to the public.
VI. Open process for formulating and reporting of banking supervisory policies	There is an open process for formulating and reporting of banking supervisory policies.
VII. Public availability of information on banking supervisory policies	Information on banking supervisory policies is available for the public.
VIII. Accountability and assurance of integrity by banking supervisory agencies	The BoL Law assures the BoL's accountability to Saeima, the Latvian Parliament. While the BoL has detailed internal governance procedures, stated in various internal regulations, these are not published through the website or other means. However, if requested, the BoL would provide such information to interested parties.

### Authorities' response and recommended next steps

The authorities pointed out the need to correct a few factual errors, which have been reflected in the text.

### C. Payment System Oversight

193. The assessment of the Latvian payment and settlement systems oversight was performed as part of the FSAP for the Republic of Latvia. The Latvian authorities cooperated fully with the assessment and provided all the necessary clarifications and documents.

194. The main objective of the assessment was to determine the level of observance with the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies* (MFP Transparency Code). No assessment methodology has been developed yet, but the assessment has taken into account the implementation issues mentioned in the *Supporting Document* to the Code.

195. The assessment was prepared by Krzysztof Senderowicz, Deputy Director, Payment Systems Department of the National Bank of Poland. The assessment was based on a review of the legal framework; a pre-FSAP questionnaire response; information available on the BoL's website; relevant laws; and discussions with BoL officials.

### **Institutional and market structure-overview**

196. As of December 31, 2000, there were 21 banks and 1 branch of a foreign bank operating in Latvia. While banks provide most of the payment services to the general public, the BoL plays the principal role in establishing and operating the interbank clearing and settlement systems. The BoL operates SAMS—Interbank Automated Payment System (an RTGS system) and EKS—Electronic Clearing System (retail net payment system). Currently, only banks are participating in these systems. The central bank provides deposit accounts, which banks use for the settlement of all payment transactions between them. These accounts are also used for maintaining banks' compulsory reserves.

197. The BoL has explicit legal responsibility for the Latvian payment system. According to the Law on the Bank of Latvia, the BoL shall organize and ensure the operation of the settlement and payment systems in Latvia.

### **Main findings**

198. The BoL displays a high degree of transparency in its payment system policy. The principle means of ensuring transparency is the Annual Report, and the BoL's website ([www.bank.lv](http://www.bank.lv)).

199. The responsibilities of the BoL for the functioning of the payment system are clearly defined in legislation and publicly disclosed. Annual reports containing information on payment system are regularly and timely disclosed to the public.

200. The BoL Law defines the main objective of the BoL with regard to payment system. However, it would be useful to explain publicly the BoL's payment system oversight role and major policies it will follow in order to achieve broad objectives.

201. Generally, the process of formulating and implementing payment system policy is open and transparent. However, it would be useful to disclose more detailed information to the general public.

202. There are no officially stated legal protections for officials and staff of the BoL. However, since Article 33, BoL Law, states that BoL employees shall be responsible for any violation of the laws established by the Republic of Latvia that arise in the course of their official duties uncertainties as to the practical consequences of such potential violations may arise.

Table 13. Latvia: Observance of MFP Transparency Code—Payment Systems Oversight: Main Findings

Subject	Main Findings
V. Clarity of roles, responsibilities and objectives of payment systems oversight agencies	The BoL's payment system oversight role and major policies it will follow in order to achieve broad objectives are not publicly explained.
VI. Open process for formulating and reporting of payment systems oversight policies	Detailed description of the BoL's policy objectives with regard to the payment system is not publicly disclosed.
VII. Public availability of information on payment systems oversight policies	The main source of information on developments in the payment system is the Annual report. It contains only very general information.
VIII. Accountability and assurance of integrity by payment systems oversight agencies	The BoL employees shall be responsible for any violation of the laws established by the Republic of Latvia that arise in the course of their official duties. Uncertainties as to the practical consequences of such potential violations may arise.

#### Recommended next steps and authorities' response

203. The disagreed with the view that wider public discussion of payment system regulations could be desirable, as proposed changes to regulations are discussed with the Consultative Council, which represents the opinion and interests of the industry. Wider public discussion could even be counterproductive, especially with respect to the rather technical documents related to the operation of payment systems.

With regard to the view that the BoL should clearly define its payment system objectives and disclose publicly its role and major policies with respect to systemically important payment systems, the authorities also pointed out that amendments to the Law on the Bank of Latvia, which will ensure payment systems oversight in accordance with the Statute of the European System of Central Banks, were approved by parliament on October 25, 2001, and will enter into force as of January 1, 2002.

#### D. Securities Regulation

204. The assessment of the Securities Market Commission's (SMC) observance of good transparency practices relating to monetary policy was carried out as part of the joint Fund-Bank FSAP. The assessment was undertaken by Melinda Roth, Senior Financial Specialist, Financial Sector Development Department, World Bank, and was based on (1) a pre-FSAP questionnaire response; (2) information available on the SMC web site; (3) relevant laws; and (4) discussions with SMC and Riga Stock Exchange (RSE) officials,

the Latvian Central Depository, and several market participants. The assessment was based on the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies* (MFP Transparency Code). No assessment methodology has been developed as yet, but the assessment has taken into account the implementation issues mentioned in the *Supporting Document* to the Code.

205. The Latvian authorities cooperated fully with the assessment and provided all the necessary clarification and documents.

206. It should be further noted that the assessment was based on the current status of the Securities Market Commission. However, the SMC will merge as of July 1, 2001 into a unified financial sector regulator, along with banking supervision and the insurance agency. This newly created Financial and Capital Markets Commission (FCMC) will therefore change the regulatory framework, and this assessment attempts to note which principles may be affected.

### **Main findings**

207. The Securities Market Commission (SMC) displays a high degree of transparency. In addition to an annual report, monthly bulletins, and the legislation published in the official government register, the SMC maintains an excellent internet site. This site contains the annual report, statistics, latest news, and all relevant legislation in both Latvian and English ([www.vtk.gov.lv](http://www.vtk.gov.lv)).

208. There is currently little financial disclosure as the SMC is a budgetary organization without its own source of revenue. In the new FCMC, market participants will be levied, and this current weakness will change as financial statements; audits; and greater financial accountability will be required.

209. The chairman has frequent press conferences, but has no specific responsibility to report to parliament. As noted above, the structure of the regulatory framework is changing as the SMC is merged into the FCMC.

### **Recommended next steps and authorities' response**

210. The authorities provided a few minor factual corrections that have been reflected in the text, and pointed out that, in fact, the SMC is required to provide financial information separate from the budget.

Table 14. Latvia: Observance of MFP Transparency Code—Securities Markets Regulation and Supervision: Main Findings

Subject	Main Findings
V. Clarity of roles, responsibilities and objectives of securities regulatory and supervisory agencies	The clarity of roles, responsibilities and objectives of the SMC are clearly defined in legislation and disclosed to the public.
VI. Open process for formulating and reporting of securities regulatory and supervisory policies	There is an open process for formulating and reporting policies, and a presumption in favor of consultations with market participants.
VII. Public availability of information on securities regulatory and supervisory policies	Information is readily available through the SMC's published annual report, monthly bulletins and a highly professional web site.
VIII. Accountability and assurance of integrity by securities regulatory and supervisory agencies	Accountability issues are a weak subject for the SMC's observance of the transparency code, though this should change as it converts from a budgetary organization with no independent financial standing into a part of the new independently financed and audited FCMC.

### E. Insurance Regulation

211. The assessment of the ISI observance of good transparency practices relating to insurance supervision and regulation was carried out as part of the joint Fund-Bank FSAP. The assessment was undertaken by Donald A. McIsaac (World Bank) and was based on (i) a pre-FSAP questionnaire response; (ii) information available on the ISI's website; (iii) relevant laws; and (iv) discussions with ISI officials and market participants. The assessment was based on the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies* (MFP Transparency Code). No assessment methodology has been developed as yet, but the assessment has taken into account the implementation issues mentioned in the *Supporting Document* to the Code.

212. The Latvian authorities cooperated fully with the assessment and provided all the necessary clarifications and documents.

#### Main findings

213. The ISI has made a concerted effort to ensure transparency in its operations. All legislation and regulations applicable to insurance companies are available through a website. In addition, the website contains copies of quarterly and annual reports issued by the ISI. These reports are also distributed in hard copy form and senior officials of the agency appear at press conferences at the time of each such distribution. Changes in regulations affecting insurance companies are discussed extensively with industry officials and the trade associations in advance of their adoption. Greater transparency in the accounting for assessments collected from insurance companies is recommended. Also, there should be further disclosure of information sharing agreements among regulatory agencies. Table 15 below summarizes the main findings of the assessment.

Table 15. Latvia: Assessment of Observance of MFP Transparency Code—Insurance Regulation and Supervision: Main Findings

Subject	Main Findings
V. Clarity of roles, responsibilities and objectives of insurance regulatory and supervisory agencies	Definition of roles, responsibilities and objectives of the ISI are broadly transparent. However, there are some shortcomings related to (i) the definition of objectives through legislation, (ii) the disclosure and explanation of objectives, and (iii) the disclosure of modalities with respect to the ISI's accountability.
VI. Open process for formulating and reporting of insurance regulatory and supervisory policies	The ISI's financial policies are generally conducted in a transparent manner. Shortcomings relate to (i) the disclosure of operating procedures, (ii) disclosure of existing information sharing arrangements, and (iii) reporting on how the ISI's objectives have been achieved.
VII. Public availability of information on insurance regulatory and supervisory policies	Information provided by the ISI is very comprehensive. A minor issue that should be addressed relates to the disclosure and clarity of potential dispute settlement processes. It will be necessary to devise a public information campaign to advise consumers on the functioning of the Policyholder Protection Fund scheme that is shortly to come into effect.
VIII. Accountability and assurance of integrity by insurance regulatory and supervisory agencies	<p>There is no requirement for senior officials of the ISI to appear before parliamentary bodies, but in practice, such appearances are a routine part of any deliberations for amendments to legislation. There is no separate reporting on operating expenses and revenues, since the ISI is treated as part of the budget.</p> <p>There does not appear to be any indemnification of ISI employees against actions laid against them for the performance of their duties. Thus, employees would be personally liable for any legal fees incurred in defending themselves.</p>

### Recommended next steps and authorities' response

214. The authorities pointed out that rules and procedures for compensation payments to policyholders from the Policy Holder Protection Fund are set forth in Articles 93 and 98 of the Law on Insurance Companies and Their Supervision. However these articles do not provide complete details on the functioning of the system, and it will be necessary to devise a public information campaign to advise consumers on the functioning of the scheme.