



LATVIA

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LIST OF ABBREVIATIONS

| | |
|--------|---|
| CAS | Central Accounting System (a component of SAMS) |
| DENOS | SSS operated by the Latvian Central Depository – <i>Depozitārija norēķinu sistēma</i> |
| EKS | Latvijas Banka’s electronic clearing system – <i>Elektroniskā klīringa sistēma</i> |
| FCCM | Financial and Capital Market Commission – <i>Finanšu un kapitāla tirgus komisija</i> |
| FDL | First Data Latvia (a card-based payment system) |
| ICN | Interbank communication network |
| Itella | Latvian giro system |
| LCD | Latvian Central Depository – <i>Latvijas Centrālais depozitārijs</i> |
| LKA | Association of Latvian Commercial Banks – <i>Latvijas Komerčbanku asociācija</i> |
| OMX | Exchange owner and operator in the Nordic and Baltic region and provider of financial services technology |
| PNS | Postal Accounting System – <i>Pasta norēķinu sistēma</i> |
| RSE | Riga Stock Exchange – <i>Rīgas Fondu birža</i> |
| SAMS | Latvijas Banka’s RTGS system – <i>Starptanku automatizēto maksājumu sistēma</i> |
| SAXESS | Electronic trading system operated by the RSE |
| VNS | SSS operated by Latvijas Banka – <i>Vērtspapīru norēķinu sistēma</i> |

INTRODUCTION

Over the past few years a number of important reforms have been implemented in the field of payment systems in Latvia. The main objective of these reforms has been to minimise the risks arising from interbank settlements and to harmonise the infrastructure and legal framework of the Latvian payment system with EU standards and requirements.

A number of laws and regulations have been adopted or amended to incorporate the requirements of EC directives. A new Law on settlement finality in payment and securities settlement systems has been adopted to implement Directive 98/26/EC on settlement finality in payment and securities settlement systems. The Financial Collateral Law has transposed into domestic legislation the requirements of Directive 2002/47/EC on financial collateral arrangements. The Credit Institution Law has been amended to incorporate the requirements of Directive 2000/46/EC on the taking up, pursuit of and prudential supervision of the business of electronic money institutions.

Latvijas Banka has exclusive responsibility for the oversight of the payment system, whereas supervision of capital market institutions, including credit institutions, is the responsibility of the Financial and Capital Market Commission (FCMC), the consolidated supervisory authority, which commenced its activities on 1 July 2001.

Large-value interbank payments in national currency (lats) are effected using Latvijas Banka's real-time gross settlement system, SAMS. SAMS commenced operations in September 2000. This system provides settlement for large-value interbank payments and urgent customer payments and serves as a tool for the implementation of monetary policy.

The major interbank retail payment system in Latvia is Latvijas Banka's electronic clearing

system, EKS. This is an ACH system which processes customer payments with same-day value.

A distinctive feature of the Latvian payment system is the predominance of credit transfers. Electronic credit transfers and card payments have continued to increase in recent years. Likewise, the number of POS and ATMs has grown, while the use of electronic means of payment has increased further. Most banks offer online services to their customers. The banks are actively taking advantage of recent innovations in information technology and expanding their services by offering internet-based and phone-based banking to their customers.

The securities market infrastructure in Latvia consists of one stock exchange – the Riga Stock Exchange (RSE) – and two SSSs – the DENOS system operated by the Latvian Central Depository (LCD) and Latvijas Banka's SSS (VNS). VNS is used mainly to register and settle collateral used in Latvijas Banka's monetary policy and intraday credit operations. Other trades and transactions in securities are settled by DENOS.

I INSTITUTIONAL ASPECTS

I.1 THE GENERAL INSTITUTIONAL FRAMEWORK

The main providers of payment services are credit institutions, Latvijas Banka and Latvia Post.

The 1992 Law on the Bank of Latvia gave the central bank the responsibility for promoting the smooth functioning of payment systems in the Republic of Latvia. Latvijas Banka is to fulfil this objective through the oversight of payment systems. The oversight of payment systems, for which Latvijas Banka has sole competence, forms an integral part of Latvijas Banka's wider responsibility for monetary and financial stability.

Under the Law on the Bank of Latvia, the central bank has the exclusive right to issue national currency in the form of banknotes and coins.

On 1 July 2001 the FCMC took over the supervision of credit institutions from Latvijas Banka. Pursuant to the 2001 Law on the Financial and Capital Market Commission, the FCMC regulates and supervises all participants in the financial and capital markets that are subject to such supervision under the relevant legislation.

Under the 1994 Postal Law, Latvia Post is authorised to issue postal payment instruments and is thus also a participant in the Latvian payment system. The regulation and supervision of Latvia Post is the responsibility of the Ministry of Transport.

The general regulatory framework for the Latvian payment system is based on a set of laws, regulations and agreements.

The 1995 Credit Institution Law governs the activity of credit institutions, which are the main providers of payment services in Latvia. Under this Law, the receiving of deposits and other repayable funds and the issuing of non-

cash payment instruments are activities for which credit institutions have exclusive responsibility. The Law also governs the insolvency and bankruptcy procedures that are applicable to credit institutions in particular. The Law on the insolvency of undertakings and companies governs the insolvency and bankruptcy procedures of legal entities other than credit institutions.

The amendments made to the Credit Institution Law in 2004 ensure the transposition into national law of the requirements of Directive 2000/46/EC on the taking up, pursuit of and prudential supervision of the business of electronic money institutions.

The 2003 Law on settlement finality in payment and securities settlement systems ensures the transposition into Latvian law of the requirements of Directive 98/26/EC on settlement finality in payment and securities settlement systems, while the 2005 Financial Collateral Law ensures the transposition of the requirements of Directive 2002/47/EC on financial collateral arrangements. The Financial Collateral Law also sets forth procedures that are applicable in the event that a legal entity becomes insolvent, with the purpose of safeguarding the smooth operation of payment and securities settlement systems.

The 1938 Cheque Law, which is based on the Geneva Convention of 1931, relates to the issuing, design and transfer of cheques.

The 2004 Financial Instruments Market Law has replaced the 1995 Securities Law. The 2004 Law governs the procedures for publicly offering financial instruments, providing investment services and ancillary (non-core) investment services, and licensing and supervising participants in the financial instruments market, and establishes the rights and obligations of participants in the financial instruments market and liability for the infringement of the requirements set out in this Law.

The general principles governing guarantees for the deposits of natural and legal entities held with banks are outlined in the 1998 Deposit Guarantee Law, which implements Directive 94/19/EC on deposit-guarantee schemes.

In addition, the 2001 Investor Protection Law, which implements Directive 97/9/EC on investor compensation schemes, provides for the protection of investors' interests in cases where a capital market participant has become insolvent. The 1998 Law on the prevention of laundering of the proceeds of criminal activity establishes the responsibilities and rights of financial institutions, credit institutions and their supervisory and regulatory authorities with the aim of preventing the laundering of such proceeds. The 1998 Law also set out the procedure for establishing the Disclosures Office, which has a mandate to prevent the laundering of such proceeds, and the Advisory Council, as well as their rights and responsibilities. All types of criminal offence subject to this Law are listed therein. The Law stipulates the procedure for reporting to the Disclosures Office information regarding financial transactions characterised by at least one of the indicators included in the list of indicators of unusual transactions. Pursuant to the Law, credit institutions and financial institutions must refrain from conducting transactions that they suspect of involving money laundering or attempted money laundering.

Most aspects relating to the issuance of payment instruments and the provision of payment services are covered by legislative acts or contracts between financial institutions, customers and retailers. The 1992 Consumer Rights Protection Law prevents the inclusion of unfair terms and conditions in legal contracts, and all agreements with customers must comply with this Law.

In order to ensure the efficient and sound functioning of clearing and payment systems, Latvijas Banka is entitled to issue regulations pertaining to the payment system and payment

services. On the basis of the powers conferred upon it by the Law on the Bank of Latvia, Latvijas Banka has issued the Regulation for credit transfers, the Regulation for issuance and maintenance of electronic money and the Regulation for the use of the IBAN, as well as Recommendations for transactions effected by means of electronic payment instruments.

The Regulation for credit transfers governs the procedure for domestic and cross-border credit transfers and stipulates the rights and obligations of all parties involved in credit transfers. It was also adopted with the aim of meeting the requirements for the execution of cross-border credit transfers established by Directive 97/5/EC on cross-border credit transfers.

The 2002 Latvijas Banka Regulation for issuance and maintenance of electronic money, complementing the Credit Institution Law, contains the requirements of Directive 2000/46/EC with regard to the issuance and redemption of electronic money, as well as the minimum requirements for institutions issuing electronic money.

The 2003 Regulation for the use of the IBAN establishes the minimum requirements that an institution registered in the Republic of Latvia must meet with regard to the procedure for providing, validating and using a Latvian IBAN. The Regulation stipulates that, from 1 January 2005, the IBAN is to be used as the sole identifier of a customer account for both domestic and cross-border payments in Latvia.

The Recommendations for transactions effected by means of electronic payment instruments establish the minimum requirements for issuing, servicing and using electronic payment instruments in Latvia. The Recommendations implement in Latvia Recommendation 97/489/EC concerning transactions by electronic payment instruments and in particular the relationship between issuer and holder.

An out-of-court redress procedure in line with Recommendation 98/257/EC on the principles

applicable to the bodies responsible for out-of-court settlement of consumer disputes was implemented by establishing an Ombudsman at the Association of Latvian Commercial Banks (LKA) in 2002. The Ombudsman resolves disputes between customers and banks in the field of credit transfers and electronic payment instruments.

To collect the statistics necessary for payment systems oversight in Latvia and for the implementation of monetary policy, Latvijas Banka has issued a Regulation on compiling credit institution payment statistics.

1.2 THE ROLE OF LATVIJAS BANKA

1.2.1 GENERAL RESPONSIBILITIES

The role of Latvijas Banka with regard to payment systems consists of three main elements: oversight of the payment system, operation of interbank payment and settlement systems, and issuance of national currency. Carried out for the purpose of controlling and minimising the potential risks inherent in payment systems, oversight of the payment system serves to promote both the stability of the financial system as a whole and public confidence in money. The operational role derives from the need for banks to have a reliable and safe environment for processing interbank payments and from Latvijas Banka's need for a secure channel for the execution of monetary policy.

1.2.2 PAYMENT SYSTEMS OVERSIGHT

The oversight function is formally assigned to Latvijas Banka by virtue of Article 9 of the Law on the Bank of Latvia, which states that "The Bank of Latvia shall promote the smooth operation of the payment systems in the Republic of Latvia. The Bank of Latvia is entitled to approve regulatory requirements and regulations in order to ensure the efficient and sound functioning of the clearing and payment systems."

Latvijas Banka performs this function independently by overseeing systemically

important payment systems, issuing regulations and recommendations, and providing settlement services for banks or other payment and clearing systems, as well as by taking other supportive action to facilitate private sector initiatives that contribute to the safe and efficient functioning of payment systems.

Oversight focuses mainly on large-value interbank payment systems that are used for settlement of Latvijas Banka's monetary policy operations and which constitute the largest source of systemic risk in the Latvian payment system. Latvijas Banka oversees these systems by analysing their compliance with the Core Principles for Systemically Important Payment Systems and requiring payment system operators to take all reasonable measures to achieve full compliance.

Only SAMS (see Section 3.2) is currently regarded as a systemically important payment system in Latvia. The role of EKS (see Section 3.4.3.1) in Latvia's payment infrastructure was assessed in 2003 against the ECB's oversight standards for euro retail payment systems, with the result that EKS was classified a systemically prominent retail payment system. Having aligned the assessment of EKS with the ECB methodology, Latvijas Banka now oversees EKS compliance with Core Principles I, II and VII–X.

Latvijas Banka conducts day-to-day monitoring of the technical and operational functions of SAMS and EKS and analyses their statistical data, in addition to developing and approving regulations governing operational procedures, risk reduction measures and principles for participation in the systems.

The responsibility for the safe and efficient functioning of other retail clearing systems is vested with the institutions which operate such payment systems and their participants, but Latvijas Banka oversees retail payment systems and, together with the system operators, evaluates the risks inherent in these systems and provides consultations on risk reduction.

In 2001 Latvijas Banka's Board of Governors approved Latvijas Banka's payment systems policy, which outlines the NCB's role and objectives with regard to payment systems in Latvia. To raise public awareness of the role of payment systems and Latvijas Banka's objectives in this regard, Latvijas Banka has issued two reports on the oversight of payment systems in Latvia.

1.2.3 THE OPERATIONAL ROLE OF THE CENTRAL BANK

Latvijas Banka operates two interbank payment systems. SAMS (see Section 3.2) is used for the real-time settlement of large-value payments through the banks' settlement accounts, and EKS (see Section 3.4.3.1) processes retail payments. Latvijas Banka also operates VNS and performs the settlement of the cash leg of transactions processed through the Latvian Central Depository (LCD). Latvijas Banka defines and formulates the rules and regulations governing the payment systems and the SSS which it manages.

Latvijas Banka executes State Treasury payments, in addition to providing settlement services in central bank money to other payment and clearing systems. Latvijas Banka issues banknotes and coins, which are distributed through the NCB's branch network.

1.2.4 ACTIVITIES IN THE AREA OF SECURITIES CLEARING AND SETTLEMENT SYSTEMS

Latvijas Banka operates an SSS called VNS (see Section 4.3.2). It uses VNS to register book-entry rights of VNS participants in securities, as well as collateral used in its monetary policy and intraday credit operations.

In addition, Latvijas Banka oversees both SSSs operating in Latvia, evaluates the risks inherent in these systems and gives consultations on risk reduction.

1.2.5 COOPERATION WITH OTHER INSTITUTIONS

In performing its role of overseeing payment and securities settlement systems, Latvijas Banka cooperates with the FCMC. Latvijas Banka and the FCMC have signed an agreement on information exchange in order to ensure that all information which is relevant to the responsibilities of both institutions is shared fully and freely.

Latvijas Banka maintains close contacts with market participants, with whom it meets on a regular basis in order to convey its ideas and obtain feedback on how the NCB's work in the area of payment and securities settlement systems is perceived. For example, any changes in the functioning or the rules of SAMS or EKS are made in close cooperation with the commercial banks. Similarly, Latvijas Banka provides the necessary support for private sector initiatives by participating in various projects relating to payment instruments. In addition, all regulations proposed by the NCB are widely discussed with market participants before finalisation.

Latvijas Banka cooperates with other central banks and international organisations on issues relating to payment and securities settlement systems.

In 2004 Latvijas Banka and the FCMC signed the Memorandum of Understanding (MoU) on cooperation between payment systems overseers and banking supervisors and the Memorandum of Understanding on high-level principles of cooperation between the banking supervisors and central banks of the European Union in crisis management situations. The purpose of the first MoU was to promote safe and continuous operation of large-value interbank payment systems. Cooperation within the framework of the MoU takes place mainly via the exchange of information between Latvijas Banka as the payment systems overseer and the FCMC as the banking supervisory authority. The second MoU stipulates a set of principles and procedures regarding the cross-border cooperation between EU central banks and

supervisory institutions in crisis management situations.

1.3 THE ROLE OF OTHER PRIVATE AND PUBLIC SECTOR BODIES

1.3.1 THE FINANCIAL AND CAPITAL MARKET COMMISSION

Pursuant to the Law on the Financial and Capital Market Commission passed on 1 June 2000 (which came into effect on 1 July 2001), the FCMC regulates and supervises the financial and capital markets and the activities of their participants. Resulting from a merger of the Credit Institutions Supervision Department of Latvijas Banka, the Securities Market Commission and the Insurance Supervision Inspectorate, the FCMC commenced its activities on 1 July 2001. The financial and capital market participants supervised by the FCMC are: issuers, investors, credit institutions, insurers, private pension funds, insurance intermediaries, credit unions, the Riga Stock Exchange, the LCD, investment firms, brokers, investment companies and investment consultants. The FCMC grants licences to provide financial services, including custody services and other intermediary activities in the Latvian financial and capital market.

1.3.2 THE ASSOCIATION OF LATVIAN COMMERCIAL BANKS

The Association of Latvian Commercial Banks represents the interests of the Latvian banking sector. The LKA was created in 1992 as a public organisation aiming to enhance the development of a modern and reliable banking sector in Latvia. The LKA organises working groups and holds regular meetings with banks to discuss various aspects of banking business and issues of common interest relating to banking operations and payment systems. It plays an active role in setting standards for payment instruments in the banking sector. The LKA also assists in drafting laws and regulations governing the activities of banks and is represented on the Consultative Council of the FCMC. The LKA Ombudsman handles the complaints of credit institution customers about

credit transfers and electronic payment instruments. The Payment and Payment Card Committees have been established in order to discuss issues related to payments, in particular standardisation issues or plans for migration to the Single Euro Payments Area (SEPA).

2 PAYMENT MEDIA USED BY NON-BANKS

2.1 CASH PAYMENTS

The national currency of the Republic of Latvia is the Latvian lats (LVL), which is divided into 100 santimi. Latvijas Banka issues the national currency in the form of banknotes and coins, including commemorative coins of various nominal values. Banknotes with the following nominal values are in circulation: LVL 5, LVL 10, LVL 20, LVL 50, LVL 100 and LVL 500. The nominal values of the coins in circulation are as follows: 1, 2, 5, 10, 20 and 50 santimi, and LVL 1, LVL 2, LVL 10 and LVL 100.

Cash is widely used in Latvia (mainly by individuals in face-to-face transactions for goods and services). No estimate is available for the value or number of cash payments, but the share of cash in M1 in Latvia has been declining for a number of years (falling from 44.0% in 1998 to 23.8% in 2006).

At end-2006 currency in circulation totalled LVL 1,073.9 million (€1,542.4 million). As the economy continues to grow, the amount of currency in circulation is rising steadily; however, the development of non-cash settlement instruments has gradually reduced the role of cash in money circulation.

2.2 NON-CASH PAYMENTS

The use of payment instruments other than banknotes and coins has become more widespread in Latvia, reflecting a general widening of the population's banking habits. Non-cash payments are effected predominantly through current accounts. Customers are free to

choose the currency in which they open their accounts. Current accounts in lats are used mainly for domestic retail payments, whereas accounts in foreign currencies are used for both cross-border and domestic payments. In Latvia non-cash payments are effected mainly by means of credit transfer. Postal instruments are also widely used, but their value is significantly less than that of credit transfers via the banking system. The overall trend seems to be that financial institutions are gradually expanding their internet, telephone and mobile banking services. The use of other payment instruments, such as payment cards, is also on the rise.

2.2.1 CREDIT TRANSFERS

Credit transfers play a dominant role in effecting payments between customers and have doubled in volume and tripled in value over the last five years. In 2006 107.4 million credit transfers, with a total value of LVL 381.1 billion (€547.4 billion), were processed. Credit transfers accounted for 62.5% of the total volume and 99.6% of the total value of non-cash payments. In recent years the use of electronic payment instruments has expanded. The share of credit transfers initiated via electronic, internet and telephone banking rose from 14.2% in 2001 to 48.1% in 2006 in terms of volume, and from 40.6% to 49.3% in terms of value. Most banks offer online services to both corporate and retail customers. Banks are actively taking advantage of recent innovations in information technology, and home banking is being replaced by internet-based and phone-based banking by customers. To encourage customers to use electronic payment instruments, banks have raised fees for payment instructions handed over in paper form. WAP banking applications (mobile phone-based banking services), which were launched in 2000, are currently offered by some banks.

2.2.2 CHEQUES

The role of cheques has traditionally been very limited, and cheques are rarely used as a payment instrument in Latvia. Almost all cheques are drawn in foreign currencies. In addition to cheques issued by foreign and

domestic banks, there are also traveller's cheques, which are used by international companies, embassies and travellers.

2.2.3 DIRECT DEBITS

In Latvia direct debits emerged in 1994, when several banks developed these as an intrabank payment instrument for the payment of utility bills by their customers. In September 2000 Itella (originally called the National Payment Centre; see Section 3.4.3.3) launched an interbank direct debit system with five banks. This system allows any utility company or commercial bank to join and thus start providing direct debit benefits to its customers. Since the launch of this system, the use of direct debits has grown rapidly, reaching 4.5 million transactions in 2006.

2.2.4 PAYMENT CARDS

A wide variety of international card products are available in Latvia. Bank customers use different types of card: credit cards, debit cards, debit cards with an overdraft facility and local cash withdrawal cards.

By the end of 2006 banks had issued 2,065,976 cards. Of these, 233,432 were cards with a credit or delayed debit function and 1,832,544 were cards with a debit function. By the end of 2006 all banks had issued payment cards to their customers.

As a result of comprehensive advertising campaigns launched by banks and First Data Latvia (FDL), payments made by payment card have quintupled in volume and quadrupled in value over the last five years and accounted for 34.9% of the total volume and 0.3% of the total value of payments made with cashless payment instruments. In 2006 figures for card payments were slightly higher than those for ATM cash withdrawals. Card payments effected outside the country accounted for 5.0% of total payments by card in terms of volume and 20.7% in terms of value.

Debit cards

Debit cards have been issued in Latvia since early 1992. Over the last few years banks have enhanced their debit card-related services by developing a POS and ATM infrastructure and offering an increasing number of debit cards with an overdraft facility. By the end of 2006 1,832,544 cards with a debit function had been issued (with this figure including both debit cards and debit cards with an overdraft facility). The most widely used card with a debit function in Latvia is Visa Electron, followed by Maestro and local cards. The choice of card scheme offered by any individual bank depends on factors such as risk management, the availability of electronic card acceptance networks, the cost and efficiency of the local communications network and the kinds of customer targeted. Debit cards are mainly associated with a customer's current account or, alternatively, a special card account.

Credit cards

The number of credit card holders is smaller than the number of debit card holders, and at first credit cards were mostly limited to business customers. However, owing to promotional efforts undertaken by banks, the number of credit cards issued to retail customers is rapidly increasing. Most of the credit cards issued by banks are Visa and Europay products. In 2006 payments made using credit cards accounted for 9.6% (3.1 million transactions) in terms of volume and 21.0% (LVL 126.3 million (€181.4 million)) in terms of value of all payments made with payment cards issued in Latvia.

Retailer cards

Retailer cards have gained in popularity over the past few years. These are single-purpose cards and, unlike bank payment cards, can only be used at POS controlled by their issuers (mainly petrol companies). Some companies process their card transactions themselves, and some are serviced by a card processing centre. By the end of 2006 129,802 retailer cards had been issued in Latvia.

Prepaid cards

Prepaid cards are mainly used for telecommunications, and the schemes are single purpose-oriented. There is a single-purpose smart card project, called "Riga Key", which was implemented by the company Netcards at the beginning of 2001. Riga Key is a prepaid rechargeable smart card which customers use to pay for entry to Riga's Old Town by car and for parking in Riga. Riga Key was designed in such a way that it can be used as a multi-purpose smart card in the future.

ATM and POS networks

The development of ATM networks began in 1996. By the end of 2006 there were a total of 952 ATMs in six networks (managed by FDL and five local banks). The networks are compatible with each other, but the transaction fees differ depending on the pricing policy applied by each network manager and card issuer. International debit and credit cards are accepted across all ATM networks. Acceptance of local cards depends on the product: local cards are generally accepted across the ATM network of the card-issuing bank, but banks can conclude agreements among themselves for the acceptance of these cards also in other networks. In 2006 85.1% of all ATMs were multi-functional, allowing customers to perform various banking operations, such as paying bills, making deposits on savings accounts, withdrawing cash and verifying current account balances.

The first steps in the establishment of a POS network were taken in 1992. At the end of 2006 there were 16,154 electronic POS terminals installed across three networks (managed by FDL and two local banks). The POS network accepts all types of payment card circulating in Latvia, as well as international cards issued by foreign banks. Banks have modernised the servicing of payment cards and have increasingly been using electronic equipment to ensure online authorisation. For this reason, the number of electronic POS terminals has increased, while the number of imprinters has declined. International debit and credit cards

are accepted across the different POS networks; local cards are normally accepted across the POS networks of the card-issuing bank, or banks can conclude agreements with merchants (who participate in the POS network of another bank or card processing centre) on the acceptance of these cards.

2.2.5 POSTAL INSTRUMENTS

Cashless payments can also be made through Latvia Post. Functioning outside the banking system, Latvia Post offers means of payment primarily used by the social security authorities to make pension payments and by companies and individuals to make money transfers. Money orders are convenient for persons which do not have a bank account. In 2006 20.2% of all credit transfers (in terms of volume) were effected through Latvia Post, although postal instruments were largely used for small-value retail payments (for a total amount of LVL 795.3 million (€1,142.3 million)). Like banks, Latvia Post offers its customers standing order, electronic credit transfer and direct debit facilities; however, paper-based payment instruments still account for 22.2% of all credit transfers executed by Latvia Post. Since the autumn of 2001 Latvia Post has also offered its customers the possibility of using debit cards issued in cooperation with a local bank.

2.2.6 OTHER PAYMENT INSTRUMENTS

No other payment instrument plays an important role in the Latvian payment system.

2.3 RECENT DEVELOPMENTS

Recently banks have been devoting more attention to the transition to chip technologies in card-based schemes. Most of the recently issued cards in Latvia have both a chip and a magnetic strip. 99% of all stand-alone POS devices have been upgraded to handle EMV chip technology. Banks have started to implement chip-card readers in ATMs. A couple of banks offer additional functions on the payment card's chip, enabling it to also serve, for example, as a student ID card or a library card.

In order to reduce the costs connected with ATM network maintenance and to improve customer service, some banks have merged ATM networks and concluded agreements on allowing customers to use other ATM networks without additional charges. To ensure more efficient use of infrastructure, banks, in cooperation with FDL, are working on the introduction of a "cash back" function on POS terminals in Latvia.

The first virtual e-money for purchases on the internet was issued in 2005. By the end of 2006 six institutions had informed Latvijas Banka about the introduction of e-money based on virtual accounts and accessed using telecommunications (see Section 3.4.1).

3 INTERBANK PAYMENT SYSTEMS

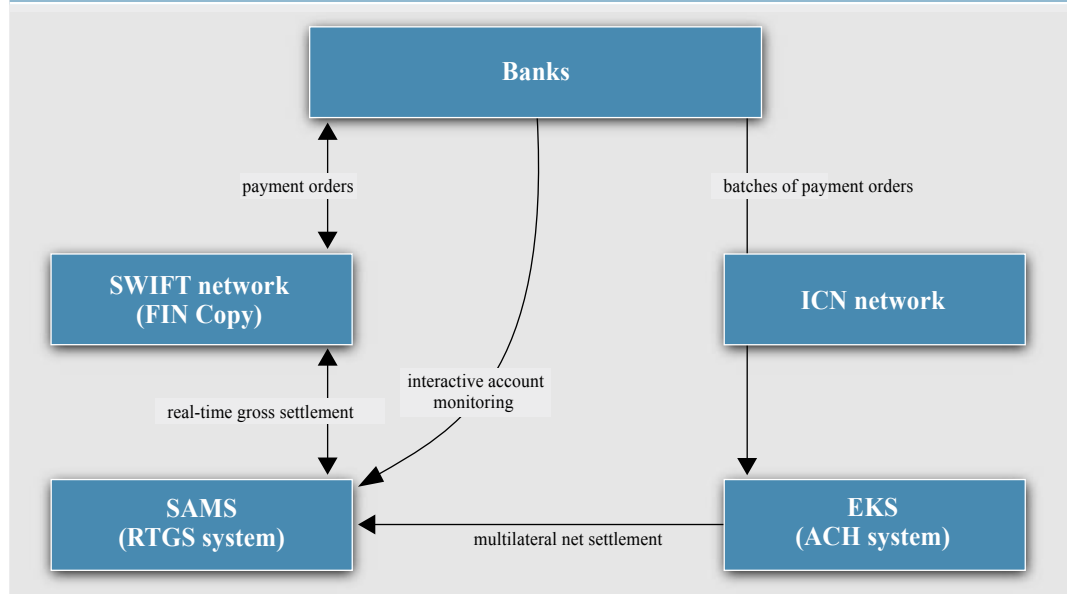
3.1 GENERAL OVERVIEW

Latvijas Banka provides clearing and settlement services for interbank transfers through the operation of two payment systems: SAMS and EKS. All banks participate directly in these systems (see Chart 1).

SAMS is used for processing large-value and urgent money, foreign exchange and capital market-related transfers, as well as large-value interbank and customer payments. In addition, it settles the net positions of other payment systems (e.g. EKS and FDL), settles the cash leg of LCD transactions and processes payments relating to monetary policy.

Retail and corporate payments are mainly processed by EKS, a multilateral net settlement system launched in November 1998. The payment messages are transferred in batches between the system participants and Latvijas Banka via the local interbank communication network (ICN). Latvijas Banka launched a new version of EKS in January 2004. The new version introduced a second clearing cycle, thus increasing settlement speed and efficiency. This allowed banks to complete the settlement

Chart 1 Latvijas Banka's interbank payment systems



of customer payments on the day of their submission.

In addition, there are three main payment service providers: FDL (card-based payment system), Latvia Post (the postal payment system) and Itella (the giro system).

3.2 THE REAL-TIME GROSS SETTLEMENT SYSTEM

SAMS is an RTGS system which commenced live operations on 8 September 2000. The system is fully automated and consists of two major components: the Central Accounting System (CAS), the software for which was provided by Logica UK Ltd; and the messaging network, i.e. SWIFT. For the purposes of monitoring their account positions, SAMS members use the participant workstations connected to the CAS by the ICN. All SAMS participants hold settlement accounts with Latvijas Banka.

3.2.1 OPERATING RULES

The operating rules adopted by Latvijas Banka are contained in the Regulation on interbank settlements effected by the Bank of Latvia. The

rules are binding on all of the system's participants. This Regulation defines:

- the access criteria;
- the system's daily timetable;
- the rights and obligations of participants and Latvijas Banka;
- the finality and the irrevocability of payments;
- rules regarding the exclusion of a participant from the system; and
- the contingency procedures.

Prior to any operation in the system, the participant and Latvijas Banka sign a bilateral agreement on participation in SAMS and an agreement on operation in the ICN. The SAMS agreement describes the liabilities and responsibilities of the participant and the system operator in detail. The ICN agreement sets out the responsibilities and liabilities of those participating in SAMS through the ICN. Since the payment messages are submitted via SWIFT,

the participants must comply with SWIFT message standards and rules.

3.2.2 PARTICIPATION IN THE SYSTEM

In addition to Latvijas Banka, any Latvian bank, any branch of a foreign bank registered in the Republic of Latvia or any credit institution registered and supervised in an EU or EEA country providing financial services in Latvia without opening a branch and complying with the provisions of the Credit Institution Law may become a participant in SAMS. To participate in the system, the bank must have a settlement account with Latvijas Banka and comply with the technical and security requirements for participation, as defined both in the Regulation on interbank settlements effected by the Bank of Latvia and in bilateral agreements with the NCB. The participant must also submit legal opinions to Latvijas Banka and must be a member of SWIFT.

By the end of 2006 there were 23 participants in the system: 21 banks, one branch of a foreign bank and Latvijas Banka. Additionally, on the basis of bilateral agreements, Latvijas Banka can execute payments in SAMS when instructed to do so by the State Treasury, the LCD or a number of other institutions which do not participate in SAMS.

3.2.3 TYPES OF TRANSACTION HANDLED

SAMS processes the following types of transaction:

- large-value interbank transactions (the Latvian lats leg of foreign exchange deals, interbank loans, etc.);
- customer payments;
- settlement of final positions for EKS and retail clearings, e.g. FDL and the LCD; and
- monetary policy operations.

In addition, Latvijas Banka has an exclusive right to transfer funds directly between

participants' settlement accounts held in SAMS. This facility is used for:

- the settlement of net positions for EKS and retail clearings;
- the settlement of DvP transactions received from the LCD; and
- transactions relating to the granting of intraday and overnight credit.

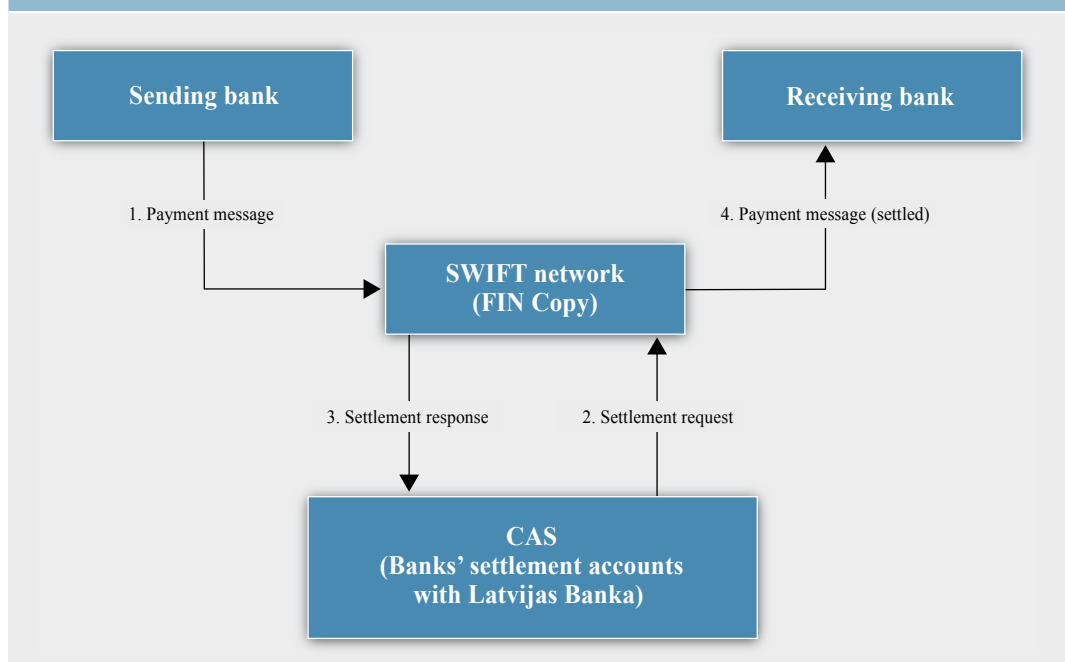
SAMS accepts the following SWIFT message types: MT 102 (multiple-customer credit transfer), MT 103 (single-customer credit transfer), MT 202 (general financial institution transfer) and MT 205 (financial institution transfer execution).

3.2.4 OPERATION OF THE SYSTEM

All participants in SAMS are members of a SWIFT closed user group, and the messages are processed using the SWIFT FIN Y-Copy (i.e. store-and-forward message processing) mode.

In Y-Copy mode a funds transfer in SAMS is initiated by submitting a SWIFT payment message addressed to the destination member. Before the message is passed to the receiving bank, it is intercepted and held pending by the FIN Copy service while a settlement response from Latvijas Banka is awaited. For this purpose, all the relevant data (the BICs of the sending and the receiving members, the value date, the value and the transaction reference number) are copied from the original message and sent to the CAS. The CAS then checks that there are sufficient funds in the sender's account to cover the payment. If there are sufficient funds in the account, the CAS settles the payment in real time by transferring the funds between the settlement accounts of the sending and receiving participants, and sends a settlement response to FIN Copy (see Chart 2). FIN Copy then forwards the queued payment message to the destination member. In the event that there are insufficient funds on the account

Chart 2 Operation of the SAMS SWIFT FIN Y-Copy mode



of the sending member, the payment is placed in SAMS' queue until sufficient funds are received.

Timetable

SAMS operates every business day from 8.30 a.m. to 5 p.m. CET+1. The timetable for SAMS is shown in Table 1.

Table 1 The timetable for SAMS

| Time (CET+1) | Activity |
|------------------|--|
| 8.30 a.m. | Open for business |
| 4 p.m. | Customer payments (MT 102, MT 103) are closed |
| 4 p.m.-4.30 p.m. | Participants must adjust their settlement account balances |
| 4.30 p.m. | Interbank payments (MT 202, MT 205) are closed |
| 4.30 p.m.-5 p.m. | Granting and settling of funds in the overnight marginal lending facility for those banks which still have a debit position at the end of the business day |
| 5 p.m. | Close of business and archiving of data |

Queuing

The CAS queues payments that cannot be settled owing to the fact that the funds on the account of the sending member are insufficient. Payments are also queued if the system is busy or if one of the member accounts involved in the payment (or the whole of the CAS) is suspended. All queues are released on the basis of the FIFO principle, taking into account the priorities of the messages in a queue. The participants assign priorities when sending their messages. In the absence of any assigned priority, a default value is set by the system. Queued payments may be cancelled or have their priority changed by the sending member through the submission of a SWIFT message to SAMS. The highest payment priorities are reserved for Latvijas Banka.

Gridlock

A payment system is in gridlock when payments cannot be settled via the normal sequential settlement process. A gridlock can be resolved either by using incoming funds from banks or through simultaneous settlement of queued

transfers using the CAS gridlock resolution algorithm. This is initiated periodically at a frequency of 30 minutes. Latvijas Banka's system manager can also initiate the gridlock resolution manually.

Enquiries and monitoring

All participants can monitor the status of their accounts and payments in real time via their participant workstations, which are connected to the CAS via the ICN. Additionally, participants may submit enquiry requests in the form of SWIFT messages concerning the status of their accounts and payments sent to or from their accounts, including queued payments. The response from the CAS is automatically sent to the submitter of the enquiry request.

Latvijas Banka's system manager has exclusive access rights to information regarding participants.

3.2.5 TRANSACTION PROCESSING ENVIRONMENT

SAMS consists of two major components: the CAS and the SWIFT FIN Y-Copy service. The CAS provides the settlement and accounting facility for payment instructions and runs on IBM RS/6000 using an AIX operating system. SWIFT in turn provides the system with the communication network between the SAMS participants and the CAS.

The ICN is used to connect participant workstations, used for monitoring functions, and the CAS. The network infrastructure is provided by a telecommunication services company with local communication points in each bank. Frame relay technology is used as the primary connection, with ISDN as a backup. There is encryption of communication lines, and local firewalls have been implemented on the network devices; all electronic information is also electronically signed and encrypted using PKI software.

SAMS operates on a central server located on the premises of Latvijas Banka and is equipped with "hot backup" facilities.

3.2.6 SETTLEMENT PROCEDURES

SAMS accepts credit payments for same-day settlement only. However, it is possible to submit a payment message for next-day settlement after the close of the current business day. All members have access to collateralised overdraft facilities in the form of interest-free intraday credit limits (see Section 3.2.4).

Payments are settled in the order of arrival and in accordance with the particular priority level. The two sides of the transaction (debit and credit) occur simultaneously and have the same time stamp. When the receiving member receives the payment message, the payment has already been settled. As defined in the Regulation on interbank settlements effected by the Bank of Latvia, the payment order becomes irrevocable and the settlement becomes final at the moment the beneficiary's bank account is credited.

3.2.7 CREDIT AND LIQUIDITY RISK

The credit risk in SAMS is eliminated by settling funds in real time, using the SWIFT FIN Y-Copy mode (see Section 3.2.4), and by processing the payments only within the debit balance limit or the fully collateralised intraday credit limit. All funds on banks' settlement accounts, including minimum reserves, are available for settlement.

The intraday credit limit is free of charge and can be requested or changed at any time during the business day. If the participant wishes to change the intraday credit limit, it can apply to Latvijas Banka. Latvijas Banka in turn transfers the relevant securities from the participant's securities account to its collateral account via VNS, increases the participant's intraday credit limit in SAMS and sends the participant confirmation of the change in its intraday credit limit. In the event that a bank wishes to reduce its intraday credit limit, a similar, but reverse, procedure takes place.

If, at the end of the settlement day, there is a debit balance on a bank's settlement account,

Latvijas Banka allows the bank to make use of an automatic overnight lending facility, within the relevant debit balance limit, at a rate set by Latvijas Banka. As collateral, Latvijas Banka selects securities pledged for the intraday credit limit.

Additionally, members of the system can effectively monitor their liquidity in real time (see Section 3.2.4).

3.2.8 PRICING

The initial investment in SAMS was carried out by Latvijas Banka; participants merely need to provide adequate hardware and software of their own in order to be able to connect to SAMS via SWIFT and the ICN. There is no entry fee for participation in the system. For the time being only a volume-based regressive fee is levied from participants. The current transaction fee is LVL 0.80 (€1.15) for the first 100 payments per month, LVL 0.50 (€0.72) for the next 900 payments per month, and LVL 0.20 (€0.29) for all subsequent payments. In addition, the participants in the system bear all of the expenses related to the implementation of their SAMS participant workstations, as well as any expenses arising from SWIFT membership.

3.2.9 STATISTICAL DATA

In 2006 the volume of payment instructions processed in SAMS was 198,590, with a total value of LVL 51.6 billion (€73.4 billion).

3.3 LARGE-VALUE PAYMENT SYSTEMS

No other large-value payment systems play an important role in Latvia.

3.4 RETAIL PAYMENT SYSTEMS

3.4.1 E-MONEY SCHEMES

Two e-money schemes, e-Ls International and CityCredit, started operations in Latvia in 2005. Both schemes provide an internet-based e-money product, although CityCredit customers can also use prepaid cards as a tool for the conversion of cash into electronic liabilities.

e-Ls is an electronic system of accounting liabilities which is used for payments through the internet. Users can exchange electronic accounting units (e-money) denominated in different currencies, transferring property rights for any goods and services. Any participant in the system can be both a payer and a payee.

The main product offered by CityCredit is payment for car parking in various car parks in Riga. Payments are made by sending SMS instructions via mobile phones.

Both companies are still in the initial phase of their business activities, so the value of e-money issued and exchanged is still negligible.

The interest in issuing e-money in Latvia is growing. By the end of 2006 six non-licensed electronic money institutions had begun offering services. In accordance with the Credit Institution Law, these have informed Latvijas Banka about the commencement of their business activities.

3.4.2 CARD-BASED SCHEMES

FDL provides payment card data processing services to the banking system. The company (originally called BankServiss) was established by Latvian commercial banks in 1992.

FDL provides standard international processing services for a range of credit and debit card products available under the Eurocard/MasterCard (MasterCard International), Visa, American Express and Diners Club trademarks, as well as local card services for various domestic and retailer cards. For some banks the company also operates a card management system for both physical and virtual payment cards.

By the end of 2006 FDL supported a network of 16,256 POS and operated a network of 952 ATMs. The services provided by the card processing centre include management of the POS terminal and ATM networks, 24-hour online authorisation, collection of data,

transaction data processing and file preparation for settlement, as well as chargeback and retrieval request processing in accordance with the MasterCard and Visa account processing procedure.

International transactions using MasterCard and Visa products are cleared by MasterCard International and Visa respectively, and the card processing centre provides its customers with primary information processing by preparing the clearing information to be processed in international and local clearing systems. FDL provides multilateral clearing for participating banks and submits net positions to Latvijas Banka for final settlement.

In 2005 FDL was fully compliant with EMV chip technologies.

FDL processes transactions carried out using more than 1,600,000 cards (international and local debit and credit cards) each month, as well as over 4 million acquiring authorisations.

FDL, together with member banks, has introduced secure internet payment technology both for Visa (known as 3-D Secure) and for MasterCard (known as SecureCode) to protect Latvian internet merchants from fraudulent transactions. A secure internet solution has also been introduced to protect member bank cardholders when making purchases online.

In addition, the card processing centre provides its members with issuing services and is developing appropriate measures to reduce the number of fraudulent card transactions in Latvia and the consequent losses to banks, merchants and card users.

Future developments

FDL, member banks and acquiring merchants in Latvia have plans to introduce integrated electronic cash registers and cardholder-activated terminals with EMV chip technology.

In addition, FDL has plans to bring the card processing centre into line with the new international payment card organisation standard known as PCI DSS (Payment Card Industry Data Security Standard).

3.4.3 RETAIL CREDIT, DEBIT AND CHEQUE TRANSFER SYSTEMS

3.4.3.1 EKS

Organisational set-up

EKS is an ACH system which handles bulk payments in electronic form.

EKS is owned by Latvijas Banka, which is responsible for formulating, issuing and applying the system's operating rules. In order to participate in the system, the banks sign a mutual agreement with Latvijas Banka, thereby accepting the rules, responsibilities and liabilities relating to their participation in EKS. In addition, participants sign a bilateral agreement with Latvijas Banka regulating the use of the ICN, which is used for the transfer of data to and from EKS.

The following steps are taken in order to minimise systemic risk in EKS:

- Direct participation in the system is granted to all banks. Non-bank entities are not authorised to participate in the system. In addition, procedures are established for removing a participant from the system.
- The system's operational procedures ensure that banks with a shortage of liquidity are able to arrange the transfer of the necessary funds from the interbank market via the RTGS system in order to cover their debit positions.
- As EKS's net positions are settled in SAMS, banks are provided with the same liquidity facilities by Latvijas Banka as in SAMS (see Section 3.2.7). The intraday liquidity facility substantially reduces delays in the final settlement.

- An unwinding procedure is established for exceptional circumstances, e.g. when a bank fails to meet its obligations by a specified cut-off time.
- Latvijas Banka ensures reliable operational and technical facilities to complete the daily processing activities of EKS.

Moreover, the changes to the Regulation on interbank settlements which came into force on 1 February 2002, to the effect that the amount of any single payment order in EKS must not exceed LVL 50,000 (around €71,839), have further reduced the possibility of liquidity and credit risk in the system and possible debit positions on the part of participants.

Participation in the system

In addition to Latvijas Banka, any Latvian bank, any branch of a foreign bank registered in the Republic of Latvia or any credit institution registered and supervised in an EU or EEA country providing financial services in Latvia without opening a branch and complying with the provisions of the Credit Institution Law may become a participant in EKS. Owing to the risks involved in the net settlement system, non-banks are not authorised to take part in EKS. At the end of 2006 21 banks, one branch of a foreign bank and Latvijas Banka were participating in EKS.

Types of transaction handled

EKS is a multilateral net settlement system which settles bulk payments with same-day value. EKS processes only corporate and retail payments in the form of electronic credit transfers. The message format of the payments processed corresponds to the SWIFT message type MT 103 (single-customer credit transfer).

Transaction processing environment

EKS operates on a central server located on the premises of Latvijas Banka and is equipped with hot backup facilities. The ICN is used for the data exchange (see Section 3.2.5).

Settlement procedures

Banks prepare files of payment instructions (batches) in electronic form, which are then submitted to Latvijas Banka daily between 8.30 a.m. and 3 p.m. CET+1. The calculation of multilateral net positions takes place twice a day at 10.30 a.m. and 3 p.m. CET+1, and multilateral net position are settled via banks' settlement accounts with Latvijas Banka. First, all the debit positions are settled, and only then does the settlement of the credit positions take place. In the event of a bank's failure to cover its debit position in the first cycle, settlement takes place up to the amount of the available funds on the settlement account. The remaining payments are then forwarded to the next cycle. If a bank fails to cover its debit positions in the second cycle, the settlement is postponed until that bank receives the necessary funds, but only until 4 p.m. CET+1. Funds can be received either from other banks via SAMS, or from intraday liquidity facilities. If the funds are not received by 4 p.m. CET+1, the system initiates the unwinding procedure, cancels all payment orders sent and received by the bank failing to cover its debit position, and recalculates the net positions for the remaining banks. After the execution of final settlement, EKS submits the accepted payment instruction files to receiving banks together with the clearing results. According to the Regulation on interbank settlements effected by Latvijas Banka, a payment order becomes irrevocable immediately after submission to EKS, and the net settlement becomes final once all credit positions within the relevant clearing cycle have been recorded.

Pricing

To cover the system's operational costs, banks are charged a monthly regressive fee based on the volume of transactions. The fee is LVL 0.015 (€0.022) for the first 10,000 payments per month, LVL 0.007 (€0.01) for the next 90,000 payments per month, and LVL 0.002 (€0.003) thereafter.

Statistical data

In 2005 the total volume of payment instructions processed in EKS was 21.8 million, with a total value of LVL 8.4 billion (€12.1 billion).

3.4.3.2 Latvia Post

Latvia Post, which is authorised under the 1994 Postal Law to issue postal payment instruments, also manages the Postal Accounting System (PNS). The PNS was developed in 1996 and is managed by the Postal Accounting Centre, which is a branch of Latvia Post. The PNS ensures convenient, fast and secure execution of a variety of payments among private individuals and legal persons, using modern data processing technology and electronic data interchange. Only part of pensions and other social payments are still processed in the PNS in paper form. A number of different money orders and postal payment orders issued by Latvia Post are used as payment instructions in the PNS (see Section 2.2.5). This system benefits from an extensive branch network. At the end of 2006 Latvia Post had a network of 979 branches, and 178,291 accounts had been opened in the PNS.

3.4.3.3 Itella

Itella (originally called the National Payment Centre) was established in 1998 by the company Swedgiro, which was a subsidiary of Swedish Post. In 2004 Finland Post acquired the National Payment Centre from Swedgiro. This system allows every utility company or commercial bank to join the giro system and thus provide direct debit instruments to their customers (see Section 2.2.3).

Itella's products and services encompass digital printing, data management, e-commerce transactions and direct marketing. Among those e-commerce transaction services are e-invoices, direct debits and giro payments. E-invoices are personalised electronic invoices, which the recipient can view on the internet using a specific user name and password. Direct debits are a payment method whereby the payer authorises a bank to transfer payments for services or goods to the payee using Itella's

direct debit system. Giro payments involve the collection of payment information from different banks, followed by its comparison, sorting and delivery to companies with a view to providing quick and accurate settlement. Itella receives billing files from partnership utilities, extracts files with the information required for direct debit instructions and sends instruction files to the respective banks. Direct debit transaction information received from banks is validated against billing files and sent to the utilities.

Itella provides information logistics solutions, i.e. solutions for communications which are going digital. Information logistics cover the management of information both on paper and in electronic format.

3.5 FUTURE DEVELOPMENTS

With the prospect of joining the euro area, the main focus is on TARGET2 and on adapting local systems and the legal framework to ensure smooth entry to this system, possibly with the first migration group.

The development of a retail payment system for payments in euro is still under discussion. At the same time, Latvijas Banka is still seeking to enhance the operation of the payment systems that it already operates.

4 SECURITIES SETTLEMENT SYSTEMS

4.1 TRADING

The basic categories of instrument traded in the Latvian securities market are as follows:

- Government debt securities traded on the RSE and the OTC market. Interest-bearing, fixed rate Treasury bonds can be issued with a maturity of two, three, five or ten years, whereas Treasury bills can be issued with a maturity of one, three, six or twelve months.

- Corporate debt securities traded on the RSE and the OTC market. This category includes corporate money market instruments (e.g. commercial paper and certificates of deposit), corporate bonds, mortgage bonds, etc. deposited with the LCD.
- Equity shares traded on the RSE and the OTC market.
- Mutual fund units.

At present there is no central market for derivatives, although some banks issue such instruments and trade them with their customers and other banks.

4.1.1 INSTITUTIONAL ASPECTS

Most securities trading takes place at the RSE. The RSE is the sole licensed stock exchange in Latvia. It is 93%-owned by the OMX Group and is incorporated as a joint stock company. The RSE is a member of the NOREX trading alliance and thus operates a fully automated electronic continuous trading system (SAXESS) based on a public order book. Any bank or brokerage company licensed by the FCMC can become a member of the RSE. Remote (foreign) participants are also eligible for membership of the RSE. It is supervised and regulated by the FCMC. The operational procedures of the exchange, such as the rules for admission of new members, the listing requirements, the trading and quotation rules, and the clearing and settlement rules, are established in the Rules of the RSE.

The settlement of OTC trades is supported by the SSSs operated by the LCD and Latvijas Banka.

4.1.2 OPERATIONAL ASPECTS

In order to buy or sell securities quoted on the RSE, an investor must approach an RSE member – a licensed bank or a brokerage company. The RSE had 20 members at the end of 2006 (9 local and 11 cross-border).

Table 2 RSE trading day

| Time (CET+1) | Activity |
|---------------------|----------------------------|
| 8.30 a.m. | Open for business |
| 9.45 a.m.-10 a.m. | Pre-opening auction period |
| 10 a.m. | Opening auction |
| 10 a.m.-1.50 p.m. | Trading period |
| 1.50 p.m.-2 p.m. | Pre-closing auction period |
| 2 p.m. | Closing auction |
| 2.05 p.m.-2.30 p.m. | After-market trading |

Since 27 September 2004 the RSE has been employing the SAXESS trading model, which is used by all OMX exchanges, as well as the NOREX alliance. The trading system has the following special features:

- transactions can be made simultaneously with securities traded on different exchanges;
- investors' transaction orders can be entered and matched automatically without the direct involvement of a broker; and
- multiple types of transaction order can be used (limit orders, market orders, etc.).

The official trading currency of the RSE is the lats. Securities denominated in euro or US dollars may be traded in RSE markets; if so, the payment will be in the relevant currency. The timetable for RSE activities is shown in Table 2.

The smallest tick size is the minimum price set for a security, by which a broker can alter transaction orders and buy confirmations displayed in the trading system. The smallest tick size for stocks listed on the RSE is LTL 0.01 (€0.014).

The minimum lot is the minimum quantity, set for each security, which may be entered in the trading system as a transaction order. The minimum lot for securities is one; hence, even

the smallest order can be entered in the trading system.

Trading in bonds and traded fund units takes place from 10 a.m. to 2 p.m. CET+1. There is no automatic matching of transactions; all transactions are executed as negotiated deals only. Bond prices are displayed in the trading system as a percentage of the nominal price, including accrued interest.

Latvian government securities are sold in the primary market through the RSE tender system. Prior to the auction, the Ministry of Finance publicly announces the auction details, e.g. the auction date, settlement date, offered amount and ISIN code. On the auction date, the system processes a competitive auction on the basis of the bids submitted by the participants. After the auction has been completed, the participants receive information about the results. The amount of securities issued is always equal to the amount of securities bought in the auction. One day after the competitive auction, a non-competitive auction is organised, and government securities are offered at the weighted average price of the competitive auction.

In the secondary market, government debt securities are bought and sold by Latvijas Banka through tenders or by market participants concluding trades mutually. (For details of the settlement of these transactions, see Sections 4.3.1.2 and 4.3.2.2.) Latvijas Banka also organises repo tenders for securities eligible for use in monetary policy operations.

4.2 CLEARING

There is no separate clearing house currently operating in Latvia.

4.3 SETTLEMENT

There are two SSSs in the Republic of Latvia: DENOS, operated by the LCD; and VNS, operated by Latvijas Banka (see Chart 3). Latvijas Banka and the LCD have established a

bilateral correspondent banking relationship to transfer securities from VNS to DENOS and vice versa. All eligible securities that are settled via VNS are registered with the LCD.

Transactions in Latvian government debt and highly rated corporate debt securities are settled in both SSSs. Trades in other Latvian securities (equities, other corporate debt securities and mutual fund units) are settled in DENOS. Automatically matched transactions are always settled on the third day after the transaction (T+3). The default day of settlement for negotiated deals is also T+3. Negotiated deals may have a settlement day between T+0 and T+40 inclusive. Settlement for OTC transactions may be up to T+360.

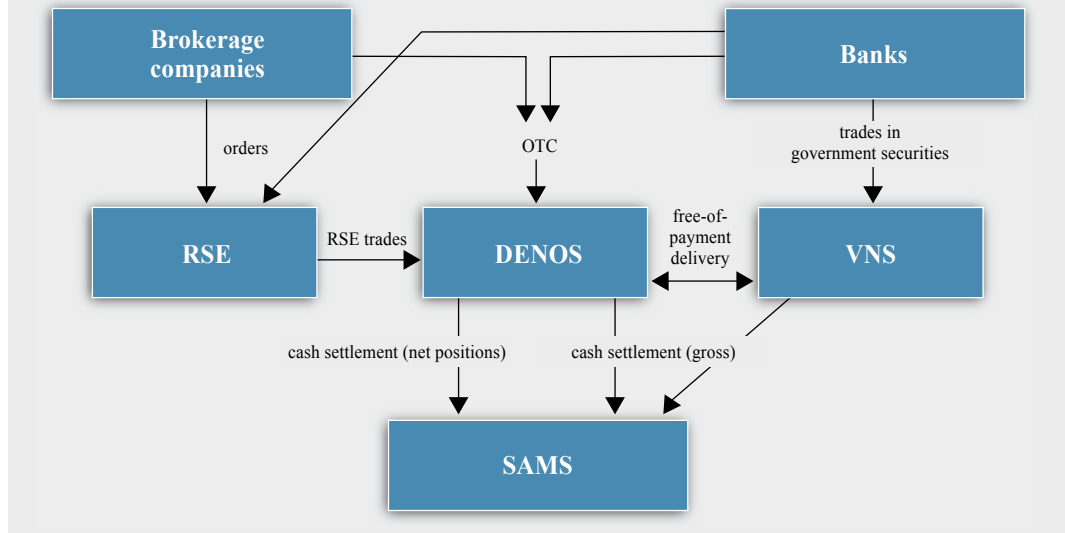
4.3.1 DENOS

4.3.1.1 Institutional and legal aspects

DENOS, which was launched in June 1995, is an SSS operated by the LCD. The LCD is a private institution which operates in accordance with the 2003 Financial Instruments Market Law, as well as in compliance with the rules and regulations approved by the FCMC. As the CSD, the LCD provides safe custody services for deposited securities, clears and settles stock exchange and OTC trades, manages corporate actions and provides information to securities market participants. The LCD does not act as a central counterparty. The services of the LCD are available only to authorised participants; those participants are not, however, required to become LCD shareholders.

The LCD participants are banks, brokerage companies and securities issuers. Special participation status is granted to the RSE, Latvijas Banka, the Estonian CSD, the Lithuanian CSD, institutional investors and mutual funds. Banks and brokerage companies licensed by the FCMC to operate in the securities market are direct participants and may be custodians of securities accounts. Brokerage companies, however, are not allowed to open cash accounts and conduct cash settlements. Thus, their cash settlements are executed on the

Chart 3 Securities settlement systems in Latvia



basis of an agreement with a bank which is an LCD participant. For the safe custody and settlement of securities, individual investors open securities accounts with a bank or brokerage company which is an LCD participant. Institutional investors and investment funds can also open securities accounts with the LCD. An indirect participant has a securities account with the LCD and participates in DENOS via a direct participant. The direct participant records the securities on behalf of the indirect participant.

4.3.1.2 Operational aspects

The daily operating hours of DENOS are from 9 a.m. until 6 p.m. CET+1 every business day.

DENOS performs the following transactions:

- DvP settlement for all transactions concluded and registered at the RSE;
- DvP settlement for OTC transactions;
- free-of-payment settlement for OTC transactions;
- transfers of securities portfolios;

- registration of pledging rights in relation to securities which are in public circulation in Latvia; and
- execution of corporate actions. (The LCD administers lists of shareholders for the purpose of general shareholder meetings, prepares lists of all shareholders as at a specific date, and pays dividends on shares and interest and principal on debt securities. Issuers use the LCD to allocate additional shares, to change the characteristics of securities and to execute other corporate actions.)

DENOS operates in a real-time processing environment. Only the LCD participants are authorised to initiate transfers in DENOS. Data exchange between the LCD participants is carried out electronically by applying special data formats to all documents used in securities transactions. At present, communication between the LCD and participants takes place using SWIFT messages sent through the SWIFT network and message files using dial-in access.

Two types of settlement are used by DENOS to settle securities transactions: net settlement and gross settlement.

Net simultaneous settlement of securities and cash (DVP Model 3) is used to settle transactions concluded at the RSE. The settlement day for trades concluded on the central and continuous markets is T+3, but for block trades it may be at any point between T+0 and T+40. The RSE uses a direct link to transmit information on concluded trades to the LCD on a daily basis. On the settlement day custodians must confirm trades in accordance with client instructions. Starting on the settlement day, the LCD calculates the multilateral net positions of market participants for securities and cash. If the securities positions are sufficient for settlement, the settlement cycle is started and the LCD sends an irrevocable instruction to Latvijas Banka to transfer cash. If cash positions are sufficient, Latvijas Banka transfers the cash, and the LCD transfers the securities. If the cash positions at Latvijas Banka are not sufficient, a second settlement attempt is made in the middle of the settlement day.

In order to minimise systemic risk, members of the RSE are obliged to contribute to a guarantee fund managed by the RSE. The guarantee fund contains only cash reserves and is used to ensure final settlement in the event of settlement failure owing to insufficient funds on the part of a participant. There is no possibility of unwinding a participant in the event of failure. As a result, the risk of another participant failing owing to the failure of the first participant is eliminated. If a participant fails, it must pay a penalty.

Gross simultaneous settlement of securities and cash (DVP Model 1) on a real-time basis is used to settle trades concluded either on the stock exchange (for the settlement period T+0 only) or on the OTC market. Each trade is settled separately. To initiate settlement for an OTC trade, brokers or custodians submit DvP instructions to the LCD. In order to facilitate communication, instructions can be submitted

by one counterparty, while the other counterparty confirms information that is received from the LCD. The LCD matches the instructions and, if necessary, requests confirmation. For matched trades, the LCD checks to see whether there is a sufficient amount of securities in the account of the seller. If so, it blocks the securities and sends an instruction to Latvijas Banka to transfer the cash. Latvijas Banka transfers the cash, and the LCD transfers the securities.

FOP transactions are executed on an RTGS basis. This type of settlement is used to settle FOP securities transfers between LCD participants, between the LCD and VNS, between the LCD and the Estonian CSD, and between the LCD and the Lithuanian CSD.

The LCD's transaction fees are regularly revised and set in accordance with its actual operational and administrative costs, which are thereby recovered. The fees differ for each type of transaction processed in the LCD.

In 2006 35,251 trades, with a market value of LVL 265 million (€377 million), were concluded on the RSE.

4.3.2 VNS

4.3.2.1 Institutional and legal aspects

VNS, launched in December 1993, is an SSS operated by Latvijas Banka and used mainly for its monetary policy operations. The Regulation on the securities settlement system of the Bank of Latvia determines the legal basis for VNS, for securities holdings and for transfers made through VNS. VNS does not act as a central counterparty.

Latvian and foreign banks which have a settlement account in lats with Latvijas Banka (i.e. a cash account) may be participants in VNS. The FCMC has been given special user status. Latvijas Banka also uses VNS to settle its monetary policy operations and to register operations with collateral.

4.3.2.2 Operational aspects

VNS provides the following services:

- settlement of operations conducted with Latvijas Banka: (namely outright transactions, collateral services for refinancing operations, the marginal lending facility, intraday credit and forex transactions with securities collateral);
- securities transfers between VNS and DENOS;
- securities redemption and interest payments; and
- provision of statements of holdings and other settlement-related information.

VNS is a continuous gross settlement system. The transactions are processed individually in real time. The daily operating hours are from 8.30 a.m. to 5 p.m. CET+1 every business day. The system processes operations with government securities, as well as operations with highly rated corporate debt securities (a list of eligible securities being approved by the Chairperson of Latvijas Banka's Board) in the secondary market. All operations processed by VNS are OTC transactions. The SWIFT network is used for securities transfers initiated by VNS participants, with the exception of the FCMC.

VNS settles securities on both a DvP and an FOP basis.

DvP gross settlement is used to settle monetary policy operations of Latvijas Banka. VNS is linked to SAMS, so that the cash leg of a transaction can be settled if necessary. If the securities and cash positions are sufficient, SAMS transfers the cash and VNS transfers the securities. VNS uses DvP Model 1: both legs of a transaction, i.e. the securities leg and the cash leg, are settled on a real-time gross settlement (trade-by-trade) basis with final and irrevocable transfers of securities taking place simultaneously with the final transfer of funds.

FOP transfers are used to settle transactions between participants, pledge securities and transfer securities between VNS and DENOS. The deliverer of securities sends an unconditional credit transfer order in electronic format as a SWIFT message. VNS checks the balance on the account of the deliverer. If the relevant securities are in the account, the account is debited, the account of the receiver is credited and both are notified of the transaction.

VNS is a continuous RTGS system which settles transfer instructions for securities and funds on a trade-by-trade basis. The only condition for performing settlements is a sufficient balance on the securities account with VNS, thus eliminating settlement risk in the system. VNS has the capacity to monitor participants' accounts continuously during working hours. Both participants involved in the securities transfer promptly receive settlement confirmation.

VNS is an integral part of Latvijas Banka and operates as a not-for-profit entity. There are neither participation nor annual fees. Participants in VNS pay only transaction fees and a monthly custody fee. Statements of holdings and other settlement-related information are available upon request via SWIFT.

In 2006 VNS settled 1,412 transactions, with a total value of LVL 3.2 billion (€4.5 billion).

4.4 THE USE OF THE SECURITIES INFRASTRUCTURE BY LATVIJAS BANKA

Latvijas Banka registers its holdings of domestic securities with VNS and uses it for settlement when carrying out operations directly related to monetary policy. Latvijas Banka mainly uses government securities deposited with VNS as collateral for monetary policy and intraday credit operations. However, certain corporate debt securities (i.e. those on a list of securities approved by the Chairperson of Latvijas Banka's Board) are also available for use as collateral for central bank operations.

Outright and reverse transactions, in which Latvijas Banka acts on its own behalf in implementing monetary policy, are executed in the form of tenders. Banks which are willing to enter into a deal with Latvijas Banka submit bids to Latvijas Banka via SWIFT. On the basis of concluded trades, the tender system initiates the respective transactions to be executed in VNS. Each deal is settled individually on a DvP basis on the trade date (T).

VNS processes operations involving collateral for intraday credit and for the overnight marginal lending facility concluded between commercial banks and Latvijas Banka. A bank may access the cash liquidity facilities provided by Latvijas Banka at any time during a settlement day by sending a request to Latvijas Banka. Upon receiving the request, Latvijas Banka calculates the necessary amount of collateral and checks the availability of collateral in the commercial bank's securities account with VNS. All collateral for transactions with Latvijas Banka is managed using a pooling method. If the necessary securities are not in VNS, the bank can transfer them from DENOS to VNS and then use them as collateral. The cash leg of the transaction is settled in SAMS (see Section 3.2).