

# **BANK OF LATVIA**

FINANCIAL STATEMENTS OF THE BANK OF LATVIA  
FOR THE YEAR ENDED 31 DECEMBER 2012  
INDEPENDENT AUDITORS' REPORT TO THE COUNCIL  
OF THE BANK OF LATVIA

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## ABBREVIATIONS

BIS	Bank for International Settlements
EC	European Commission
ECB	European Central Bank
ESCB	European System of Central Banks
EU	European Union
FCMC	Financial and Capital Market Commission
IMF	International Monetary Fund
JSC	Joint Stock Company
OECD	Organisation for Economic Co-operation and Development
OTC	over-the-counter
SDR	Special Drawing Rights
TARGET2-Latvija	component system of the Trans-European Automated Real-time Gross settlement Express Transfer system in Latvia
US	United States of America

## BALANCE SHEET

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

ASSETS	Notes <sup>1</sup>	2012	2011
FOREIGN ASSETS		<b>4 053 478</b>	3 507 542
Gold	6	218 750	210 066
Special Drawing Rights	7	83 367	79 069
Convertible foreign currencies	8	3 692 653	3 184 920
Participating interest in the European Central Bank	9	750	750
Participating interest in the Bank for International Settlements	10	19 991	18 997
Other foreign assets	11	37 967	13 740
DOMESTIC ASSETS		<b>32 857</b>	31 683
Fixed assets	12, 13	31 963	30 675
Other domestic assets	14, 15	894	1 008
TOTAL ASSETS		<b>4 086 335</b>	3 539 225

<sup>1</sup> The accompanying Notes set out on pages 9 to 41 are an integral part of these financial statements.

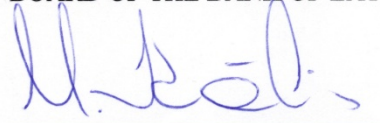
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(at the end of the year; in thousands of lats)

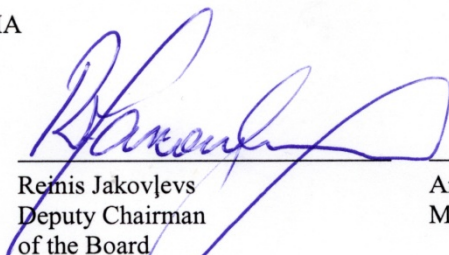
LIABILITIES, CAPITAL AND RESERVES	Notes	2012	2011
<b>FOREIGN LIABILITIES</b>		<b>27 680</b>	72 372
Convertible foreign currencies	16	18 775	9 560
International Monetary Fund	7	305	313
Other international institution deposits in lats	17	3 341	18 271
Foreign bank deposits in lats		2 332	712
Other foreign liabilities	18	2 927	43 516
<b>LATS IN CIRCULATION</b>	19	<b>1 234 147</b>	1 160 183
<b>DOMESTIC LIABILITIES</b>		<b>2 462 505</b>	1 979 508
Balances due to credit institutions	20	1 688 349	1 197 740
Balances due to the government	21	761 152	737 088
Balances due to other financial institutions	22	10 814	42 715
Other domestic liabilities	23, 24	2 190	1 965
<b>CAPITAL AND RESERVES</b>		<b>362 003</b>	327 162
Nominal capital	25	25 000	25 000
Reserve capital	25	159 797	148 587
Valuation account	25	143 245	121 547
Profit of the reporting year	25	33 961	32 028
<b>TOTAL LIABILITIES, CAPITAL AND RESERVES</b>		<b>4 086 335</b>	3 539 225

The financial statements, which are set out on pages 3 to 41, were authorised by the Board of the Bank of Latvia on 13 March 2013.

BOARD OF THE BANK OF LATVIA



Māris Kālis  
Chairman of the Board



Reinis Jakovļevs  
Deputy Chairman  
of the Board



Andris Ņikitins  
Member of the Board



Harijs Ozols  
Member of the Board



Raivo Vanags  
Member of the Board

## PROFIT AND LOSS STATEMENT

(in thousands of lats)

	Notes	2012	2011
<b>INTEREST INCOME</b>			
Foreign operations	35	<b>47 555</b>	73 265
Interest on securities		45 579	58 813
Interest on deposits with foreign credit institutions and other foreign financial institutions		995	5 832
Interest on derivative financial instruments		981	8 620
Domestic operations	35	<b>8</b>	13
Interest on loans to credit institutions		8	1
Interest on derivative financial instruments		–	12
<b>INTEREST EXPENSE</b>			
Foreign operations	35	<b>–5 521</b>	–494
Interest on deposits		–8	–7
Interest on derivative financial instruments		–5 513	–487
Domestic operations	35	<b>–4 410</b>	–11 475
Interest on deposits of credit institutions		–2 063	–4 057
Interest on government deposits		–2 273	–7 125
Interest on deposits of other financial institutions		–74	–293
<b>NET INTEREST INCOME</b>	<b>35</b>	<b>37 632</b>	61 309

*(cont.)*

(in thousands of lats)

	Notes	2012	2011
REALISED GAINS/LOSSES (-) FROM FINANCIAL OPERATIONS	36	<b>17 518</b>	5 942
Foreign operations		<b>15 944</b>	-3 505
Debt securities		25 892	11 836
Derivative financial instruments		-9 948	-15 341
Foreign currency exchange transactions		<b>1 574</b>	9 447
WRITE-DOWNS OF REVALUATION RESULT ON FINANCIAL ASSETS AND POSITIONS	25, 37	<b>-1 585</b>	-16 556
Foreign operations		<b>-1 482</b>	-14 905
Debt securities		-1 482	-14 905
Foreign currency position		<b>-103</b>	-1 651
INCOME FROM PARTICIPATING INTEREST	38	<b>278</b>	245
OTHER OPERATING INCOME	39	<b>1 482</b>	1 261
BANKNOTE PRODUCTION AND COINAGE COSTS	40	<b>-797</b>	-582
OTHER OPERATING EXPENSES		<b>-20 567</b>	-19 591
Remuneration	41	-10 243	-9 902
Social security costs	41	-2 430	-2 373
Depreciation and amortisation charges	12, 15	-2 887	-2 948
Maintenance and operation of information systems		-1 993	-1 670
Other operating expenses	42	-3 014	-2 698
<b>PROFIT OF THE REPORTING YEAR</b>		<b>33 961</b>	32 028

## STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

(in thousands of lats)

	Notes	2012	2011
<b>REVALUATION</b>	25	<b>34 815</b>	27 871
Equity instruments		995	17 233
Foreign currency and gold		6 253	6 068
OTC interest rate swap arrangements		–	25
Debt securities		27 567	4 545
<b>REALISATION OF ACCUMULATED REVALUATION RESULT</b>	25	<b>–14 702</b>	–30 493
Foreign currency and gold		–145	–13 761
OTC interest rate swap arrangements		–25	–
Debt securities		–14 532	–16 732
<b>WRITE-DOWNS OF REVALUATION RESULT ON FINANCIAL ASSETS AND POSITIONS</b>	25, 37	<b>1 585</b>	16 556
<b>PROFIT OF THE REPORTING YEAR</b>		<b>33 961</b>	32 028
<b>TOTAL</b>		<b>55 659</b>	45 962

## CASH FLOW STATEMENT

(in thousands of lats)

	Notes	2012	2011
<b>CASH FLOW FROM OPERATING ACTIVITIES</b>			
Profit of the reporting year		<b>33 961</b>	32 028
Non-cash transaction adjustments	43 (1)	<b>4 462</b>	19 506
Net movements in balance sheet positions	43 (1)	<b>398 298</b>	6 178
Net cash and cash equivalents inflow from operating activities		<b>436 721</b>	57 712
<b>CASH FLOW FROM INVESTING ACTIVITIES</b>			
Dividends on shares of the Bank for International Settlements	38	<b>278</b>	245
Acquisition of fixed assets	12	<b>-3 925</b>	-2 345
Disposal of fixed assets	12	<b>13</b>	-
Acquisition of intangible assets	15	<b>-218</b>	-92
Net cash and cash equivalents outflow from investing activities		<b>-3 852</b>	-2 192
<b>CASH FLOW FROM FINANCING ACTIVITIES</b>			
Profit appropriated to the state budget	25	<b>-20 818</b>	-15 440
Net cash and cash equivalents outflow from financing activities		<b>-20 818</b>	-15 440
<b>NET CASH AND CASH EQUIVALENTS INFLOW</b>		<b>412 051</b>	40 080
Cash and cash equivalents at the beginning of the year	43 (2)	<b>596 730</b>	556 650
Cash and cash equivalents at the end of the year	43 (2)	<b>1 008 781</b>	596 730



## NOTES TO THE FINANCIAL STATEMENTS

### 1. PRINCIPAL ACTIVITIES

The Bank of Latvia is the central bank of Latvia. It was established on 19 September 1922 (re-established in 1990) and operates under the Law of the Republic of Latvia "On the Bank of Latvia" and other legislative provisions.

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

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

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

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

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

The Head Office of the Bank of Latvia is situated in K. Valdemāra iela 2A, Riga. The Bank of Latvia manages the storage, processing and circulation of cash through its Riga Branch and the regional branches in Daugavpils and Liepāja. Since 2012 the Bank of Latvia's building at K. Valdemāra iela 1B, Riga, is used to ensure the operation of the interbank payment systems, compilation and publishing of statistics, operation of the Credit Register and customer service for cash transactions.

### 2. PRINCIPAL ACCOUNTING POLICIES

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

#### 2.1. Basis of presentation

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

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

#### 2.2. Basis of measurement

These financial statements have been prepared in accordance with the historical cost basis of accounting except for gold, debt securities, participating interest (except the participating interest in the ECB), currency future contracts and interest rate derivatives, which are accounted for at fair value. Forward exchange rate contracts and currency swap arrangements are valued according to the principles described in Note 2.15. The reconciliation of the book value and fair value of these instruments is provided in Note 26.

#### 2.3. Fair value of financial assets and financial liabilities

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

Fair value of financial instruments is determined by the Bank of Latvia using quoted prices in active markets, other financial market information sources or discounted cash flows. The discounted cash flows are modelled using quoted market prices of financial instruments and money market interest rates. The breakdown of assets and liabilities measured at fair value, taking into account the hierarchy of fair value determination, is provided in Note 5.

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

#### 2.4. Foreign currency and gold translation

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

Transactions in foreign currencies are included in the calculation of net foreign currency position of the respective currency. The transactions in foreign currencies reducing the respective currency position result in realised gains or losses. Any gain or loss arising from revaluation of transactions in foreign currencies and currency positions are credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles referred to in Note 2.25. The principles referred to herein and in Note 2.25 for valuation and recording of transactions denominated in foreign currencies shall be applicable also to gold reserves and transactions in gold.

The exchange rates of major foreign currencies set by the Bank of Latvia and used in the preparation of the balance sheet for the year ended 31 December 2012 and the year ended 31 December 2011 are as follows:

	(at the end of the year)		
	2012	2011	Changes (%)
Euro (EUR)	<b>0.702804</b>	0.702804	0
US dollar (USD)	<b>0.531</b>	0.544	-2.4
Japanese yen (JPY)	<b>0.00619</b>	0.007	-11.6
Gold (XAU)	<b>879.554</b>	844.634	4.1
Special Drawing Rights (XDR)	<b>0.818</b>	0.839	-2.5

#### 2.5. Recognition and derecognition of financial assets and liabilities

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

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

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

#### 2.6. Offsetting financial assets and financial liabilities

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

#### 2.7. Use of estimates and assumptions

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

The major estimates and assumptions in the preparation of the financial statements have been made with respect to the following: impairment of assets (see Note 2.19), the method for establishing the fair value of the BIS shares (see Note 10), the useful life of fixed assets and intangible assets (see Notes 2.17 and 2.18), the repurchasing probability of collector coins (see Note 2.22), as well as the court proceedings of the bankrupt JSC *Banka Baltija* (see Note 47).

#### 2.8. Gold

Gold reserves are stated at market value in the balance sheet in accordance with the principles described in Note 2.4.

Any gain or loss arising from transactions in gold and revaluation of gold reserves is credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles described in Note 2.25.

### **2.9. Debt securities**

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

Interest on securities, including premium and discount, is recognised in the profit and loss statement as interest income. Gain or loss arising from transactions in debt securities and revaluation are credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles referred to in Note 2.25.

### **2.10. Reverse repurchase agreements**

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

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

### **2.11. Repurchase agreements**

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

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

### **2.12. Securities lending**

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

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

### **2.13. Loans to credit institutions, deposits and similar financial claims and financial liabilities**

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

### **2.14. Participating interest**

Participating interest includes long-term investments of the Bank of Latvia in equity instruments. The Bank of Latvia has no control or significant influence in any institution, therefore participating interest is not accounted for as an investment in a subsidiary or an associate. Equity instruments are reported at fair value in the balance sheet, except participating interest in the ECB, which is reported at cost in the balance sheet in accordance with the legal framework for accounting and financial reporting in the ESCB.

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

### **2.15. Derivative financial instruments**

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

Interest on derivative financial instruments, including the spot and forward interest rate spread of forward exchange rate contracts and currency swap arrangements, is recognised in the profit and loss statement as interest income or interest expense. Any gain or loss arising from a change in fair value of interest rate and currency future contracts is included in the profit and loss statement. Any gain or loss arising from a change in fair value of other derivative financial instruments is credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles referred to in Note 2.25.

## 2.16. Accrued interest income and expense

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

## 2.17. Fixed assets

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

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

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

In 2012 and 2011, the useful life set for fixed assets was as follows:

	(years)	
	2012	2011
Buildings and their components, improvement of territory	5–100	5–100
Transport vehicles	10–15	10
Office equipment and inventories	5–25	5–25
Cash processing and verifying equipment	5–15	5–15
Computer and telecommunication equipment	2–7	2–7
Other fixed assets	5–15	5–15

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

## 2.18. Intangible assets

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

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

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

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

## 2.19. Impairment of assets

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

No impairment of assets was detected in 2012 and 2011.

## 2.20. Lats in circulation

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

## 2.21. Gold circulation coins

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

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

#### **2.22. Collector coins**

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

#### **2.23. Provisions**

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

#### **2.24. Cash and cash equivalents**

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

#### **2.25. Recognition of gains or losses on financial instruments**

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

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

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

#### **2.26. Interest income and expense**

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

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

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

#### **2.27. Realised gains or losses from financial operations**

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

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

#### **2.28. Income from participating interest**

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

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

#### **2.29. Banknote production and coinage costs**

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

### **2.30. Other expense and income**

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

## **3. SUMMARY OF THE BANK OF LATVIA'S FINANCIAL POSITION AND FINANCIAL PERFORMANCE**

### **3.1. Financial position**

In 2012, the Bank of Latvia assets grew by 547.1 million lats mainly on account of an increase in foreign assets.

Assets in convertible foreign currencies posted 507.7 million lats growth, mostly as a result of increases of 423.5 million lats in credit institution deposits in foreign currencies and 195.6 million lats<sup>1</sup> in the Bank of Latvia foreign exchange transactions with credit institutions, while a 181.7 million lats reduction in the Latvian government's foreign currency deposits with the Bank of Latvia had a decreasing effect.

As a result of persistent excess liquidity in lats held by credit institutions, the Bank of Latvia had granted no loans to credit institutions at the end of 2012. Credit institution deposits in lats grew by 67.1 million lats in 2012.

With the demand for cash growing, the amount of cash in circulation expanded in 2012, hence the Bank of Latvia balance sheet caption "Lats in circulation" increased by 74.0 million lats.

Capital and reserves of the Bank of Latvia grew by 34.8 million lats on account of profits earned in 2012 (34.0 million lats) and net changes in valuation of financial instruments (21.7 million lats), whereas profits remitted to the state budget revenue in the amount of 20.8 million lats had a decreasing effect.

### **3.2. Financial performance**

In 2012 the Bank of Latvia profit amounted to 34.0 million lats (32.0 million lats in 2011).

In 2012 net interest income decreased by 23.7 million lats in comparison with 2011. Interest income on securities shrank by 13.2 million lats, with the adverse impact of the mostly low interest rates in the US and euro area in 2012 persisting. However, such adverse impact from the low interest rates was partly offset by an increase in the Bank of Latvia's foreign reserves and investment decisions, which ensured a higher return on foreign reserves in comparison with that on the benchmark.

In 2012 the short-term interest rates on the US dollar exceeded those on the euro, reducing interest income from and increasing interest expense on financial derivatives used for hedging currency and gold price risk (hereinafter, currency risk).

Given the excess lats liquidity of credit institutions, the Bank of Latvia issued loans to credit institutions in minimum amounts in 2012 and the respective interest income was 8 thousand lats (1 thousand lats in 2011).

With average credit institution deposits in lats with the Bank of Latvia decreasing and due to lower average interest rates on these deposits than in 2011, the interest expense on credit institution deposits contracted by 2.0 million lats. Lower interest rates on government deposits in foreign currencies and a smaller amount of funds in foreign currencies received from the Latvian government as deposits accounted for a 5.6 million lats fall in interest expense on the above deposits, while interest expense on the government deposits in lats grew by 0.7 million lats.

Realised gains from financial operations increased by 11.6 million lats, while write-downs of the negative revaluation result on financial assets and positions decreased by 15.0 million lats in comparison with 2011, mostly on account of a fall in interest rates in the euro area and the US in 2012, which in turn positively affected the market value of the respective securities, as well as the realisation of the positive revaluation result accumulated in the previous periods. The realised gains from financial operations were also affected by the result of currency future contracts concluded for the purpose of hedging the currency risk and realised gains on foreign exchange transactions. The positive revaluation result of the hedged balance sheet items is reported in the balance sheet caption "Valuation account".

The uncertainty of the Bank of Latvia's further financial performance is mostly related to interest rate developments in the euro area and US financial markets since the Bank of Latvia is exposed to the interest rate risk. In view of the very low levels of interest rates, a further interest rate fall is potentially negligible in comparison with a potential rise; thus, the expected pickup in interest rates in foreign financial markets may negatively affect the income on foreign fixed income securities.

## **4. INVESTMENT POLICY**

Managing of foreign reserves is conducted in compliance with the basic principles set out in the "Guidelines for Managing the Bank of Latvia's Foreign Reserves" as approved by the Council of the Bank of

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<sup>1</sup> On a settlement date basis.

Latvia (hereinafter, the Guidelines), including preserving the value of foreign reserves, ensuring their liquidity and earning income within the framework of acceptable risk without contradicting to the Bank of Latvia's monetary policy.

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

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

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

The breakdown of foreign reserves by type of investment portfolio at the end of 2012 and 2011 was as follows:

	Portfolio value (in thousands of lats)		Percentage (%)	
	2012	2011	2012	2011
Portfolios managed against multi-currency fixed income securities benchmark	<b>2 703 967</b>	2 388 804	<b>79.9</b>	72.7
Portfolios of borrowed funds	<b>274 931</b>	507 330	<b>8.1</b>	15.4
Gold reserves portfolio	<b>225 862</b>	215 374	<b>6.7</b>	6.5
Portfolios managed against asset-backed securities benchmark	<b>181 438</b>	175 883	<b>5.3</b>	5.4
<b>Total</b>	<b>3 386 198</b>	3 287 391	<b>100.0</b>	100.0

In 2012 the Bank of Latvia increased diversification of foreign reserves by pledging the government securities of Canada and Singapore to its multi-currency fixed income securities benchmark; consequently, now it is pledged to the weighted 1–3 year government securities index of the euro area countries, US, Japan, Canada and Singapore (merely the euro area countries, the US and Japan in 2011).

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

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

The benchmark of portfolios managed against asset-backed securities benchmark is pledged to the US mortgage-backed securities index.

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

The description of the main methods used in financial risk management is provided in Note 27.1.

## BALANCE SHEET NOTES

### 5. ASSETS AND LIABILITIES AT FAIR VALUE

Fair value of Bank of Latvia's assets and liabilities is determined using the following hierarchy (see also Note 2.3):

- quoted market price. Fair value is determined using quoted prices for identical financial instruments in active markets;
- observable data. Fair value is determined using quoted prices for similar financial instruments in active markets, quoted prices for similar or identical financial instruments in inactive markets or using models where all significant inputs are observable;
- non-observable data. Fair value is determined using models where significant inputs are not observable.

At the end of 2012 and 2011, Bank of Latvia's assets and liabilities carried at fair value were generally valued on the basis of quoted market price.

At the end of 2012 and 2011, participating interest in the BIS was assessed using non-observable data. The assessment was conducted using the 70% net asset value model (see also Note 10).

At the end of 2012 and 2011, the breakdown of assets and liabilities carried at fair value according to the fair value hierarchy was as follows:

	(in thousands of lats)			
	Quoted market price	Observable data	Non- observable data	Total
<b>As at 31 December 2012</b>				
FOREIGN ASSETS				
Gold	218 750	–	–	218 750
Convertible foreign currencies				
Debt securities	2 418 964	264 908	–	2 683 872
Participating interest in the Bank for International Settlements	–	–	19 991	19 991
Other foreign assets				
Forward transactions in securities	158	–	–	158
<b>Total foreign assets at fair value</b>	<b>2 637 872</b>	<b>264 908</b>	<b>19 991</b>	<b>2 922 771</b>
FOREIGN LIABILITIES				
Other foreign liabilities				
Forward transactions in securities	121	–	–	121
<b>Total foreign liabilities at fair value</b>	<b>121</b>	<b>–</b>	<b>–</b>	<b>121</b>
<b>As at 31 December 2011</b>				
FOREIGN ASSETS				
Gold	210 066	–	–	210 066
Convertible foreign currencies				
Debt securities	2 227 982	214 727	–	2 442 709
Participating interest in the Bank for International Settlements	–	–	18 997	18 997
Other foreign assets				
Forward transactions in securities	560	–	–	560
OTC interest rate swap arrangements	–	25	–	25
<b>Total foreign assets at fair value</b>	<b>2 438 608</b>	<b>214 752</b>	<b>18 997</b>	<b>2 672 357</b>
FOREIGN LIABILITIES				
Other foreign liabilities				
Forward transactions in securities	147	–	–	147
<b>Total foreign liabilities at fair value</b>	<b>147</b>	<b>–</b>	<b>–</b>	<b>147</b>

The average market prices on the last trading day of the reporting year are obtained from the electronic information systems *Bloomberg* and *Interactive Data*. Where the above price for a financial instrument is absent in the electronic information systems, the price provided by a market participant (broker) or the price determined by applying the discounted cash flow approach is used for evaluating the financial instrument.



## 6. GOLD

	Troy ounces	In thousands of lats
As at 31 December 2010	248 706	187 179
During 2011		
Increase in gold market value	x	22 887
As at 31 December 2011	248 706	210 066
<b>During 2012</b>		
Increase in gold market value	x	8 684
<b>As at 31 December 2012</b>	<b>248 706</b>	<b>218 750</b>

The Bank of Latvia hedges the risk related to fluctuations in gold reserves market value by entering into forward exchange rate contracts, currency swap arrangements, and currency future contracts (see also Note 2.8, 2.15 and 28). Revaluation of gold reserves, forward exchange rate contracts, and currency swap arrangements is recognised in the balance sheet caption "Valuation account", whereas revaluation of currency future contracts, taking into account settlement, is recognised in the profit and loss statement caption "Realised gains/losses from financial operations".

## 7. SPECIAL DRAWING RIGHTS, INTERNATIONAL MONETARY FUND

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

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

Latvia's liabilities to the IMF are made up of the IMF holdings in lats and IMF allocations. In 2012 liabilities to the IMF decreased, with the Latvian government repaying the IMF loan in the amount of 982 240 SDR and thus redeeming the promissory notes of the same amount issued by the government of Latvia.

At the end of 2012, the claims on the IMF in SDR as recorded on the Bank of Latvia's balance sheet were equivalent to 83 367 thousand lats (at the end of 2011 – 79 069 thousand lats), whereas the liabilities to the IMF are made up of funds at the disposal of the IMF in the amount of 305 thousand lats (at the end of 2011 – 313 thousand lats) held on its Accounts No. 1 and No. 2.

At the end of 2012 and 2011, Latvia's net liabilities to the IMF were as follows:

	(in thousands of lats)		(in thousands of SDR)	
	2012	2011	2012	2011
Latvia's quota in the IMF	<b>116 238</b>	119 222	<b>142 100</b>	142 100
IMF holdings in lats	<b>-116 207</b>	-943 290	<b>-142 062</b>	-1 124 302
Promissory notes of the Latvian government	-115 902	-942 977	-141 690	-1 123 930
Account No. 1	-291	-298	-355	-355
Account No. 2	-14	-15	-17	-17
Stand-by Arrangement for Latvia	-	824 099	-	982 240
Reserve position in IMF	<b>45</b>	46	<b>55</b>	55
SDR	<b>83 367</b>	79 069	<b>101 916</b>	94 242
General allocation	<b>-76 890</b>	-78 864	<b>-93 998</b>	-93 998
Special allocation	<b>-21 942</b>	-22 505	<b>-26 824</b>	-26 824
Latvia's net liabilities to the IMF	<b>-15 420</b>	-22 254	<b>-18 851</b>	-26 525

The reserve position in the IMF is the difference between the Latvia's quota in the IMF and the IMF holdings in lats, excluding the balance on Account No. 2 and adding the amount of the Stand-by Arrangement for Latvia.

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

## 8. CONVERTIBLE FOREIGN CURRENCIES

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

The carrying amount of interest bearing debt securities includes accrued interest income (18 724 thousand lats at the end of 2012 and 19 604 thousand lats at the end of 2011).

At the end of 2012 and 2011, the balance sheet asset caption "Convertible foreign currencies" was comprised of the following assets:

	(in thousands of lats)	
	2012	2011
Debt securities of foreign governments, financial institutions and non-financial corporations	<b>2 683 872</b>	2 442 709
Demand deposits with foreign central banks, credit institutions and international institutions	<b>991 831</b>	519 867
Time deposits with foreign credit institutions and other foreign financial institutions	<b>3 611</b>	208 733
Foreign currency in cash	<b>13 339</b>	13 611
Total	<b>3 692 653</b>	3 184 920

For pledged assets in convertible foreign currencies see Note 45.

## 9. PARTICIPATING INTEREST IN THE EUROPEAN CENTRAL BANK

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

At the end of 2012 and 2011, the Bank of Latvia's percentage share in the ECB's capital was 0.2837% equivalent to 30 528 thousand euro (21 455 thousand lats). As Latvia does not participate in the euro area, pursuant to the transitional provisions of the Statute of the ESCB and of the ECB and Decision of the ECB's General Council, the Bank of Latvia has paid up a 3.75% minimum contribution of its total subscribed capital in

the ECB amounting to 1 145 thousand euro or 750 thousand lats (1 145 thousand euro or 750 thousand lats at the end of 2011; see also Note 47).

In accordance with the legal framework for accounting and financial reporting in the ESCB participating interest in the ECB's capital has been reported at cost in the balance sheet of the Bank of Latvia. ECB's capital shares are not traded in the public securities market, and the share of the Bank of Latvia in the ECB's capital can be increased or decreased only in the cases referred to in this Note (see also Note 2.14).

#### **10. PARTICIPATING INTEREST IN THE BANK FOR INTERNATIONAL SETTLEMENTS**

At the end of 2012 and 2011, the Bank of Latvia owned 1 070 shares in the BIS, which correspond to 0.19% of the total subscribed and paid-up BIS capital.

The nominal value of the Bank of Latvia's shareholding in the BIS is 5 350 thousand SDR (the nominal value per share is 5 thousand SDR), paid up in the amount of 1 338 thousand SDR or 25% (see also Note 47). At the end of 2012 and 2011, the BIS shareholding is reported in the Bank of Latvia balance sheet at fair value. BIS shares are not traded in the public securities market. In the opinion of the Bank of Latvia's management, the most appropriate method for establishing the fair value of the BIS shares is 70% of the BIS net assets based on the latest audited financial statements of the BIS. The BIS applied this valuation method for calculating the price of its shares; the International Court at the Hague has also recognised it as appropriate for the valuation of shares when repurchasing them from former private shareholders of the BIS. Pursuant to the Statutes of the BIS, only central banks can be shareholders in the BIS. At the end of 2012, the fair value of BIS shares was 19 991 thousand lats (18 997 thousand lats at the end of 2011) (see also Note 2.14).

#### **11. OTHER FOREIGN ASSETS**

	(in thousands of lats)	
	<b>2012</b>	2011
OTC financial derivative and spot exchange rate contracts with non-residents	<b>37 001</b>	13 143
Prepaid expense	<b>740</b>	461
Interest accrued on deposits	<b>1</b>	59
Other	<b>225</b>	77
<b>Total</b>	<b>37 967</b>	13 740

## 12. FIXED ASSETS

(in thousands of lats)

	Buildings, improvement of territory, and land	Furniture and office equipment	Cash processing equipment	Transport vehicles	Other fixed assets	Total
<b>As at 31 December 2010</b>						
Cost	37 000	6 368	4 580	1 235	5 133	54 316
Accumulated depreciation	-11 041	-4 878	-2 488	-743	-4 163	-23 313
Net book value	25 959	1 490	2 092	492	970	31 003
<b>During 2011</b>						
Additions	1 566	306	30	–	443	2 345
Change in classification	–	88	-37	–	-51	–
Disposals and write-offs	–	-64	-3	-24	-169	-260
Net change in cost	1 566	330	-10	-24	223	2 085
Depreciation charge	-1 694	-372	-238	-102	-265	-2 671
Change in classification	–	-39	36	–	3	–
Accumulated depreciation on disposals and write-offs	–	63	3	24	168	258
Net change in accumulated depreciation	-1 694	-348	-199	-78	-94	-2 413
<b>As at 31 December 2011</b>						
Cost	38 566	6 698	4 570	1 211	5 356	56 401
Accumulated depreciation	-12 735	-5 226	-2 687	-821	-4 257	-25 726
Net book value	25 831	1 472	1 883	390	1 099	30 675
<b>During 2012</b>						
Additions	2 872	552	25	–	476	3 925
Change in classification	-8	–	–	–	-27	-35
Disposals and write-offs	-1	-455	-12	-38	-38	-544
Net change in cost	2 863	97	13	-38	411	3 346
Depreciation charge	-1 715	-320	-240	-43	-281	-2 599
Accumulated depreciation on disposals and write-offs	1	452	12	38	38	541
Net change in accumulated depreciation	-1 714	132	-228	-5	-243	-2 058
<b>As at 31 December 2012</b>						
Cost	41 429	6 795	4 583	1 173	5 767	59 747
Accumulated depreciation	-14 449	-5 094	-2 915	-826	-4 500	-27 784
<b>Net book value</b>	<b>26 980</b>	<b>1 701</b>	<b>1 668</b>	<b>347</b>	<b>1 267</b>	<b>31 963</b>

At the end of 2012, the total cadastral value of land under the ownership and possession of the Bank of Latvia was 1 771 thousand lats (1 811 thousand lats at the end of 2011; the change is related to a revision in the cadastral value of land). Land is reported in the balance sheet of the Bank of Latvia at cost (1 669 thousand lats at the end of 2012 and 2011).

At the end of 2012, the Bank of Latvia's contractual commitments related to acquisition of fixed assets were 165 thousand lats (3 338 thousand lats at the end of 2011); their reduction is mostly related to the completion of the reconstruction of the building at K. Valdemāra iela 1B, Riga.

### 13. LEASING

The Bank of Latvia's assets subject to leases are premises, land, and equipment. In the balance sheet they are reported as fixed assets. Asset lease agreements where the Bank of Latvia acts as a lessor are operating leases. Lease payments, except those that are directly transferred to the state budget, are recognised in the profit and loss statement proportionally over the term of the respective agreement. The depreciation of the assets given on lease is calculated on the basis of the depreciation policy described in Note 2.17 and reported in the profit and loss statement as depreciation charges.

Carrying amount of assets given on lease at the end of 2012 and 2011 was as follows:

	(in thousands of lats)
<hr/>	
As at 31 December 2011	
Cost	1 146
Accumulated depreciation	-538
<hr/>	
Net book value	608
<hr/>	
<b>As at 31 December 2012</b>	
Cost	1 163
Accumulated depreciation	-580
<hr/>	
<b>Net book value</b>	<b>583</b>
<hr/>	

### 14. OTHER DOMESTIC ASSETS

	(in thousands of lats)	
	2012	2011
<hr/>		
Intangible assets	405	440
Prepaid expense	161	108
Spot exchange rate contracts with residents	73	-
Other	255	460
<hr/>		
Total	894	1 008
<hr/>		

## 15. INTANGIBLE ASSETS

(in thousands of lats)

As at 31 December 2010	
Cost	3 878
Accumulated amortisation	-3 253
Net book value	625
During 2011	
Additions	92
Net change in cost	92
Amortisation charge	-277
Net change in accumulated amortisation	-277
As at 31 December 2011	
Cost	3 970
Accumulated amortisation	-3 530
Net book value	440
<b>During 2012</b>	
Additions	218
Change in classification	35
Net change in cost	253
Amortisation charge	-288
Net change in accumulated amortisation	-288
<b>As at 31 December 2012</b>	
Cost	4 223
Accumulated amortisation	-3 818
<b>Net book value</b>	<b>405</b>

## 16. CONVERTIBLE FOREIGN CURRENCIES

At the end of 2012 convertible foreign currency liabilities mostly consisted of the cash collateral received by the Bank of Latvia for securing transactions in derivative financial instruments, as well as funds on the EC account for settlements in euro. The EC account is used by the EC for the distribution of EU budgetary funds (see also Note 17).

(in thousands of lats)

	2012	2011
Cash collateral received	15 279	3 580
EC demand deposits	1 488	5 681
Other liabilities	2 008	299
Total	18 775	9 560

### 17. OTHER INTERNATIONAL INSTITUTION DEPOSITS IN LATS

Other international institution deposits in lats mostly consist of funds on the EC account for settlements in lats, which is used for effecting Latvian government payments to the EU budget (see also Note 16).

	(in thousands of lats)	
	2012	2011
EC demand deposits	2 965	18 024
Other deposits	376	247
Total	3 341	18 271

### 18. OTHER FOREIGN LIABILITIES

	(in thousands of lats)	
	2012	2011
OTC financial derivative contracts and spot exchange rate contracts with non-residents	1 977	43 210
Payments due	607	–
Accrued expense	309	272
Other	34	34
Total	2 927	43 516

### 19. LATS IN CIRCULATION

Banknotes and coins with the total nominal value of 1 160 654 thousand lats and 73 493 thousand lats respectively were in circulation at the end of 2012 (1 093 313 thousand lats and 66 870 thousand lats respectively at the end of 2011).

At the end of 2012, the total nominal value of the issued gold circulation coins (fineness .999), with the denomination of 100 lats, and collector coins was 1 989 thousand lats and 1 613 thousand lats respectively (1 989 thousand lats and 1 556 thousand lats at the end of 2011 respectively). The respective coins in circulation are not included in the balance sheet caption "Lats in circulation" (see also principles described in Notes 2.21 and 2.22).

### 20. BALANCES DUE TO CREDIT INSTITUTIONS

Balances due to credit institutions include balances on the settlement accounts of domestic credit institutions opened with the Bank of Latvia, as well as overnight and 7-day deposits (deposit facility) received from them. The respective credit institutions place their funds with the Bank of Latvia in order to comply with its minimum reserve requirement, as well as to effect interbank and customer payments, and settlements related to the Bank of Latvia's monetary policy operations. At the end of 2012, the overnight deposit facility rate and 7-day deposit facility rate as set by the Bank of Latvia were 0.05% and 0.075% respectively (at the end of 2011, the overnight deposit facility rate and 7-day deposit facility rate were 0.25% and 0.375% respectively).

	(in thousands of lats)	
	2012	2011
Current account balances in lats	857 728	824 840
Current account balances in euro	567 191	143 680
Overnight deposit facility in lats	11 930	2 220
7-day deposit facility in lats	251 500	227 000
Total	1 688 349	1 197 740

## 21. BALANCES DUE TO THE GOVERNMENT

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

	(in thousands of lats)	
	2012	2011
Demand deposits in lats	441 218	235 441
Demand deposits in foreign currencies	319 934	242 523
Time deposits in foreign currencies	–	259 124
<b>Total</b>	<b>761 152</b>	<b>737 088</b>

## 22. BALANCES DUE TO OTHER FINANCIAL INSTITUTIONS

Balances due to other financial institutions mostly include the funds of the FCMC and the Deposit Guarantee Fund and Fund for the Protection of the Insured, both managed by the FCMC, in the amount of 9 080 thousand lats (41 027 thousand lats at the end of 2011).

## 23. OTHER DOMESTIC LIABILITIES

	(in thousands of lats)	
	2012	2011
Accrued expense and similar liabilities	1 669	1 571
Tax liabilities	96	69
Accrued interest expense	9	63
Other	416	262
<b>Total</b>	<b>2 190</b>	<b>1 965</b>

## 24. TAX

	(in thousands of lats)						
	Personal income tax	Compul- sory social security contribu- tions (by employer)	Compul- sory social security contribu- tions (by employee)	Tax on real estate	Value added tax	Other taxes and duties	Total
Liabilities as at 31 December 2010	0	0	0	0	80	0	80
<b>During 2011</b>							
Calculated	2 044	2 373	1 086	92	427	1	6 023
Increase in deferred liabilities	0	5	0	0	0	0	5
Paid	–2 044	–2 378	–1 086	–92	–438	–1	–6 039
Liabilities as at 31 December 2011	0	0	0	0	69	0	69
<b>During 2012</b>							
Calculated	2 074	2 430	1 097	89	505	1	6 196
Decrease in deferred liabilities	0	–27	0	0	0	0	–27
Paid	–2 074	–2 403	–1 097	–89	–478	–1	–6 142
<b>Liabilities as at 31 December 2012</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>96</b>	<b>0</b>	<b>96</b>

In addition to the tax payments indicated herein, the Bank of Latvia transfers 65% of the profit for the reporting year, including the payment for the usage of state capital (20 818 thousand lats in 2012;



15 440 thousand lats in 2011; see also Notes 25 and 44) to the state budget. The Bank of Latvia is not subject to corporate income tax.

## 25. CAPITAL AND RESERVES

	(in thousands of lats)				
	Nominal capital	Reserve capital	Valuation account	Profit of the reporting year	Capital and reserves
As at 31 December 2010	25 000	140 273	107 613	23 754	296 640
<b>During 2011</b>					
Revaluation, realisation, and write-downs	x	x	13 934	x	13 934
Profit appropriated to the state budget	x	x	x	-15 440	-15 440
Profit transferred to the reserve capital	x	8 314	x	-8 314	0
Profit of the reporting year	x	x	x	32 028	32 028
As at 31 December 2011	25 000	148 587	121 547	32 028	327 162
<b>During 2012</b>					
Revaluation, realisation, and write-downs	x	x	21 698	x	21 698
Profit appropriated to the state budget	x	x	x	-20 818	-20 818
Profit transferred to the reserve capital	x	11 210	x	-11 210	0
Profit of the reporting year	x	x	x	33 961	33 961
<b>As at 31 December 2012</b>	<b>25 000</b>	<b>159 797</b>	<b>143 245</b>	<b>33 961</b>	<b>362 003</b>

The capital of the Bank of Latvia is comprised of the nominal capital, reserve capital and the balance sheet item "Valuation account", as well as the undistributed profit of the reporting year. The Bank of Latvia does not take decisions affecting the formation of the nominal capital, reserve capital, and the profit distribution as they are provided for by the Law "On the Bank of Latvia". The balance sheet item "Valuation account" comprises the positive result on revaluation of the financial instruments and gold. The accounting policy, harmonised with the principal accounting policies established by the legal framework for accounting and financial reporting in the ESCB and described in Note 2, stipulates that the realised gains are recognised in the profit and loss statement only after the disposal of a financial instrument or settlement while unrealised gains are recorded under the balance sheet item "Valuation account", thus facilitating the preservation of the capital under the impact of financial instrument price, interest rate and exchange rate fluctuations.

The legislation does not provide for any capital adequacy requirements for the central bank; nevertheless, the amount of the Bank of Latvia's capital should be adequate to promote credibility of the monetary policy implemented by the Bank of Latvia, and to ensure implementation of its operations and financial independence when performing the tasks set forth by the Law "On the Bank of Latvia". The Bank of Latvia does not hedge interest rate risk related to domestic financial assets to avoid a conflict with the monetary policy pursued by it. The implementation of the monetary policy as well as exposure to other financial and operational risks may adversely affect the Bank of Latvia income or cause losses to be covered from the capital and reserves of the Bank of Latvia.

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

The Law "On the Bank of Latvia" establishes that a part of the Bank of Latvia's profit of the reporting year, calculated by applying the same percentage as the tax rate set for resident corporate entities of Latvia by the Law "On Corporate Income Tax", together with a payment in the amount of 50% of the profit of the reporting year for the usage of state capital shall be transferred to the state budget. At the end of 2012 and 2011, the corporate income tax rate applicable to residents of Latvia was 15%. Therefore, 65% of the Bank of Latvia's profit of the reporting year shall be transferred to the state budget within 15 days following the approval of the Annual Report of 2012 by the Council of the Bank of Latvia. In 2013, the Bank of Latvia will transfer 22 075 thousand lats from its profit earned in 2012 to the state budget.

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

In 2012 and 2011, changes in the balance sheet caption "Valuation account" were as follows:

(in thousands of lats)

	2012	Write-downs	Revaluation	Realisation	2011	Write-downs	Revaluation	Realisation	2010
Initial valuation account	<b>24 018</b>	x	x	–	24 018	x	x	–75	24 093
Deferred result on revaluation of foreign currencies and gold	24 018	x	x	–	24 018	x	x	–	24 018
Deferred result on revaluation of debt securities	–	x	x	–	–	x	x	–75	75
Revaluation reserve for equity instruments	<b>18 228</b>	–	995	–	17 233	–	17 233	–	–
Result on revaluation of foreign currencies and gold	<b>55 793</b>	103	6 253	–145	49 582	1 651	6 068	–13 761	55 624
Result on revaluation of OTC interest rate swap arrangements	–	–	–	–25	25	–	25	–	–
Result on revaluation of debt securities	<b>45 206</b>	1 482	27 567	–14 532	30 689	14 905	4 545	–16 657	27 896
<b>Total</b>	<b>143 245</b>	1 585	34 815	–14 702	121 547	16 556	27 871	–30 493	107 613

The initial valuation account was established by transferring thereto the result on revaluation prior to the change in the accounting policy on 1 January 2007, whereas the revaluation reserve for equity instruments has been established to account for the result on revaluation of the BIS shares.

## 26. DERIVATIVE FINANCIAL INSTRUMENTS AND SPOT EXCHANGE RATE CONTRACTS

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

(in thousands of lats)

	Contract or notional amount		Book value			
			Assets		Liabilities	
	2012	2011	2012	2011	2012	2011
OTC financial derivative and spot exchange rate contracts with non-residents						
Forward exchange rate contracts and currency swap arrangements	2 462 085	1 775 002	36 805	12 211	1 660	43 026
Spot exchange rate contracts	66 645	114 643	38	347	196	37
Forward transactions in securities	249 195	152 949	158	560	121	147
Interest rate swap arrangements	–	870	–	25	–	–
Total	x	x	37 001	13 143	1 977	43 210
Spot exchange rate contracts with residents						
Spot exchange rate contracts	22 229	–	73	–	–	–
Total	x	x	73	–	–	–
Traded financial derivative contracts with non-residents						
Interest rate future contracts	957 105	1 189 194	x	x	x	x
Currency future contracts	154 718	151 365	x	x	x	x

The book value of the OTC financial derivative contracts and spot exchange rate contracts is reported in the respective balance sheet captions of other assets or other liabilities (see also Notes 11, 14 and 18). Since settlement has been made for the change in the fair value of future contracts, it is reported as demand deposits in the balance sheet asset caption "Convertible foreign currencies".

At the end of 2012 and 2011, the book value and the fair value of OTC contracts concluded by the Bank of Latvia and not reported at their fair value, were not materially different. The reconciliation of the book value and net fair value of these instruments at the end of 2012 and 2011 was as follows:

(in thousands of lats)

	Net fair value		Net book value		Difference	
	2012	2011	2012	2011	2012	2011
OTC financial derivative and spot exchange rate contracts with non-residents						
Forward exchange rate contracts and currency swap arrangements	34 899	–31 290	35 145	–30 815	–246	–475
Spot exchange rate contracts	–158	311	–158	310	–	1
Total	34 741	–30 979	34 987	–30 505	–246	–474
Spot exchange rate contracts with residents						
Spot exchange rate contracts	73	–	73	–	–	–
Total	73	–	73	–	–	–

## MAJOR RISKS AND PRINCIPLES FOR THEIR MANAGEMENT

### 27. RISK MANAGEMENT

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

#### 27.1. Financial risks

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

The Bank of Latvia manages financial risks related to foreign reserves in accordance with the Guidelines. The basic principles of investment policy set out in the Guidelines are provided in Note 4. Foreign reserves are managed by classifying them into different investment portfolios. Parameters for a benchmark reflecting the acceptable level of financial risks and return target are set out for each portfolio type in the Guidelines. On a business day basis, the Risk Management Division of the Market Operations Department monitors the compliance of foreign reserves with the requirements set out in the Guidelines.

In 2012 parameters of the multi-currency fixed income securities portfolio benchmark have been changed in order to increase the diversification of the benchmark and reduce credit risk.

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

##### 27.1.1. Market Risk

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

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

The Bank of Latvia's exposure to currency risk is determined by the structure of its foreign reserves, which cannot be formed in compliance with the Bank of Latvia's liability parameters. The Bank of Latvia manages the currency risk by determining open currency position limits and using tracking error. Tracking error is calculated as the expected annualised standard deviation of the difference in return between the investment portfolio and the respective benchmark. The aggregate market and credit risk of portfolios managed against multi-currency fixed income securities benchmark and asset-backed securities benchmark (see also Note 4) is managed by determining the tracking error limit. Tracking error in 2012 and 2011 is provided in Note 30.

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

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

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

The Bank of Latvia's exposure to market risk (as at the end of 2012 and 2011) is disclosed in Notes 28–30.

### **27.1.2. Credit Risk**

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

The Bank of Latvia manages exposure to credit risk related to investments made in foreign financial instruments by establishing limits on investments of different credit quality in the Guidelines. Credit quality is evaluated on the basis of ratings assigned by the international credit rating agencies Fitch Ratings, Moody's Investors Service and Standard & Poor's. The Bank of Latvia is allowed to invest in financial instruments of certain credit quality of the OECD countries. Limits are set also on the maximum investment in financial instruments of the same class and counterparty, as well as in financial instruments of one issuer. To hedge the credit risk associated with OTC derivative counterparties, the Bank of Latvia enters with them into International Swaps and Derivatives Association, Inc. Master Agreements and Credit Support Annexes. In order to monitor the Bank of Latvia's credit risk exposure associated with its foreign operations, the Risk Management Division of the Market Operations Department is involved in monitoring of the Bank of Latvia's compliance with the Guidelines on a business day basis.

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

The Bank of Latvia's exposure to credit risk (as at the end of 2012 and 2011) is disclosed in Notes 32 to 34.

### **27.1.3. Liquidity Risk**

Liquidity risk is associated with a failure to meet liabilities timely. The Bank of Latvia's exposure to liquidity risk arises mainly from the need to ensure foreign currency for conducting foreign exchange transactions with credit institutions and repaying deposits of the Latvian government and other institutions. The Bank of Latvia manages liquidity risk by investing foreign reserves in liquid debt securities issued by international institutions, foreign governments and the corporate sector, short-term deposits with foreign financial institutions and other financial instruments. Investments are made so as to ensure timely settlement of the Bank of Latvia's liabilities. The structure of the Bank of Latvia's cash and its equivalents is provided in Note 43. The liquidity profile of the Bank of Latvia's assets and liabilities as at the end of 2012 and 2011 is disclosed in Note 31.

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

## **27.2. Operational risks**

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

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

In 2012 the regulation for the management of the Bank of Latvia operational risks was amended, highlighting risk revision after the event (an incident, audit recommendation, changes in the internal or external environment, etc.) and providing for risk revision at least once in four years. Development of the Bank of Latvia register of operational risks improves the registration of information on risks and expands its availability for all registered users of the register.

In order to ensure confidentiality, authorised access to and integrity of information, the Bank of Latvia information systems are classified into levels depending on their significance; the owners of the Bank of Latvia information systems in cooperation with the Information Systems Department have established the rules for the usage and access rights of the information system, as well as ensure the implementation of the risk analysis of the respective information system, coordinated by the information systems security manager of the Bank of Latvia who also oversees the introduction of measures aimed at minimising the identified risks. The Head of Information Systems Department ensures the compliance of the functionality and performance of the Bank of Latvia information system infrastructure with the requirements stipulated for the information systems, as well as its safe and continuous operation. The Bank of Latvia conducts, on a regular basis, the analysis of information systems security risks and improves security measures and tools.

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

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

In order to limit the implications of operational risks, the Bank of Latvia is insured against a possible impact of certain types of operational risks.

In 2012, the Bank of Latvia was not exposed to the risks that could substantially affect or hamper its operation.

## 28. CURRENCY PROFILE<sup>1</sup>

(in thousands of lats)

	LVL	EUR	USD	JPY	Gold	Other	Total
<b>As at 31 December 2012</b>							
Assets							
Foreign assets	37 735	1 935 478	1 315 386	263 702	218 750	282 427	4 053 478
Domestic assets	32 829	28	–	–	–	–	32 857
<b>TOTAL ASSETS</b>	<b>70 564</b>	<b>1 935 506</b>	<b>1 315 386</b>	<b>263 702</b>	<b>218 750</b>	<b>282 427</b>	<b>4 086 335</b>
Liabilities							
Foreign liabilities	7 144	14 270	5 986	44	–	236	27 680
Lats in circulation	1 234 147	–	–	–	–	–	1 234 147
Domestic liabilities	1 575 364	801 144	61 489	8 197	–	16 311	2 462 505
<b>TOTAL LIABILITIES</b>	<b>2 816 655</b>	<b>815 414</b>	<b>67 475</b>	<b>8 241</b>	<b>–</b>	<b>16 547</b>	<b>3 724 332</b>
Net position on balance sheet	–2 746 091	1 120 092	1 247 911	255 461	218 750	265 880	362 003
Net position on financial instruments' off-balance sheet accounts	–	2 004 323	–1 234 596	–254 185	–219 009	–261 436	35 097
Net position on balance sheet and off-balance sheet accounts	–2 746 091	3 124 415	13 315	1 276	–259	4 444	397 100
<b>Profile of the net position on balance sheet and off-balance sheet accounts (%)</b>	<b>x</b>	<b>99.5</b>	<b>0.4</b>	<b>0</b>	<b>0</b>	<b>0.1</b>	<b>100.0</b>
Benchmark currency structure (%)	x	100.0	0	0	0	0	100.0
<b>As at 31 December 2011</b>							
TOTAL ASSETS	44 960	1 851 528	1 176 038	238 913	210 066	17 720	3 539 225
TOTAL LIABILITIES	2 556 172	596 849	39 585	8 164	–	11 293	3 212 063
Net position on balance sheet	–2 511 212	1 254 679	1 136 453	230 749	210 066	6 427	327 162
Net position on financial instruments' off-balance sheet accounts	–	1 542 642	–1 131 368	–227 796	–210 314	–3 231	–30 067
Net position on balance sheet and off-balance sheet accounts	–2 511 212	2 797 321	5 085	2 953	–248	3 196	297 095
<b>Profile of the net position on balance sheet and off-balance sheet accounts (%)</b>	<b>x</b>	<b>99.6</b>	<b>0.2</b>	<b>0.1</b>	<b>0</b>	<b>0.1</b>	<b>100.0</b>
Benchmark currency structure (%)	x	100.0	0	0	0	0	100.0

<sup>1</sup> The assets and liabilities, denominated in SDR and exposed to the SDR currency risk, including liabilities to the IMF, are reported as per the SDR basket of currencies.

## 29. REPRICING MATURITY

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

	(in thousands of lats)					
	Up to 3 months	3–6 months	6–12 months	1–3 years	Over 3 years	Total
<b>As at 31 December 2012</b>						
Foreign assets						
Special Drawing Rights	83 367	–	–	–	–	83 367
Convertible foreign currencies	1 548 759	80 324	108 887	1 268 329	662 429	3 668 728
<b>Total interest-sensitive assets</b>	<b>1 632 126</b>	<b>80 324</b>	<b>108 887</b>	<b>1 268 329</b>	<b>662 429</b>	<b>3 752 095</b>
Foreign liabilities						
Convertible foreign currencies	15 280	–	–	–	–	15 280
Domestic liabilities						
Balances due to credit institutions	1 120 326	–	–	–	–	1 120 326
Balances due to the government	631 136	–	–	–	–	631 136
Balances due to other financial institutions	2 396	–	–	–	–	2 396
Other domestic liabilities	2	–	–	–	–	2
<b>Total interest-sensitive liabilities</b>	<b>1 769 140</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>1 769 140</b>
Net position on balance sheet	–137 014	80 324	108 887	1 268 329	662 429	1 982 955
Assets on financial instrument off-balance sheet accounts	3 080 862	–	–	692 492	173 291	3 946 645
Liabilities on financial instrument off-balance sheet accounts	3 571 031	398	–	4 909	335 210	3 911 548
<b>Net position on balance sheet and off-balance sheet accounts</b>	<b>–627 183</b>	<b>79 926</b>	<b>108 887</b>	<b>1 955 912</b>	<b>500 510</b>	<b>2 018 052</b>
<b>As at 31 December 2011</b>						
Total interest-sensitive assets	1 351 339	12 221	84 090	1 089 024	710 297	3 246 971
Total interest-sensitive liabilities	1 730 258	–	–	–	–	1 730 258
Net position on balance sheet	–378 919	12 221	84 090	1 089 024	710 297	1 516 713
Assets on financial instrument off-balance sheet accounts	2 637 476	1 088	3 264	566 165	146 078	3 354 071
Liabilities on financial instrument off-balance sheet accounts	2 753 163	865	3 264	376 752	250 094	3 384 138
Net position on balance sheet and off-balance sheet accounts	–494 606	12 444	84 090	1 278 437	606 281	1 486 646



### 30. TRACKING ERROR

The exposure to aggregate market risk and credit risk of foreign reserves, included in portfolios managed against multi-currency fixed income securities benchmark and asset-backed securities benchmark is characterised by the tracking error, which is measured as the expected annualised standard deviation of the difference in return between the investment portfolio and the respective benchmark (see also risk management principles described in Note 27.1). At the end of 2012 and 2011, the actual (*ex-post*) tracking errors of the portfolios managed against multi-currency fixed income securities benchmark were 27 basis points and 54 basis points respectively, whereas the tracking errors of the portfolios managed against asset-backed securities benchmark were 69 basis points and 84 basis points respectively.

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

	Book value (at the end of the year, in thousands of lats)	Expected tracking error (number of business days)			
		10–39	40–69	70–99	100–110
<b>During 2012</b>					
Portfolios managed against multi-currency fixed income securities benchmark	2 703 967	2	242	8	–
Portfolios managed against asset-backed securities benchmark	181 438	–	13	212	27
<b>During 2011</b>					
Portfolios managed against multi-currency fixed income securities benchmark	2 388 804	–	253	–	–
Portfolios managed against asset-backed securities benchmark	175 883	–	171	76	6

### 31. LIQUIDITY PROFILE

(in thousands of lats)

	2012			2011		
	Up to 3 months	No fixed maturity	Total	Up to 3 months	No fixed maturity	Total
<b>Assets</b>						
Foreign assets	4 031 772	21 706	<b>4 053 478</b>	3 487 257	20 285	3 507 542
Domestic assets	241	32 616	<b>32 857</b>	376	31 307	31 683
<b>TOTAL ASSETS</b>	<b>4 032 013</b>	<b>54 322</b>	<b>4 086 335</b>	<b>3 487 633</b>	<b>51 592</b>	<b>3 539 225</b>
<b>Liabilities</b>						
Foreign liabilities	27 646	34	<b>27 680</b>	72 339	33	72 372
Lats in circulation	–	1 234 147	<b>1 234 147</b>	–	1 160 183	1 160 183
Domestic liabilities	2 462 505	–	<b>2 462 505</b>	1 979 508	–	1 979 508
<b>TOTAL LIABILITIES</b>	<b>2 490 151</b>	<b>1 234 181</b>	<b>3 724 332</b>	<b>2 051 847</b>	<b>1 160 216</b>	<b>3 212 063</b>
Net position on balance sheet	1 541 862	–1 179 859	<b>x</b>	1 435 786	–1 108 624	<b>x</b>

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

### 32. SECTORAL PROFILE OF ASSETS

	Amount (in thousands of lats)		Percentage (%)	
	2012	2011	2012	2011
Foreign central governments and other governmental institutions	<b>1 284 308</b>	1 104 267	<b>31.4</b>	31.2
Foreign local governments	<b>31 626</b>	51 437	<b>0.8</b>	1.5
Foreign central banks and credit institutions	<b>1 690 083</b>	1 493 624	<b>41.4</b>	42.2
Other foreign financial institutions	<b>879 987</b>	668 356	<b>21.5</b>	18.9
Foreign non-financial corporations	<b>31 372</b>	78 127	<b>0.8</b>	2.2
International institutions	<b>135 141</b>	110 837	<b>3.3</b>	3.1
Unclassified assets	<b>33 818</b>	32 577	<b>0.8</b>	0.9
<b>Total</b>	<b>4 086 335</b>	3 539 225	<b>100.0</b>	100.0

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

	Amount (in thousands of lats)		Percentage (%)	
	2012	2011	2012	2011
Euro area countries	<b>1 464 393</b>	1 526 724	<b>36.1</b>	43.5
Other EU countries	<b>621 690</b>	725 868	<b>15.3</b>	20.7
US	<b>494 259</b>	519 974	<b>12.2</b>	14.8
Canada	<b>275 222</b>	103 468	<b>6.8</b>	3.0
Japan	<b>261 529</b>	231 590	<b>6.5</b>	6.6
Other countries and international institutions	<b>936 385</b>	399 918	<b>23.1</b>	11.4
<b>Total</b>	<b>4 053 478</b>	3 507 542	<b>100.0</b>	100.0

Assets under "Other countries and international institutions" also comprise claims on the ECB corresponding to the balances on the settlement accounts of the direct participants in TARGET2-Latvija, standing at 616 232 thousand lats at the end of 2012 (143 425 thousand lats at the end of 2011).

### 34. ASSETS BY CREDIT RATING ASSIGNED TO THE COUNTERPARTY

	Credit rating	Amount (in thousands of lats)		Percentage (%)	
		2012	2011	2012	2011
<b>FOREIGN ASSETS</b>					
Gold	AAA	<b>218 750</b>	210 066	<b>5.4</b>	5.9
Special Drawing Rights	AAA	<b>83 367</b>	79 069	<b>2.0</b>	2.2
Foreign debt securities	AAA	<b>1 255 817</b>	838 391	<b>30.8</b>	23.8
	AA+	<b>631 139</b>	361 359	<b>15.4</b>	10.2
	AA	<b>50 227</b>	149 536	<b>1.2</b>	4.2
	AA-	<b>454 599</b>	475 843	<b>11.1</b>	13.5
	A+	<b>182 817</b>	238 576	<b>4.5</b>	6.8
	A	<b>71 599</b>	350 477	<b>1.8</b>	9.9
	A-	<b>7 403</b>	6 662	<b>0.2</b>	0.2
	BBB+	<b>6 058</b>	806	<b>0.1</b>	0
	BBB	<b>956</b>	–	<b>0</b>	–
	BBB-	<b>355</b>	373	<b>0</b>	0
	BB+	<b>22 902</b>	20 686	<b>0.6</b>	0.6
	Deposits with foreign financial institutions	AAA	<b>818 704</b>	438 969	<b>20.1</b>
AA+		<b>110 355</b>	31 985	<b>2.7</b>	0.9
AA		<b>27 092</b>	25 867	<b>0.7</b>	0.7
AA-		–	45 396	–	1.3
A+		<b>35 579</b>	129 163	<b>0.9</b>	3.7
A		<b>3 638</b>	57 220	<b>0.1</b>	1.6
A-		<b>74</b>	–	<b>0</b>	–
Foreign currency in cash	AAA	<b>13 332</b>	13 607	<b>0.3</b>	0.4
	AA+	<b>7</b>	4	<b>0</b>	0
Participating interest in the European Central Bank	AAA	<b>750</b>	750	<b>0</b>	0
Participating interest in the Bank for International Settlements	AAA	<b>19 991</b>	18 997	<b>0.5</b>	0.5
Derivative financial instruments	AAA	<b>1 917</b>	560	<b>0</b>	0
	AA-	<b>4 844</b>	82	<b>0.1</b>	0
	A+	<b>3 189</b>	7 791	<b>0.1</b>	0.2
	A	<b>16 847</b>	4 609	<b>0.4</b>	0.1
	A-	<b>7 670</b>	101	<b>0.2</b>	0
	BBB+	<b>1 982</b>	–	<b>0</b>	–
	BBB	<b>552</b>	–	<b>0</b>	–
Accrued interest income	Different	<b>1</b>	59	<b>0</b>	0
Other foreign assets	Different	<b>965</b>	538	<b>0</b>	0
<b>DOMESTIC ASSETS</b>	Different	<b>32 857</b>	31 683	<b>0.8</b>	0.9
<b>TOTAL</b>		<b>4 086 335</b>	3 539 225	<b>100.0</b>	100.0

The amount in the rating group "BB+" consisted of securities issued by an agency partially owned by an OECD country government; these securities were disposed of in February 2013.

At the end of 2012 and 2011, the Bank of Latvia's foreign assets broken down by major categories of credit ratings assigned to the counterparty were as follows:

	Credit rating category	Amount (in thousands of lats)		Percentage (%)	
		2012	2011	2012	2011
Foreign assets	AAA	2 412 628	1 600 409	59.6	45.6
	AA	1 278 263	1 090 072	31.5	31.1
	A	328 816	794 599	8.1	22.7
	BBB	9 903	1 179	0.2	0
	BB	22 902	20 686	0.6	0.6
	Different	966	597	0	0
<b>Total</b>		<b>4 053 478</b>	<b>3 507 542</b>	<b>100.0</b>	<b>100.0</b>

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

## PROFIT AND LOSS NOTES

### 35. NET INTEREST INCOME

The Bank of Latvia net interest income was mainly derived from investing foreign currency reserves. In 2012 net interest income decreased by 23 677 million lats in comparison with 2011.

In 2012, interest income from foreign operations shrank by 25 710 thousand lats in comparison with 2011, and interest expense grew by 5 027 thousand lats year-on-year. Lower interest rates in 2012 resulted in a 13 234 thousand lats fall in interest income from securities.

Higher short-term interest rates on the US dollar in comparison with those on the euro in 2012 in their turn mostly accounted for a 7 639 thousand lats drop in the net interest income from financial derivatives and a 5 026 thousand lats increase in the net interest expense on them.

Interest income from domestic operations was a mere 8 thousand lats (13 thousand lats in 2011) as the demand for loans granted by the Bank of Latvia was low due to the excess lats liquidity of credit institutions.

Interest expense on domestic operations was largely comprised of interest on deposits of domestic credit institutions and the Latvian government. Interest expense on credit institution deposits contracted by 1 994 thousand lats, as interest paid on these deposits decreased in 2012, including the remuneration for holding the minimum reserves. In 2012 the average amount of Latvian government funds, placed as deposits with the Bank of Latvia, remained broadly unchanged in comparison with 2011; however, interest rates on deposits in foreign currencies declined, therefore interest expense on government deposits shrank by 4 852 thousand lats.

### 36. REALISED GAINS/LOSSES FROM FINANCIAL OPERATIONS

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

Gains from the disposal of debt securities increased by 14 056 thousand lats in comparison with 2011. A larger amount of the positive debt securities revaluation result, accumulated on the valuation account in previous reporting years, was realised in comparison with 2011.

The realised gains or losses from financial operations were negatively affected by the negative result on derivative financial instruments, despite the fact that it decreased by 5 393 thousand lats in comparison with 2011, mostly on account of the result of interest rate future contracts as well as the result of currency future contracts concluded for the purpose of hedging currency risks. The negative result of the currency future contracts concluded for the purpose of hedging currency risk exposure is offset in equal value by the positive

revaluation result of the hedged balance sheet items reported in the balance sheet caption "Valuation account" as well as the realised gains on foreign exchange transactions recognised in the profit and loss statement.

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

The revaluation result of several debt securities and foreign currency positions at the end of 2012 and 2011 was negative, and it has been recognised in the profit and loss statement while the positive result on the revaluation of debt securities and foreign currency positions has been reported in the balance sheet caption "Valuation account" (see also Note 25).

### 38. INCOME FROM PARTICIPATING INTEREST

Income from participating interest comprises the dividends received from the participating interest in the BIS (see also Note 10).

### 39. OTHER OPERATING INCOME

	(in thousands of lats)	
	<b>2012</b>	2011
Income from sale of collector coins	773	581
Income from payment and securities settlement services	368	379
Other	341	301
<b>Total</b>	<b>1 482</b>	1 261

### 40. BANKNOTE PRODUCTION AND COINAGE COSTS

	(in thousands of lats)	
	<b>2012</b>	2011
Coinage of collector coins	-715	-481
Coinage of circulation coins	-82	-101
<b>Total</b>	<b>-797</b>	-582

### 41. REMUNERATION AND SOCIAL SECURITY COSTS

	(in thousands of lats)	
	<b>2012</b>	2011
Remuneration		
Remuneration of Members of the Council and the Board	-880	-895
Remuneration of other personnel	-9 363	-9 007
<b>Total remuneration</b>	<b>-10 243</b>	-9 902
Social security costs	-2 430	-2 373
<b>Total remuneration and social security costs</b>	<b>-12 673</b>	-12 275

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

The number of employees in 2012 and 2011 was as follows:

	<b>2012</b>	2011
Number of employees at the end of the year		
Members of the Council and the Board	<b>14</b>	13
Other personnel	<b>547</b>	543
Total at the end of the year	<b>561</b>	556
Average number of employees per period	<b>561</b>	563

#### **42. OTHER OPERATING EXPENSES**

(in thousands of lats)

	<b>2012</b>	2011
Municipal services	<b>-671</b>	-553
Information and public relations	<b>-366</b>	-214
Maintenance of buildings, territory and equipment	<b>-348</b>	-398
Business travel	<b>-269</b>	-209
Risk insurance	<b>-263</b>	-267
Telecommunications services and system maintenance	<b>-197</b>	-167
Personnel training	<b>-181</b>	-139
Acquisition of low value office supplies	<b>-175</b>	-227
Transport provision	<b>-114</b>	-109
Tax on real estate	<b>-89</b>	-91
Audit, advisory and legal services	<b>-38</b>	-27
Other	<b>-303</b>	-297
Total	<b>-3 014</b>	-2 698

The audit, advisory and legal services expenses also comprise the remuneration in the amount of 24 thousand lats paid to Ernst and Young Baltic SIA for the audit of 2012 financial statements (23 thousand lats to Deloitte Audits Latvia SIA in 2011) and 8 thousand lats for the audit of tax calculations.

## NOTE TO THE CASH FLOW STATEMENT

### 43. CASH FLOW STATEMENT

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

	(in thousands of lats)	
	<b>2012</b>	2011
Profit before appropriation	<b>33 961</b>	32 028
Non-cash transaction adjustments		
Depreciation of fixed assets and amortisation of intangible assets	2 887	2 948
Profit (-)/loss on disposal of fixed assets	-10	2
Write-downs of revaluation result on financial assets and positions	1 585	16 556
Net non-cash transaction adjustments	<b>4 462</b>	19 506
Change in balance sheet items		
Net increase (-)/decrease in Special Drawing Rights	-6 277	22 589
Net increase (-)/decrease in foreign debt securities and other foreign investments	-148 718	606 426
Net decrease in other assets	-217	-32
Net increase/decrease (-) in foreign convertible currency liabilities	9 215	-4 122
Net increase/decrease (-) in foreign bank and other international institution deposits in lats	-13 310	9 752
Net increase in lats in circulation	73 964	222 279
Net increase/decrease (-) in deposits of domestic credit institutions	490 609	-492 490
Net increase/decrease (-) in Latvian government deposits	24 064	-343 922
Net decrease in deposits of other financial institutions	-31 901	-14 023
Net increase/decrease (-) in other liabilities	869	-279
Net change in balance sheet items	<b>398 298</b>	6 178
Net cash and cash equivalents inflow arising from operating activities	<b>436 721</b>	57 712

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

	(at the end of the year; in thousands of lats)				
	<b>2012</b>	Change	2011	Change	2010
Convertible foreign currencies in cash	<b>13 339</b>	-272	13 611	-2 102	15 713
Demand deposits with foreign credit institutions and other foreign financial institutions	<b>991 831</b>	471 964	519 867	-11 868	531 735
Time deposits with foreign credit institutions and other foreign financial institutions with original maturity up to 5 business days	<b>3 611</b>	-59 641	63 252	54 050	9 202
Total cash and cash equivalents	<b>1 008 781</b>	412 051	596 730	40 080	556 650

## OTHER NOTES

### 44. TRANSACTIONS WITH THE LATVIAN GOVERNMENT

The Bank of Latvia, whose capital is wholly owned by the Republic of Latvia, carries out transactions with the Treasury, acting as the financial agent of the Latvian government. Performing this function, the Bank of Latvia services the Treasury's accounts in lats and foreign currencies, as well as conducts foreign exchange transactions. The Bank of Latvia conducts government securities transactions in the secondary securities market in order to implement monetary policy (in 2012 and 2011 the Bank of Latvia did not perform such transactions). The Bank of Latvia is independent in making its own decisions on entering into the above transactions.

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

At the end of 2012 and 2011, the breakdown of the Bank of Latvia claims on and liabilities to the Latvian government and the respective interest rates were as follows:

	Amount (in thousands of lats)		Interest rate (%)	
	2012	2011	2012	2011
Liabilities/claims (–)				
Demand deposits in lats	<b>441 218</b>	235 441	<b>0.31</b>	0.57
Demand deposits in foreign currencies	<b>319 934</b>	242 523	<b>0.00–0.30</b>	0.00–0.22
Time deposits in foreign currencies	–	259 124	–	0.32–0.51
Spot exchange rate contracts	<b>–73</b>	–	<b>x</b>	x
Accrued interest expense	–	20	<b>x</b>	x
Tax liabilities	<b>96</b>	69	<b>x</b>	x
Total net liabilities	<b>761 175</b>	737 177	<b>x</b>	x

In 2012 and 2011, the breakdown of the Bank of Latvia's income and expense related to the Latvian government, as well as the Bank of Latvia's profit of the previous reporting year appropriated to the state budget was as follows (see also Notes 24, 25, and 35):

	(in thousands of lats)	
	2012	2011
Expense and the Bank of Latvia's profit appropriated to the state budget		
Interest on government deposits	<b>2 273</b>	7 125
Taxes	<b>6 196</b>	6 023
Profit appropriated to the state budget	<b>20 818</b>	15 440
Total expense and the Bank of Latvia's profit appropriated to the state budget	<b>29 287</b>	28 588

### 45. PLEDGED ASSETS

Securities and other financial instruments with the market value of 15 464 thousand lats, as at the end of 2012 (23 720 thousand lats at the end of 2011), have been pledged to provide collateral for forward exchange contracts and interest rate and currency future contracts. These financial instruments are included in the balance sheet asset caption "Convertible foreign currencies".

### 46. SECURITIES LENDING

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



At the end of 2012, the fair value of Bank of Latvia's securities lent was 262 087 thousand lats (278 577 thousand lats at the end of 2011).

At the end of 2012 and 2011, the fair value of collateral provided in securities lending transactions was as follows:

	(in thousands of lats)	
	2012	2011
Foreign currency cash	243 203	241 602
Debt securities of foreign governments, financial institutions and non-financial corporations	23 355	41 987
<b>Total</b>	<b>266 558</b>	<b>283 589</b>

Foreign currency cash or securities provided as collateral in securities lending transactions is not recognised in the Bank of Latvia's balance sheet (see also principles described in Note 2.12).

#### 47. CONTINGENT LIABILITIES AND COMMITMENTS

In 2005, the liquidator of the bankrupt JSC *Banka Baltija* filed a claim against the Bank of Latvia on behalf of the creditors of JSC *Banka Baltija* in the Riga Regional Court for the recovery of losses. In February 2010, the amount of the claim was increased from 185.6 million lats to 238.3 million lats. The claimant alleges that the Bank of Latvia, as the institution in charge of banking supervision at that time, is responsible for losses arising from the bankruptcy of JSC *Banka Baltija* in 1995. On 12 October 2010, the Civil Court Collegium of Riga District Court as the court of first instance ruled to satisfy the claim against the Bank of Latvia in part, collecting 60 million lats from the Bank of Latvia for the benefit of the JSC *Banka Baltija* undergoing liquidation for the purpose of reimbursing losses, and 32 thousand lats as stamp duty for the benefit of the State. The Bank of Latvia appealed the judgement of the court of first instance, thus the judgement did not take effect. On 21 February 2012, the Chamber of Civil Court of the Supreme Court announced a judgement whereby the court ruled that the claim against the Bank of Latvia be completely rejected and court expenses in the amount of 16 thousand lats and legal services in the amount of 150 thousand lats be collected from the JSC *Banka Baltija* undergoing liquidation. On 12 April 2012 the claimant appealed the judgement under cassation procedure to the Senate of the Supreme Court. The Bank of Latvia is confident that the claim is without merits and therefore no provisions are recognised in the financial statements. Should the Senate of the Supreme Court refuse to initiate the cassation proceedings, the judgement of the Chamber of Civil Court of the Supreme Court of 21 February 2012 whereby the claim against the Bank of Latvia was completely rejected will take effect. Should the Senate of the Supreme Court initiate the cassation proceedings, the final judgement in this case could be expected no earlier than in 2015.

The Bank of Latvia has not paid up 96.25% of the Bank of Latvia's share in the ECB subscribed capital, which is payable following the decision of the General Council of the ECB. At the end of 2012 and 2010, the Bank of Latvia's unpaid share in the ECB subscribed capital was 29 383 thousand euro (20 651 thousand lats; see also Note 9).

The Bank of Latvia's uncalled portion of the BIS shares is 75% of their nominal value. These shares are callable following the decision of the BIS Board. At the end of 2012, the uncalled portion of the BIS share holding was 4 013 thousand SDR (3 367 thousand lats; 4 013 thousand SDR or 3 291 thousand lats at the end of 2011; see also Note 10).

At the end of 2012, the Bank of Latvia had issued collector coins in the nominal value of 1 613 thousand lats (1 556 thousand lats at the end of 2011) and gold circulation coins with a nominal value of 1 989 thousand lats (1 989 thousand lats at the end of 2011). These coins may be represented to the Bank of Latvia in exchange for lats at a nominal value. In the opinion of management of the Bank of Latvia, the probability that the Bank of Latvia will be required to repurchase these coins from their holders is considered low and no provisions have been made.

## INDEPENDENT AUDITORS' REPORT

### To the Council of the Bank of Latvia

We have audited the accompanying financial statements of the Bank of Latvia ("the Bank") set out on pages 3 to 41, which comprise the balance sheet as at 31 December 2012, and the related statements of profit and loss, total recognised gains and losses and cash flows for the year then ended, and a summary of principal accounting policies and other explanatory notes.

#### *Board's Responsibility for the Financial Statements*

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

#### *Auditors' Responsibility*

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

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

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

#### *Opinion*

In our opinion, the financial statements of the Bank give a true and fair view of the financial position of the Bank as at 31 December 2012, and of its financial performance and its cash flows for the year then ended in accordance with the "Financial Accounting Policy of the Bank of Latvia" approved by the Council of the Bank, and the law "On the Bank of Latvia".

Ernst and Young Baltic SIA  
Licence No. 17

Iveta Vimba  
Member of the Board

Riga, Latvia  
13 March 2013

The State Audit Office  
of the Republic of Latvia

Elita Krūmiņa  
Auditor General

Riga, Latvia  
13 March 2013