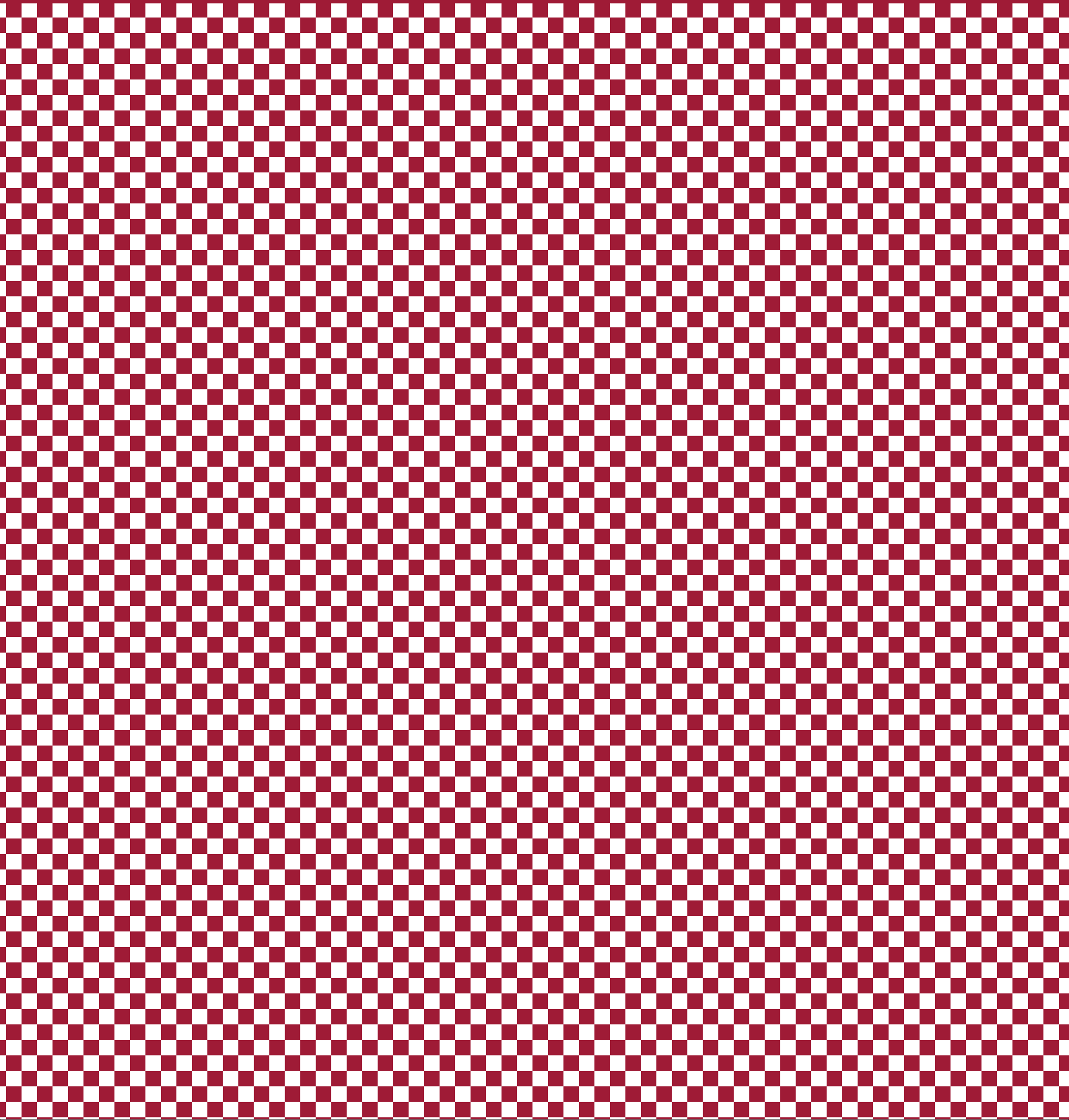


**PAYMENT AND SECURITIES SETTLEMENT SYSTEM OVERSIGHT  
CARRIED OUT BY THE BANK OF LATVIA IN 2011**



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## ABBREVIATIONS

ACBL – Association of Commercial Banks of Latvia  
 ATM – Automated Teller Machine  
 COGEPS – Contact group on euro payments strategy  
 CPSS – Committee on Payment and Settlement Systems  
 CPSS-IOSCO – Committee on Payment and Settlement Systems  
 and International Organization of Securities Commissions; (CPSS-IOSCO)  
 CRPC – Consumer Rights Protection Centre  
 CSB – Central Statistical Bureau of Latvia  
 CSD – Central Securities Depository  
 DENOS – securities settlement system of the LCD  
 DVP – delivery versus payment  
 EC – European Commission  
 ECB – European Central Bank  
 EEA – European Economic Area  
 EKS – Bank of Latvia electronic clearing system  
 e-money – electronic money  
 EPC – European Payments Council  
 ESCB – European System of Central Banks  
 EU – European Union  
 ESCB-CESR – ESCB and the Committee of European Securities Regulators; (CESR)<sup>1</sup>  
 FCMC – Financial and Capital Market Commission  
 FDL – First Data Latvia Ltd.  
 FOP – free of payment  
 JSC – Joint Stock Company  
 LCD – Latvian Central Depository  
 LDDK – Employers' Confederation of Latvia  
 LIKTA – Latvian Information and Communications Technology Association  
 Ltd – Limited liability company  
 MPSWG – Money and Payment Systems Working Group of the Republic of Latvia Euro  
 Project Steering Committee  
 MVKAKP – Small and Medium-Sized Enterprises and Crafts Consultative Committee  
 NUG – National User Group  
 NSWG – National SEPA Working Group  
 POS – Point of Sale  
 PPS – Postal payment system of JSC Latvijas Pasts  
 PSPWG – Payment Systems Policy Working Group  
 SAMS – Bank of Latvia interbank automated payment system  
 SEPA – Single Euro Payments Area  
 SJSC – State Joint Stock Company  
 SRS – State Revenue Service  
 SSIA – State Social Insurance Agency  
 Stock Exchange – Stock Exchange *Nasdaq OMX Riga*  
 SWIFT – an international organisation established by banks to ensure the transmission of  
 interbank financial messages by means of the telecommunications network (*Society for  
 Worldwide Interbank Financial Telecommunication*)  
 TARGET – Trans-European Automated Real-time Gross settlement Express Transfer  
 system  
 TARGET2 – second generation system TARGET2  
 T2S – TARGET2-Securities  
 VNS – Bank of Latvia securities settlement system

<sup>1</sup> As of 11 January 2011 – the European Securities and Markets Authority (ESMA).

## EXECUTIVE SUMMARY

In Latvia, the payment system oversight is performed in accordance with Article 9 of the Law "On the Bank of Latvia", stipulating that the Bank of Latvia shall promote smooth operation of payment systems in the Republic of Latvia. To achieve the above goal, the Bank of Latvia performs oversight of the payment systems, ensures the operation of the interbank payment systems as well as provides settlement services in central bank money to financial market participants. The Bank of Latvia is also in charge of the oversight of securities settlement systems since problems in the securities settlement infrastructure may cause disruptions in payment system operation and affect the implementation of monetary policy.

In 2011, the oversight was conducted in accordance with "The Bank of Latvia's Payment and Securities Settlement System Policy" (approved by the Bank of Latvia Council Resolution No 189/6 of 13 January 2011).

The Bank of Latvia maintains the operation of the interbank payment systems thus ensuring secure, rapid and efficient settlement between credit institutions as well as final settlement of other systems. Hence efficient payment infrastructure is available to credit institutions providing payment services to their customers.

The overseers conducted a day-to-day oversight of the Bank of Latvia payment systems SAMS, EKS, TARGET2-Latvija and securities settlement system DENOS of the LCD, analysing the technical and operational functions of the systems and collecting statistical data on the systems. In 2011, the daily average of payments processed via all three systems maintained by the Bank of Latvia totalled 140.6 thousand payments in the value of 1.2 billion lats. The SAMS availability ratio was 99.93% (the system was unavailable to its participants for 1 hour, 8 minutes and 52 seconds), the availability of TARGET2 totalled 99.89% in the entire system and that of EKS stood at 99.77% (the delays in settlement exceeded 30 minutes only on three occasions over the year). The analysis of systemic risk suggested that risk still remained low. The total volume of transfers via DENOS was 62.0 thousand, of them, DVP accounted for 29.4 thousand (total value – 669.8 million lats) and FOP amounted to 32.5 thousand per annum. DENOS ensured 99.9% availability.

The Bank of Latvia continued to oversee the retail payment systems operating outside the Bank of Latvia, establishing priorities of the oversight in accordance with the risk-based assessment of Latvia's payment systems conducted in 2009. In 2011, the overseers assessed, within the framework of the payment system oversight, the compliance of the EKS and direct debit payment infrastructure of JSC *Itella Information* – Automated payment system (hereinafter, JSC *Itella Information* system) with the *Core Principles for Systemically Important Payment Systems* (hereinafter, the Core Principles), approved by the CPSS. The overseers in cooperation with the FCMC and LCD commenced the compliance assessment of DENOS and the related infrastructure against the ESCB-CESR recommendations, planned to be completed in 2012.

To promote integration of Latvia's payment systems into SEPA, the Bank of Latvia engaged in further activities of SEPA Project in the capacity of the payment system overseer. To promote integration of Latvia's securities settlement systems into the harmonised securities settlement process of the EU Member States, the overseers continued to participate in T2S project.

## 1. OVERSIGHT OF SYSTEMICALLY IMPORTANT PAYMENT AND SECURITIES SETTLEMENT SYSTEMS

In 2011, the Bank of Latvia, in the capacity of an overseer of the systemically important payment and securities settlement systems, performed the day-to-day oversight (including the analysis of statistical data) and assessed systemic risk as well as commenced the compliance assessment of DENOS and the related infrastructure against the ESCB-CESR recommendations.

### 1.1 The SAMS

In 2011, the SAMS was the only systemically important payment system for the lats payments in Latvia. According to statistical data, the total volume of payments recorded an average monthly growth of 1.8%, totalling 216.4 thousand per annum, while the total value of payments rose on average by 1.2% per month and totalled 137.8 billion lats per annum. In 2011, the SAMS availability ratio was 99.93%. The analysis of systemic risk suggested that risk still remained low.

In 2011, the SAMS was the sole systemically important payment system for lats payments in Latvia. The above system continued to ensure real-time gross settlement in lats for the Bank of Latvia monetary policy operations, large-value interbank payments, final settlement or netting of other payment systems operating in Latvia and urgent customer payments.

In order to proceed with the evaluation of liquidity conditions in the system (Core Principle III) and notice the signs of potential operational risk on a timely basis (Core Principle VII), the following functions of the day-to-day or ongoing oversight were performed in 2011: collection and analysis of the SAMS statistical data and assessment of both the system's availability and incidents, thereby analysing their impact on other systems.

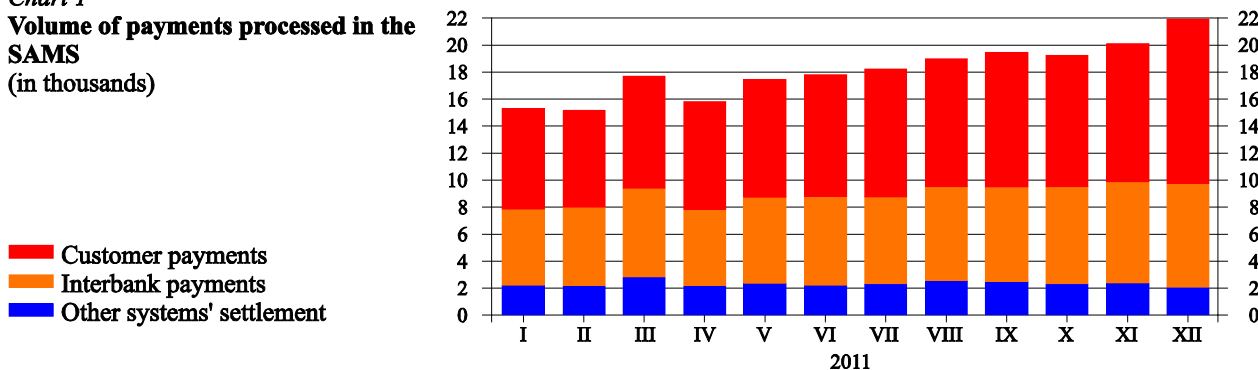
#### Analysis of the system's statistical data

At a monthly frequency, the Bank of Latvia compiled detailed data reported by the SAMS operators on the payments executed via the SAMS in the previous month. Statistical data were published on the Bank of Latvia website as well as used for compiling the Bank of Latvia reports.

At the end of 2011, there were 26 participants in the SAMS, i.e. a year-on-year increase of one participant since three new participants joined the above system over the year: JSC *Latvijas Biznesa banka*, *Rigensis Bank AS* and Treasury, and two participants, Joint Stock Company Bank SNORAS Latvian branch and JSC *Latvijas Krājbanka*, ceased to participate in the system. 24 credit institutions (including four branches of foreign banks), the Bank of Latvia and Treasury participated in the system. In 2011, the total volume of payments processed in the SAMS recorded an average monthly rise of 1.8% and totalled 216.4 thousand per annum, while the total value grew on average by 1.2% per month, totalling 137.8 billion lats per annum (see Charts 1 and 2). In 2011, the volume of payments executed via the SAMS expanded by 12.1%, while the value shrank by 17.1% year-on-year. The transaction value of the SAMS declined as of April 2010, with the Bank of Latvia introducing 7-day deposit facility, since until then payments had to be made more frequently due to resorting to the deposit facility with the Bank of Latvia.

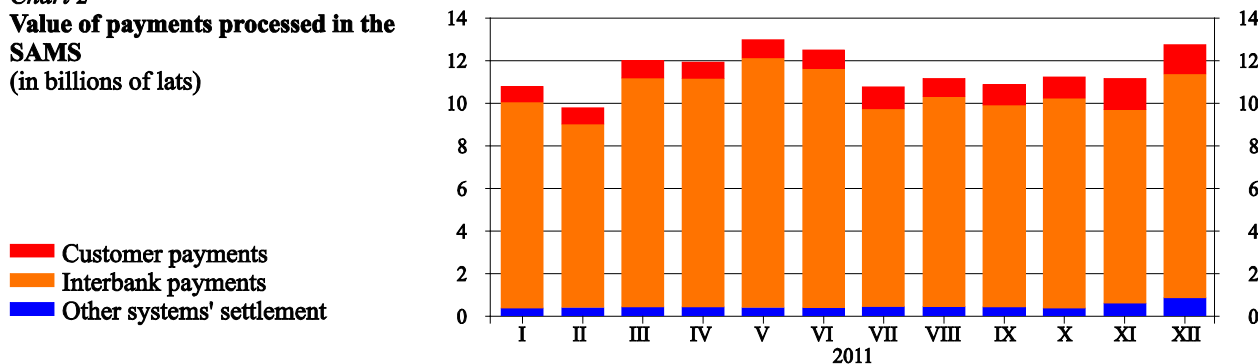
**Chart 1**

**Volume of payments processed in the SAMS**  
(in thousands)



**Chart 2**

**Value of payments processed in the SAMS**  
(in billions of lats)



In 2011, the share of interbank payment value reached 87.5% in the SAMS, that of customer payment value was 8.5% and the share of interbank and customer payment volume amounted to 36.5% and 50.6% respectively. The SAMS ensured final settlement of the following card payment systems: *MasterCard Europe Sprl* and *Visa Europe Services Inc.*, DENOS, FDL and EKS in 2011. The share of final settlement of ancillary systems in the SAMS stood at 4.0% and 12.9% in terms of value and volume respectively.

On the basis of the data entered into the Bank of Latvia Incident register, the overseers were notified of the operational problems incurred by the SAMS or its maintenance resources and the solution thereof. The overseers monitored the problem-solving process and informed Head of the Payment Systems Department of the Bank of Latvia and other experts involved in the elimination of operational disruptions on the impact of such disruptions on other systems, where necessary.

In 2011, the SAMS availability ratio was 99.93% (99.99% in 2010). Four operational failures were identified in the system and SAMS was not available for 1 hour, 8 minutes and 52 seconds (3 minutes and 5 seconds in 2010). Only one operational failure caused discontinuity of the Bank of Latvia critical processes and it lasted for 53 minutes. The above disruption did not result in systemic risk. Other operational failures were temporary and did not cause discontinuity of the Bank of Latvia critical processes.

**Risk assessment**

In 2011 as before, three indicators were analysed to assess systemic risk: 1) the share of the system in the respective segment of payments; 2) concentration ratio and 3) the netting effect ratio.

In 2011, 92.9% of all interbank credit transfers initiated in Latvia in lats were made via the SAMS and their share of value amounted to 96.8% (89.3% and 96.7% in 2010 respectively).

The volume concentration ratio of the SAMS was 71.9% and value concentration ratio stood at 78.4% in 2011 (73.0% and 81.3% in 2010 respectively). Such a decrease in the above ratio points to a declining probability of a domino effect in the SAMS.

The netting effect ratio of the SAMS characterising the utilisation of settlement funds in the case of gross settlement systems, amounted to 44.9% in 2011 (55.0% in 2010). It was calculated as the ratio of the annual average value of daily payments sent by the participants via the SAMS to the average daily balance on the participants' accounts with the Bank of Latvia. In 2011, the above amounted to 341.6 million lats and 760.1 million lats. Since the account balance of the Bank of Latvia as the participant in the system may not be reported separately, the payments submitted by the Bank are not taken into account in the calculation.

The netting effect ratio remained low and hence the probability of systemic risk was low. The value of payments executed per day in efficient payment systems may even several times exceed that of the funds available on the accounts. Such netting effect ratio may be attributed to the fact that credit institution deposits held in lats accounts with the Bank of Latvia are used for executing the payments and fulfilling the minimum reserve requirements stipulated by the Bank of Latvia. Thus the value of funds on these accounts exceeds the value required for the payment execution.

To determine whether a failure by an individual participant in the SAMS to send a payment might affect the ability of other SAMS participants to execute a payment, and to assess the adequacy of liquidity in the SAMS, in 2011, the Bank of Latvia conducted simulation of the SAMS data with the help of the payment and settlement system simulation model BoF-PSS2 developed by Suomen Pankki – Finlands Bank. It may be concluded from the simulation results that the Bank of Latvia is a significant participant in the SAMS and it shall ensure high business continuity requirements, as are currently implemented.

It is concluded upon the assessment of the availability of liquidity in the SAMS that the highest daily level of liquidity required for the execution of payments in real time without delays only amounts on average to 9.6% of the current funds on the settlement accounts. Too high liquidity on the settlement accounts of the system's participants is mainly related to the compliance with the minimum reserve requirement. The scope of the above ratios is considerably higher than the liquidity required for the settlement. The adequacy of the settlement funds in the SAMS is also on account of liquidity made available to the system's participants by the participants in other systems, and the payment transmission time is dispersed throughout the entire operation time of the system.

## 1.2 TARGET2-Latvija

**In 2011, TARGET2 was one of the systemically important payment systems processing euro payments in the EU. The Eurosystem performed the oversight of TARGET2. The Bank of Latvia overseers were involved in the oversight of TARGET2 in the capacity of observers and provided data on the operation of TARGET2-Latvija for the oversight purposes. In 2011, the Eurosystem assessed the impact of changes in the new release of TARGET2 on compliance with the**

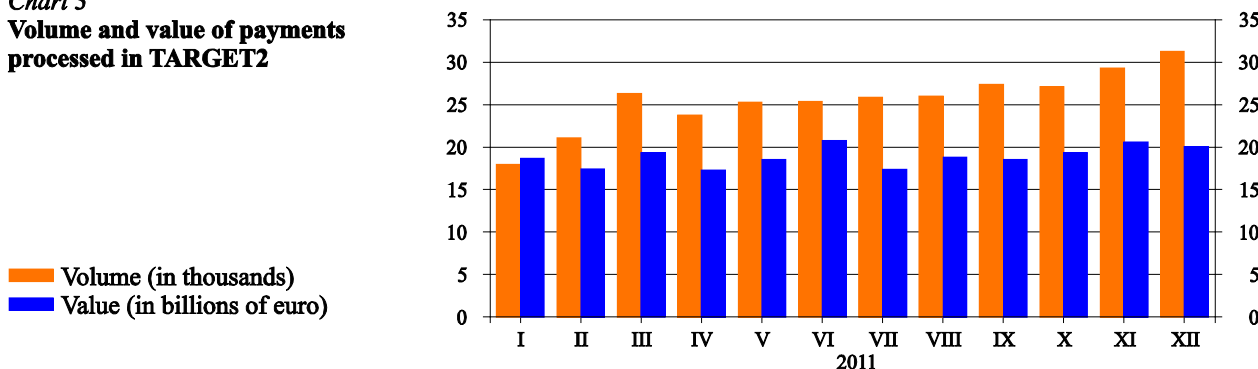
**Core Principles and stated that the system's assessment remained unchanged. All changes contributed favourably to the containment of liquidity and credit risk. According to statistical data, the total volume of payments executed via TARGET2-Latvija in 2011 recorded an average monthly rise of 2.2%, totalling 307.4 thousand per annum, while the total value of payments posted an average monthly increase of 0.2%, reaching 227.8 billion euro per annum overall (see Chart 3).**

In 2011, the Bank of Latvia, together with other participants of the ESCB provided the operation of TARGET2. The Bank of Latvia maintained the operation of TARGET2-Latvija, the component of TARGET2, enabling the payment settlement among the system participants in euro and final settlement of other systems in euro.

On 31 December 2011, TARGET2-Latvija comprised 24 participants (one participant less than on 31 December 2010) since *Rigensis Bank AS* joined the system during the year, whereas Joint Stock Company Bank SNORAS Latvian branch and JSC *Latvijas Krājbanka* ceased to participate in the system. 22 credit institutions (including three branches of foreign banks), Treasury and Bank of Latvia were participants in the above system. In 2011, TARGET2-Latvija enabled the execution of the final settlement in euro via the EKS.

The volume of payments processed in TARGET2-Latvija recorded an average monthly rise of 2.2% in 2011, totalling 307.4 thousand per annum, while the total value of payments posted an average monthly increase of 0.2%, reaching 227.8 billion euro per annum overall (see Chart 3). In 2011, the total volume and value of payments was 7.1% and 13.9% higher year-on-year.

**Chart 3**  
**Volume and value of payments processed in TARGET2**



TARGET2-Latvija is a component of TARGET2, and the system's availability ratio is calculated for the whole system. In 2011, the availability ratio of TARGET2 stood at 99.89% (100% in 2010).

In order to notify the users of incidents in TARGET2 and ensure incident solutions, the ECB published information about the availability of TARGET2 in the TARGET information system, *Reuters* and on the ECB website.

### 1.3 DENOS

**In 2011, DENOS was the only systemically important securities settlement system in Latvia. The Bank of Latvia compiled statistical data on transfers processed in DENOS as of 2011. Pursuant to the above data, the volume of transfers processed**



**in DENOS was 61.9 thousand in 2011, of them, DVP accounted for 29.4 thousand (total value stood at 669.8 million lats) and FOP amounted to 32.5 thousand.**

The Bank of Latvia in cooperation with the FCMC and LCD commenced the compliance assessment of DENOS and the related infrastructure in accordance with the ESCB-CESR recommendations, planned to be completed in 2012.

In 2011, DENOS was the only systemically important securities settlement system in Latvia. It continued to provide DVP gross and net settlement for transactions executed at the Stock Exchange as well as DVP and FOP gross settlements for OTC transactions.

In 2011, the LCD continued to provide via DENOS the bilateral cross-border settlement with the Estonian CSD *Eesti Väärtpaberikeskus AS* and Lithuanian CSD *Vertybinių popierių atsiskaitymo sistema (CSDL)*. The LCD terminated cooperation with the international CSD *Euroclear Bank* since the above cooperation was not sufficiently effective and concluded an agreement with the international CSD *Clearstream Banking SA Luxembourg (CBL)*. The relevant link is unilateral and ensures that international securities registered with *Clearstream Banking SA Luxembourg* by the participants in DENOS and their customers are transferred to Latvia. The links with *Eesti Väärtpaberikeskus AS*, *Vertybinių popierių atsiskaitymo sistema* and *Clearstream Banking SA Luxembourg* provide for securities settlement by means of FOP and DVP.

Close cooperation and information exchange has to be maintained with the supervisory authorities of the securities markets upon performing the oversight of the securities settlement system in accordance with the ESCB-CESR recommendations, therefore the Bank of Latvia and FCMC cooperate in addressing the issues of operation and development of the Latvian securities settlement systems.

The Bank of Latvia in cooperation with the FCMC and LCD commenced the compliance assessment of DENOS and the related infrastructure in accordance with the ESCB-CESR recommendations in 2011. Such assessment is essential for the oversight purposes and is also one of the CSD compliance provisions regarding the access to T2S services.

In 2011, upon conducting the oversight of DENOS, the Bank of Latvia notified the LCD of the revision of CPSS-IOSCO recommendations and a consultative report published by the Bank for International Settlements on new standards (principles) for the systemically important financial market infrastructures, that set forth tighter requirements and replace the current CPSS-IOSCO Recommendations for the securities settlement systems, systemically important payment systems and central counterparties, by sending the drafted summary of the most essential changes regarding the requirements stipulated for the securities settlement systems.

To assess the settlement liquidity of DENOS and notice the potential signs of operational risk on a timely basis, a day-to-day or ongoing oversight was performed in 2011, focussing on the compilation and analysis of DENOS statistical data and assessment of both the system's availability and incidents and analysing their impact on other systems.

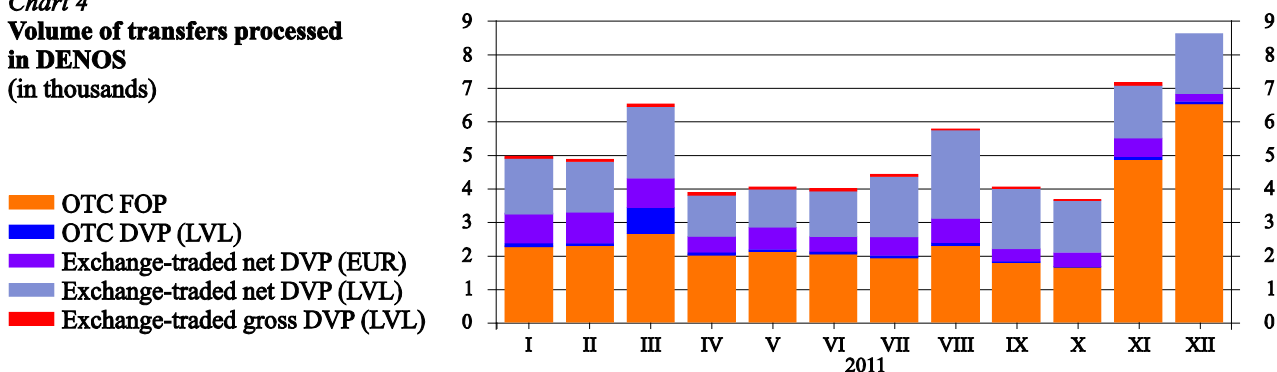
### **Analysis of the system's statistical data**

The full information on the securities transfers processed in DENOS was reported by the FCMC to the Bank of Latvia as of 2011, and at a monthly frequency, the Bank compiled

the reported detailed data on transaction value of DENOS for the previous month, five largest participants in DENOS and efficiency of using settlement funds for the transfers processed in net settlement cycle in the previous month. The statistical data of the LCD are subject to commercial safeguarding, hence, for the purpose of confidentiality the above data were not released.

At the end of 2011, the number of DENOS participants amounted to 21. The Bank of Latvia, 16 credit institutions, one investment brokerage firm and three link CSDs were participants in DENOS. The number of participants remained unchanged year-on-year, whereas on 22 November 2011, the Management Board of the LCD suspended the participant's status of JSC *Latvijas Krājbanka* on the basis of the FCMC notification, terminating all operations allowed to JSC *Latvijas Krājbanka* in the capacity of the participant in the LCD. The participation in the securities settlement systems is not suspended immediately, unlike that in the payment systems, but the status of a participant is suspended to enable the transfer of securities of the insolvent participant's customers to other participants. The participant is excluded from the participants' list after the securities of all customers are transferred. Pursuant to the LCD regulations, the LCD started to accept for settlement the transfers of the financial instruments of JSC *Latvijas Krājbanka* customers to the customer financial instrument accounts with another participant in the LCD as of 24 November 2011, to ensure the safeguarding of securities held by JSC *Latvijas Krājbanka* customers. Hence the volume of FOP transfers rose in November and December (see Chart 4).

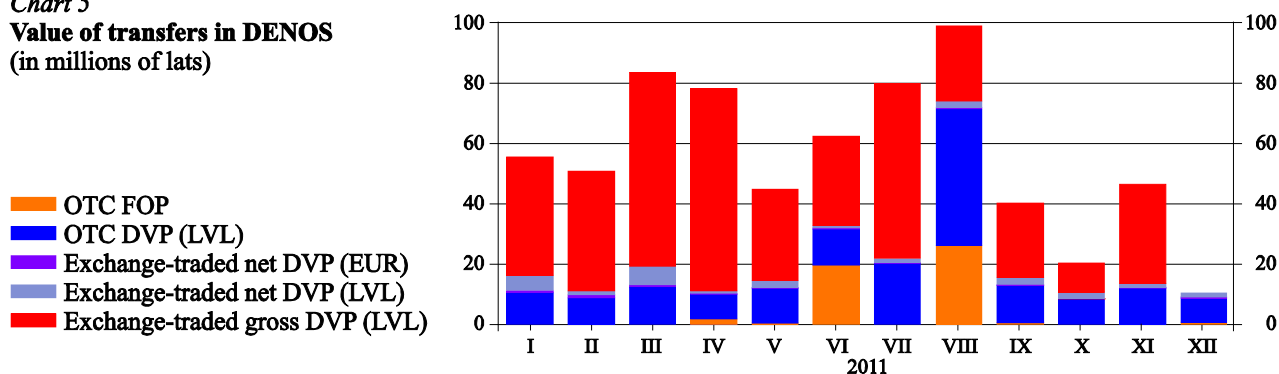
**Chart 4**  
**Volume of transfers processed in DENOS (in thousands)**



In 2011, 61.9 thousand transfers were made in DENOS. Depending on the transaction execution site, 33.9 thousand (54.7%) were over-the-counter transfers while other were the transfers of transactions executed at the Stock Exchange. 32.5 thousand (52.5%) of total transfer volume were FOP transfers and other were DVP transfers. Of all DVP transfers, 22.2 thousand (75.6%) were transfers executed in lats and 7.2 thousand (24.4%) were those made in euro. The transactions of DVP transfers executed in other currencies were over-the counter transactions and their total value was insignificant.

The total value of DVP transfers stood at 669.8 million lats in 2011 (including the value of the transfers of transactions executed at the Stock Exchange – 451.6 million lats or 67.4%). The value of transfers executed in lats was 616.8 million lats (92.0% of total value of DVP transfers). The value of the transfers of transactions executed at the Stock Exchange in net settlement amounted to 26.5 million lats (4.3% of the value of DVP transfers made in lats) and value of such transfers processed in gross settlement was 420.7 million lats (68.2%), while the value of over-the-counter transfers stood at 169.6 million lats (27.5%). The total value of DVP transfers executed in euro and other currencies was insignificant (see Chart 5).

**Chart 5**  
**Value of transfers in DENOS**  
 (in millions of lats)



The Bank of Latvia was notified of the operational problems incurred by DENOS or its maintenance resources and the solution thereof by means of the incident reporting procedure agreed on by the overseers and LCD in 2010. The above procedure provides for the reporting of incident information by using the Bank of Latvia file exchange service, and the above information shall be reported on a standard form, indicating all the data necessary for the assessment of the relevant impact. The overseers monitored the problem-solving process.

In 2011, DENOS ensured 99.9% availability.

## Risk assessment

It was taken into consideration upon the risk assessment of transfers executed in DENOS that the settlement risks may be related both to cash settlement and securities settlement in the securities settlement systems. The overseers only assessed risk of those transfers, where the settlement was executed in lats since the share of such transfers in the total value of cash settlement related transfers amounted to 92.0%.

### A. Assessment of risk related to cash settlement in lats

Similar to the payment systems, the Bank of Latvia analysed three indicators in order to assess the risks of DVP transfers made in lats via DENOS: 1) the volume and value concentration ratios of DVP transfers (total gross and net DVP) made in lats; 2) the volume and value concentration ratios of net settlement (net DVP) of the lats transfers; 3) the netting effect ratio of the DVP net transfers executed in lats. The Bank also reviewed the settlement risk mitigation procedures incorporated in the LCD regulations.

In 2011, the annual concentration ratios of DVP transfers (total gross and net DVP) made in lats and processed by DENOS amounted to 87.0% and 73.2% in terms of volume and value. The volume and value concentration ratios exceeding 80% point to high systemic risk. The volume concentration ratio of DENOS exceeded 80% and high value concentration ratio was also observed in some months. However, the LCD regulations stipulate the procedures for the containment of settlement risk, moreover, the settlement in lats is executed via the SAMS where the participants have substantial account balances, hence the probability of systemic risk materialisation is low. The total value of DVP transfers made in lats and processed in DENOS only amounted to 0.4% of the total value of payments processed in the SAMS.

In 2011, the annual concentration ratio of DVP net transfers made in lats and processed in DENOS stood at 90.9% and 95.9% in terms of transfer volume and value respectively. The volume concentration ratio exceeded 80% and pointed to the

probability of systemic risk in the DVP net settlement of the transactions executed at the Stock Exchange in lats. Only transfers based on transactions executed at the Stock Exchange are processed on such settlement basis. The Stock Exchange runs a Guarantee Fund that may be enacted subject to a decision taken in case a participant has insufficient funds for settling the transactions executed during the Stock Exchange continuous trading. In addition, the LCD regulations stipulate an option to organise a second settlement cycle in case a participant has insufficient amount of funds at the moment of settlement. Given the above procedures and the fact that the value of transfers processed in net settlement cycle is very small and the relevant settlement is made via the SAMS where the participants have substantial account balances, the probability of systemic risk materialisation is low. In terms of value, the DVP net transfers made in lats and processed in DENOS only amounted to 0.02% of the total value of payments processed in the SAMS.

In 2011, the netting effect ratio (i.e. the system participants' net debit positions as a percentage of the system's gross transaction value) of DVP transfers made in lats and processed in net settlement cycle of DENOS amounted to 34.7%. A netting effect ratio below 10% points to a significant risk, hence the netting effect did not point to a significant risk in 2011.

In addition, the LCD and Stock Exchange stipulate the procedures aimed at mitigating the cash settlement related risk, for instance, the application of DVP to all cash settlement related transfers, ensuring settlement finality; additional net settlement cycle to enable the settling of transactions executed at the Stock Exchange, if funds are insufficient during the first cycle; application of the procedures established by the Stock Exchange Guarantee Fund for the completion of the continuous trading related settlement at the Stock Exchange in case a participant has insufficient funds for executing such settlement; rolling over a transfer instruction to the next day's settlement cycle, if the transfers are not settled in the first or second cycle due to insufficient funds.

Overall, it could be concluded that, given the settlement risk containment procedures applied by the LCD and Stock Exchange and current value of settlement funds, the probability of the systemic risk materialisation was low.

#### *B. Assessment of risk related to securities settlement*

To assess risks related to the securities settlement in DENOS, the Bank of Latvia relied on the information submitted by the LCD about default transaction indicators obtained by assessing DENOS, and reviewed the settlement risk mitigation procedures incorporated in the LCD regulations, which the LCD and Stock applied in cases where a DENOS participant had insufficient amount of securities.

According to the data reported by the LCD, more than 99.99% of the transactions are settled in DENOS on the planned settlement date in terms of volume and value respectively, while 99.99% of transactions outstanding on the settlement date are settled within one or two business days of the outstanding transaction date.

DENOS does not currently offer a centralised securities lending option due to the fact that the market participants failed to use such system when provided by DENOS, and hence it was closed. Where a participant in DENOS has insufficient number of securities, the system ensures that the LCD participants may transfer securities in accordance with the settlement period  $T + 0$ . In practice, the DENOS participants agree on the delivery of securities over-the counter.

The LCD and Stock Exchange stipulate the procedures aimed at mitigating the securities settlement related risk, for instance, the application of DVP to all cash settlement related transfers, ensuring settlement finality; execution of securities transfer only upon the receipt of the confirmation on the execution of linked payment from the settlement agent; blocking of securities on the securities accounts prior to cash settlement; application of the deferred settlement where the amount of securities is insufficient in net settlement cycle, i.e. suspension of settlement instructions from net settlement cycle due to non-certified cash positions, converting them into gross transfers and settling separately; rolling over a default transfer instruction to the next settlement day. If the amount of securities is insufficient for continuous trading related settlement, Stock Exchange may take a decision on the purchase of securities at a market price. The Stock Exchange may impose sanctions. DENOS provides for the transfer of only such number of securities as recorded in the participant's correspondent account in DENOS.

Overall, the probability of systemic risk in relation to the securities settlement is minimal, since DENOS and Stock Exchange have established the procedures applicable in case a participant in DENOS has insufficient number of securities and statistics regarding the failure to transfer securities confirms that the set of implemented measures is adequate.

The concentration ratios of DENOS pointed to high systemic risk, while the settlement risk containment procedures applied by the LCD and Stock Exchange, netting effect ratio, indicator of the transaction execution, settlement value and other provisions suggested that overall, the probability of systemic risk materialisation remained low.

## 2. RETAIL PAYMENT SYSTEMS

**The Bank of Latvia proceeded with the oversight of four retail payment systems functioning in Latvia, compiling statistical data and analysing the development of the above systems. The performed data analysis suggested that it was not necessary to implement additional measures of risk containment in the systems.**

### 2.1 The EKS

**In 2011, the EKS was a systemically prominent retail payment system. In 2011, the monthly rise in the volume of lats payments processed in the EKS was 0.3% on average, totalling 34.6 million per annum, and the monthly increase in total value amounted to 2.1%, reaching 12.0 billion lats per annum. The EKS processed 464.0 thousand payments in the total value of 2.8 billion in euro settlement. The EKS availability ratio stood at 99.77%. The analysis of systemic risk pointed to a minimal probability of systemic risk.**

The overseers assessed the compliance of the EKS with the Core Principles in 2011. Pursuant to the above assessment, the EKS fully complies with the Core Principles.

In 2011, the EKS was a systemically prominent retail payment system used for the execution of retail payments in lats and euro. The EKS is an ACH (Automated Clearing House) system where payment processing is fully automated and only electronic payment documents are accepted and processed. The EKS final settlement in lats is effected in the participants' accounts opened with the Bank of Latvia in the SAMS, while that in euro is executed in the participants' accounts opened with the Bank of Latvia in TARGET2-Latvija. On 21 November 2011, the Bank of Latvia implemented the new version of the EKS enabling the EKS participants to execute payments in euro

with no limit set on any payment, by exercising the prepayment option, and providing an opportunity to submit and receive payments indirectly from the EKS via any direct participant in the system. Another clearing cycle for the processing of payments in euro was implemented in the EKS (at 9.30), ensuring even faster execution of cross-border payments in euro and crediting the customer accounts on the same day. The euro payments executed via the EKS were handled in four clearing cycles – at 9.30, 11.30, 14.30 and 17.00. The lats payments were handled in two clearing cycles – at 10.30 and 15.00.

Pursuant to "The Bank of Latvia's Payment and Securities Settlement System Policy", the Bank of Latvia performed the EKS oversight in line with the Core Principles. The overseers assessed the compliance of the EKS with the Core Principles in 2011. Pursuant to the ECB "Oversight Standards for Euro Retail Payment Systems" of June 2003, systemically prominent retail payment systems shall comply with Core Principles I, II and VII–X. According to the assessment, the EKS observes the above Core Principles (for the Oversight Report see Appendix 1 hereto).

At the beginning of 2011, the Bank of Latvia published the updated self-assessment of the EKS SEPA in line with the new functionality of the euro settlement in the EKS. Information about the launching of the EKS SEPA, compliance with the updated SEPA Credit Transfer Scheme Rulebooks and detailed information about the Testing Framework was incorporated into the updated self-assessment.

In 2011, a day-to-day or ongoing oversight of the EKS was performed by collecting and analysing the system's statistical data and monitoring the system's operation in order to identify potential signs of the operational risk (Core Principle VII) on a timely basis.

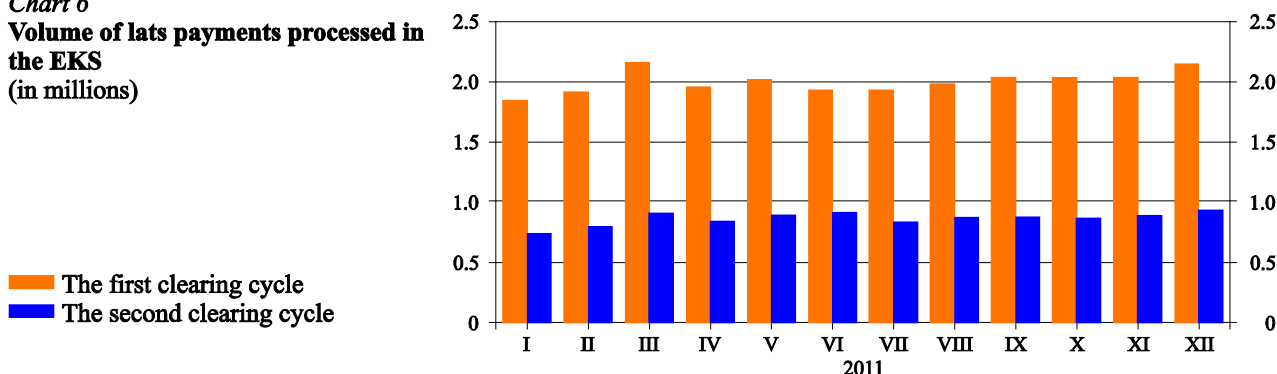
### **Analysis of the system's statistical data**

At the beginning of each month of 2011 (similar to the SAMS), the overseers compiled data on the payments executed via the EKS in the previous month. Data were published on the Bank of Latvia website on a monthly basis and detailed data were used for compiling the Bank of Latvia reports.

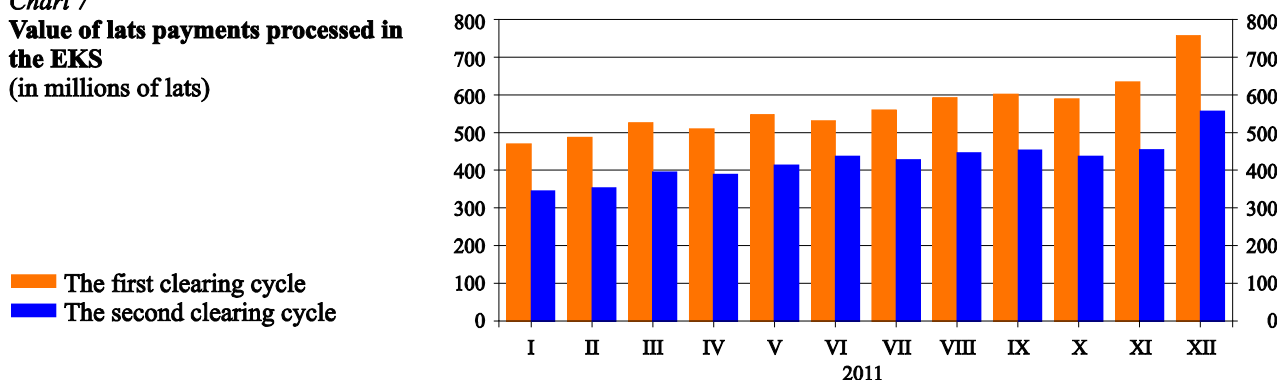
At the end of 2011, 24 credit institutions (including four branches of foreign banks), the Treasury and the Bank of Latvia were the participants in the EKS lats settlement. As regards the settlement in lats, JSC *Latvijas Biznesa banka*, *Rigensis Bank AS* and Treasury joined the system in the capacity of direct participants, whereas Joint Stock Company Bank SNORAS Latvian Branch and JSC *Latvijas Krājbanka* ceased to participate in the system. 15 banks (including one branch of a foreign bank), the Treasury and the Bank of Latvia participated in the EKS euro settlement. As regards the settlement in euro, Joint Stock Company Bank SNORAS Latvian Branch and JSC *Latvijas Krājbanka* suspended their participation in the above system.

In 2011, the monthly rise in the volume of lats payments processed in the EKS was 0.3% on average, totalling 34.6 million per annum, and total value expanded by 2.1%, reaching 12.0 billion lats per annum. The average value per payment rose to 348.14 lats (320.92 lats in 2010). Of all lats payments submitted and processed daily in the EKS, the payments made in lats via the EKS were mainly processed in the first clearing cycle (from 8.30 to 10.30), amounting to 69.7% and 57.1% in terms of volume and value respectively (see Charts 6 and 7).

**Chart 6**  
**Volume of lats payments processed in the EKS**  
 (in millions)

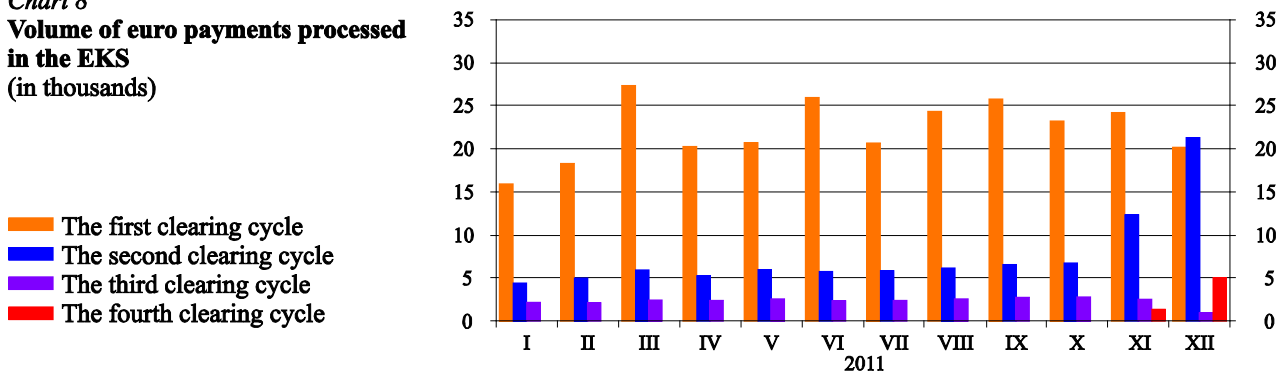


**Chart 7**  
**Value of lats payments processed in the EKS**  
 (in millions of lats)



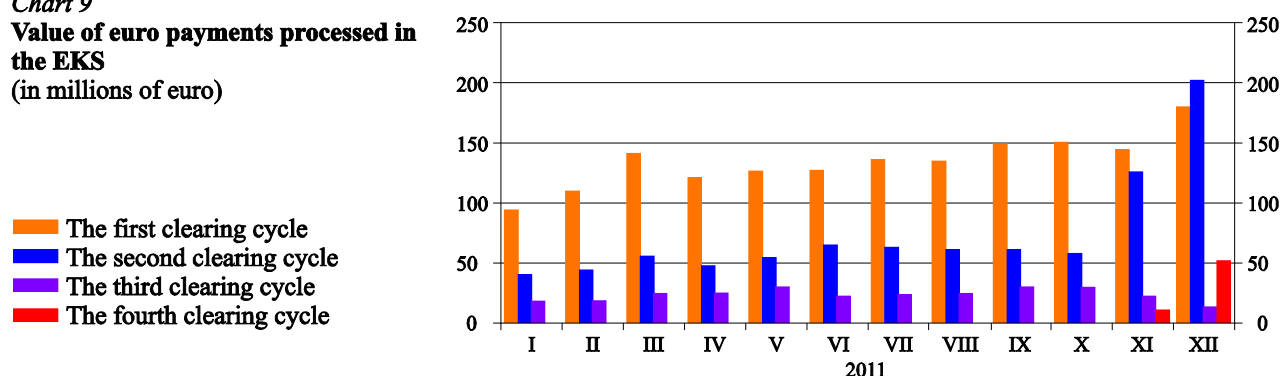
The total volume of payments processed in the EKS in euro increased by 49.6% (to 464.0 thousand) while their total value expanded by 83.9% (to 2.8 billion lats; see Charts 8 and 9). The average value per payment executed via the EKS in euro stood at 6 140 euro in 2011. The increase in the total volume and value of the executed euro payments processed in the EKS was primarily attributable to the payments made by foreign banks to the participants in the EKS via SEPA Clearer, the system of *Deutsche Bundesbank*.

**Chart 8**  
**Volume of euro payments processed in the EKS**  
 (in thousands)



On the basis of the data entered into the Incident register, the overseers were promptly notified of the operational problems incurred by the EKS or its maintenance resources and the solution thereof, and they monitored the problem-solving process accordingly.

**Chart 9**  
**Value of euro payments processed in the EKS**  
 (in millions of euro)



The EKS availability ratio stood at 99.77%, i.e. such a share of the entire EKS net position or offsetting settlement was executed within the stipulated time frame. Overall, only three settlement delays exceeded 30 minutes of the clearing cycle time (all delays were related to the euro settlement) and caused a discontinuity of the Bank of Latvia critical processes in 2011.

In the event of the discontinuity of the Bank of Latvia critical processes the overseers assessed the impact of incident on other payment and securities settlement systems. The above disruptions in the EKS did not affect the liquidity of other systems and participants, the default was not identified since such disruptions were eliminated on a timely basis and settlement in the EKS was completed.

## Risk assessment

Similar to the SAMS, the following three indicators were analysed to identify the probability of systemic risk in the EKS: 1) the share of the system in the respective payment segment; 2) concentration ratio and 3) the netting effect ratio.

In 2011, of all customer credit transfers executed among the credit institutions in Latvia in lats, 74.7% and 75.4% were handled by the EKS in terms of volume and value respectively (74.8% and 74.9% in 2010 respectively).

In 2011, the volume concentration ratio of the payments made in the EKS in lats decreased to 69.2% and the value concentration ratio declined to 70.4% (78.3% and 78.2% in 2010 respectively).

In 2010, the netting effect ratio of the payments executed via the EKS in lats in the first and second clearing cycle (i.e. the system participants' net positions as a percentage of the system's gross transaction value) amounted to 24.6% in the first clearing cycle and 18.0% in the second clearing cycle (27.2% and 17.8% respectively in 2010). The probability of systemic risk is deemed to increase, where the netting effect ratio declines. A netting effect ratio below 10% points to a significant risk. Hence in 2011, as before, the netting effect did not point to a significant risk. Moreover, in 2011, the net debit positions of payments executed by the EKS participants in lats were minor (0.2% on average) in comparison with the balance on the credit institution settlement accounts opened with the Bank of Latvia.

Overall, it can be concluded that the probability of systemic risk is minimal in the EKS, given the current value of settlement funds.



## 2.2 The FDL

**In 2011, the FDL qualified as a systemically prominent retail payment system. Within the scope of the oversight, the overseers requested the FDL to submit semi-annual data on the processed card transactions. In 2011, the market share of transactions conducted at terminals with credit institution cards remained broadly unchanged.**

Within the scope of the oversight, the overseers requested the FDL to submit semi-annual data on the volume and value of processed card transactions, serviced customers, concentration and net settlement positions. The aggregated data were used for monitoring the FDL development with respect to the card payments as well as for comparing the above data with those on payment card transactions as reported by credit institutions. The data reported by the FDL were not published subject to the principle of confidentiality.

In 2011, the FDL provided the payment card authorisation and calculated the card transaction net positions in lats. In 2011, the total value of final settlement of the FDL, the card payment system, processed via the SAMS was many times higher in comparison with that of the final settlements of *MasterCard Europe Sprl* and *Visa Europe Services Inc.*, the card payment systems. Hence the FDL maintained the status of systemically prominent system. As regards international transactions, some Latvian credit institutions had concluded direct agreements with international card scheme centres or they could also execute card payments through parent banks or their payment card authorisation centres. The overseers have analysed the market share of FDL in the total Latvian credit institution transactions effected with credit institution cards at terminals, however, the above data are classified as restricted information and are not published. In 2011, the market share of FDL remained broadly unchanged year-on-year.

Net position settlement of payments processed via the FDL was executed among credit institutions in the SAMS each business day, while the payments made in Latvia with cards issued outside the country and transactions effected abroad with cards issued in Latvia were settled at the international card scheme centres.

The Bank of Latvia did not receive information from the FDL on the disruptions of the system's operation in 2011.

## 2.3 Postal settlement system (PNS)

**The overseers compiled data on the system and its statistical data. The PNS processed 4.0% (9.5 million transactions) of all customer payments (the fourth highest result in Latvia's payment system), however, the value of such transactions only amounted to 0.2% of the total value of customer payments (0.6 billion lats – the 22nd result in Latvia's payment system). The volume of PNS customer payments shrank by 14.3% and the value declined by 10.3% year-on-year.**

In 2011, within the scope of the oversight, the overseers requested the SJSC *Latvijas Pasts* to submit data on the payments processed via PNS in the first and second half of the year. Payment statistics was published on the Bank of Latvia website. On 10 November 2000, the incorporation of PNS statistical data into the report on Latvia's payment statistics was agreed with the SJSC *Latvijas Pasts* in writing.

In 2011, the SJSC *Latvijas Pasts* continued to maintain the network of post offices independently and ensure the provision of payment services, offering credit transfer services to its customers. The total volume of PNS customer payments shrank by 14.3% and the value decreased by 10.3% year-on-year. The average value per payment executed in 2011 stood at 67.86 lats (64.85 lats in 2010).

PNS processed 4.0% (9.5 million transactions) of the entire customer payments, however, the value of such transactions only amounted to 0.2% (0.6 billion lats) of the total value of customer payments.

At the end of 2011, the settlement accounts of PNS customers were opened in lats only and their volume was 4.8% (245.8 thousand) of all settlement accounts, i.e. those opened by the customers of the Bank of Latvia, Latvian credit institutions and SJSC *Latvijas Pasts*. The number of accounts opened with PNS rose by 3.2% since the end of 2010.

In 2011, in addition to cashless payments, 11.5% of all cash deposits and cash withdrawals (9.4 million transactions – the third highest result in the payment system of Latvia) executed in the payment system of Latvia were made via the SJSC *Latvijas Pasts* in terms of volume and 4.2% (611.6 million lats – the seventh highest result in the payment system of Latvia) – in terms of value.

## 2.4 JSC *Itella Information* system

As in the previous years, JSC *Itella Information* was the only company providing infrastructure for interbank direct debit payments in Latvia also in 2011. In 2011, the JSC *Itella Information* was a systemically prominent retail payment system. The JSC *Itella Information* system provides diverse payment related services, including the processing of direct debit payments in JSC *Itella Information* system, enabling the straight-through processing of invoices related to mutual settlement between the customers, companies and credit institutions, while credit institutions execute cash settlement of automated payments outside the JSC *Itella Information* system.

In 2011, within the scope of the oversight, the overseers requested JSC *Itella Information* to submit data on the volume and value of direct debit payments processed in the first half and second half of the year, five largest participants in the system as well as provide information on the number of agreements concluded with credit institutions, companies and customers. The data reported by JSC *Itella Information* were not published subject to the principle of confidentiality.

In 2011, the overseers assessed the compliance of the JSC *Itella Information* system with the Core Principles on the basis of a self-assessment made by JSC *Itella Information*. Pursuant to the ECB "Oversight Standards for Euro Retail payment Systems" of June 3003, systemically prominent retail payment systems shall comply with Core Principles I, II and VII–X. The overseers have stated in their assessment that the JSC *Itella Information* system observes Core Principle I and broadly observes Core Principles II and VII–X, while it is necessary to enhance compliance with Core Principles II, VII and IX. The overseers suggested that the recommendations regarding Core Principles VIII and X should be taken into consideration to the extent that efficient operation of JSC *Itella Information* was not affected. The assessment report is enclosed in Appendix 2 hereto.

The Bank of Latvia sent the report to *JSC Itella Information*, requesting information on its action plan regarding the instructions and recommendations issued by the overseers.

In September 2011, *JSC Itella Information* notified the overseers of its intention to ensure the compliance with Core Principle II along with the transfer to SEPA direct debit standard upon entering into the relevant agreements with the participants anew. Other recommendations would be implemented in 2012.

### 3. PAYMENT INSTRUMENTS

**Pursuant to the "Bank of Latvia's Payment and Securities Settlement System Policy", data on payment instruments used in Latvia in 2011 were compiled and analysed. In 2011, the development of payment instruments proceeded smoothly and hence it was not necessary to implement the risk containment measures related to the use of payment instruments.**

The overseers continued to compile statistical data on payment instruments, based on the Bank of Latvia Regulation No. 74 "Regulation for Compiling 'Credit Institution and Electronic Money Institution Payment Statistics Report' of 12 May 2011. The overseers collect statistical data from the *SJSC Latvijas Pasts* subject to an agreement, and the above data are compiled in accordance with the methodology stipulated by the "Regulation for Compiling 'Credit Institution and Electronic Money Institution Payment Statistics Report". The overseers provided a brief analytical insight into the area of payment systems on the website.

Analysing the data submitted by credit institutions and FDL, the overseers monitored the development of payment cards, terminals and ATM networks.

#### 3.1 Development of payment instruments

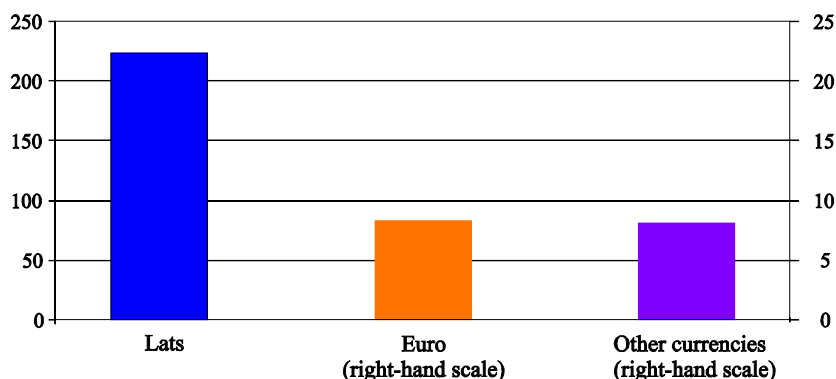
Data on Latvia's payment statistics were surveyed on a semi-annual basis. Latvia's payment statistics is compiled on the basis of the data from the "Credit Institution and Electronic Money Institution Payment Statistics Report", submitted until 25 July and 25 January by all credit institutions registered in Latvia, also the Bank of Latvia, *SJSC Latvijas Pasts* and electronic money institutions (hereinafter – the payment market participants).

In 2011, total volume and value of customer payment instruments used in Latvia expanded by 7.0% (to 238.6 million) and 14.0% (to 298.9 billion lats) respectively.

Of all customer payment instruments, the volume of payments executed in lats amounted to 93.2%, that in euro stood at 3.5% and in other currencies – 3.3% (see Chart 10). In terms of value, the majority of payments (60.3%) were made in other currencies, 21.1% were executed in euro and 18.6% in lats (see Chart 11).

The concentration ratio of five payment market participants in the total volume of customer payments executed in lats amounted to 82.8%, while in that customer payments made in euro it was 76.0% and in other currencies it stood at 70.7%. The concentration ratio of five payment market participants in the total volume of customer payments made in lats comprised 76.7%, while in that of customer payments executed in euro and in other currencies it stood at 58.4% and 64.5% respectively.

**Chart 10**  
**Volume of payments by currency**  
 (2011; in millions)



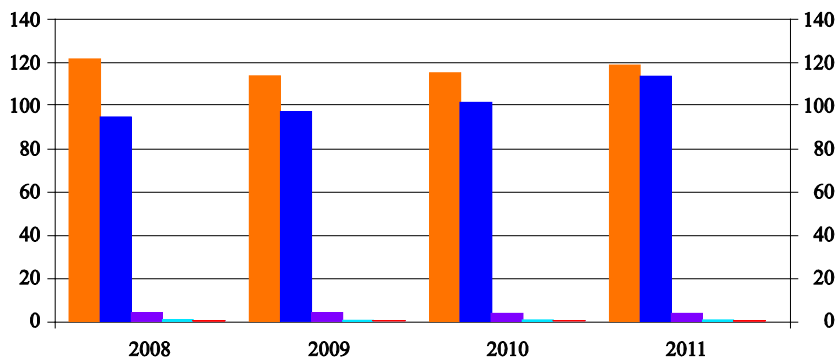
**Chart 11**  
**Value of payments by currency**  
 (2011; in billions of lats)



Assessing the use of individual payment instruments, customer credit transfers and card payments (50.0% and 47.8% respectively) were used most frequently of all customer payment instruments in Latvia in terms of volume (see Chart 12). In terms of value, customer credit transfers and card payments amounted to 99.4% and 0.6% respectively. Year-on-year, the volume and value of customer credit transfers rose by 3.0% (to 119.3 million) and 14.0% (to 297.1 billion lats) respectively. Such increase was mainly attributable to a growth in the value of customer credit transfers initiated via the Internet in other currencies (10.4%) and in euro (24.9%). The volume of card payments recorded a year-on-year rise of 11.9% (to 114.0 million), and their value expanded by 18.2% (to 1.7 billion lats).

**Chart 12**  
**Customer payment instruments in Latvia**  
 (in millions of payments)

- Customer credit transfers
- Card payments
- Direct debits
- E-money payments
- Cheques



Payments executed by credit institution customers accounted for the largest share in total customer payments in terms of volume and value (92.3% (220.1 million) and 97.7% (292.1 billion lats) respectively). The share of payments made by SJSC *Latvijas Pasts* customers amounted to 4.0% (9.5 million) and 0.2% (0.6 billion lats) in terms of volume and value respectively. The payments made by the Bank of Latvia customers accounted for the remaining share.

Of credit institution customer payments, card payments accounted for the majority (51.8%; 114.0 million) in 2011. Of the volume of credit institution customer payments, credit transfers amounted to 45.8% (100.8 million), direct debits were 1.9% (4.2 million) and e-money payments stood at 0.5% (1.1 million). 14.7 thousand cheque payments were also executed.

Credit transfers made by five payment market participants amounted to 82.1% and 52.6% of all customer credit transfers made in Latvia in terms of volume and value respectively.

At the end of 2011, credit institutions had issued 2.3 million payment cards (a year-on-year decline of 104.1 thousand cards). At the end of 2011, payment cards were offered by all credit institutions in Latvia. The majority of cards (77.7%) were issued by three credit institutions. As regards the total volume and total value of card payments executed in Latvia, the share of three credit institutions amounted to 80.2% and 68.4% respectively. At the end of 2011, 1 207 ATMs were installed in Latvia and 63.8% of them were serviced by three credit institutions. At the end of 2011, 154 ATMs with cash deposit function were installed in Latvia. Three credit institutions serviced 82.9% of 24.7 thousand POS terminals.

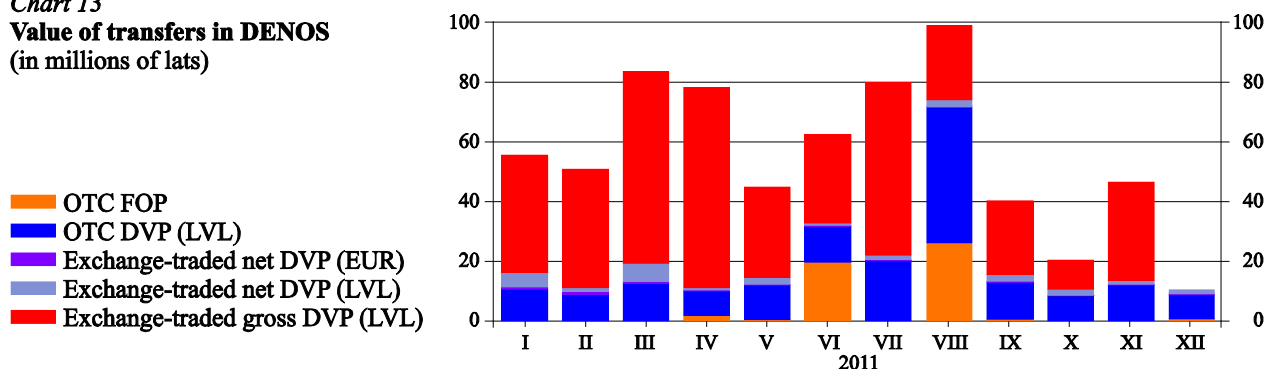
In 2011, the overseers compiled data on card transactions at terminals. The data on card payments and other transactions at POS terminals and ATMs were reported under this item, recording separately the transactions executed at terminals located in the country with cards issued in the country, transactions executed at terminals located in the country with cards issued outside the country and transactions executed at terminals located outside the country with cards issued in the country.

In 2011, 170.5 million transactions were executed at terminals (a year-on-year rise of 9.7%) and their total value reached 6.1 billion lats (a year-on-year increase of 14.1%). Transactions at terminals located in the country with cards issued in the country amounted to 88.1% and 79.9% of the total volume and value respectively, transactions at terminals located in the country with cards issued outside the country were 5.8% and 6.6% respectively and transactions at terminals located outside the country with cards issued in the country stood at 6.1% and 13.5% respectively.

At the end of 2011, all cards issued by credit institutions were co-branded with international card organisations (VISA, MasterCard, American Express etc.). International cards were issued in line with the regulations of the respective card scheme. Card schemes ensured the compliance of credit institutions with the respective scheme regulations.

At the end of 2011, overall 5.1 million customer accounts were opened with the credit institutions, the Bank of Latvia, SJSC *Latvijas Pasts* and electronic money institutions, 69.9% (3.6 million) of which were Internet-linked accounts (see Chart 13). Three credit institutions serviced 63.3% of total number of customer settlement accounts opened in Latvia.

**Chart 13**  
**Value of transfers in DENOS**  
 (in millions of lats)



In 2011, 1.1 million e-money payments in the value of 5.8 million lats were executed.

### 3.2 Customer counselling

In 2011, overseers in cooperation with experts from the Legal Department of the Bank of Latvia advised natural and legal persons and took part in drafting the Bank's replies to the issues pertaining to the Bank of Latvia regulations and other payments related matters.

The overseers in cooperation with the Competition Council submitted an explanatory document to the ECB regarding the Resolution No. E02-15 adopted by the Competition Council on 3 March 2011 about the identified violation and imposed penalties in relation to the violation of Paragraph 1(1) of Section 11 of the Competition Law by 22 Latvian credit institutions with respect to their operations upon entering into the agreement on applying multilateral interbank fees to card transactions at POS terminals and via Internet.

The overseers in cooperation with the Bank of Latvia experts took part in the International Museum Night organised by the Bank of Latvia, and offered the IBAN game to the visitors (visitors had to identify a credit institution's IBAN by looking at the disclosed part of IBAN), a pyramid puzzle of Latvia's payment system with a varying degree of difficulty, and informative presentation about the payment systems.

In 2011, the overseers furnished information on the issues regarding the SEPA payment statistics and time frame of performance and Regulation (EC) No 924/2009 of the European Parliament and of the Council of 16 September 2009 on cross-border payments in the Community.

In 2011, the overseers advised several students whose research was devoted to the issues pertaining to payment systems.

## 4. SEPA PROJECT

**SEPA Project is one of the Bank of Latvia projects within the framework of the Bank of Latvia's payment system oversight. In 2011, the Bank of Latvia continued its involvement in SEPA Project by steering the National SEPA Working Group and taking part in the SEPA Working Group of the Payment Committee of the ACBL and EU Forum of the National SEPA Coordination Committees organised by the EC, as well as developing further the SEPA Project at the Bank of Latvia.**

**The major goals achieved in SEPA Project were as follows: 1) drafting Version 3.0 of Latvia's National SEPA Plan; 2) involvement in developing draft SEPA Regulation<sup>2</sup>; 3) organising a SEPA seminar to public authorities.**

**At the end of 2011, Latvian credit institutions reached the limit of critical mass stipulated by Latvia's National SEPA Plan and hence launched SEPA payments in Latvia, i.e. 95.0% of all credit transfers initiated via Latvian credit institutions in euro were SEPA credit transfers, and 100% of ATMs, 99.3% of POS terminals, 99.2% of debit cards and 99.3% of credit cards were compliant with the SEPA requirements. In the second half of 2011, one Latvian credit institution executed SEPA direct debit payments for the first time.**

To promote integration of Latvia's payment systems into SEPA encompassing all European Union Member States, Iceland, Liechtenstein, Norway, Switzerland and Monaco, the Bank of Latvia engaged in SEPA Project in the capacity of the payment system overseer. The Bank of Latvia's overseers continued to steer the NSWG, coordinating the cooperation among the representatives of the payment market supply side (ACBL, SJSC *Latvijas Pasts*, FDL, JSC *Itella Information*, Latvian Information and Communications Technology Association) and representatives of the demand side (the Consumer Rights Protection Centre, MVKAKP, LDDK, Treasury, Ministry of Finance of the Republic of Latvia and Bank of Latvia). The representatives of the respective institutions and associations coordinated, within the scope of their competence, the assignments of integration into SEPA. The MPSWG supervised the activities of the NSWG.

The assignments of SEPA Project accomplished by the overseers in 2011 have been described in Appendix 3 hereto.

## **5. PROJECT "TARGET2-SECURITIES"**

**T2S is the most significant Bank of Latvia project within the framework of the securities settlement system oversight. The above Project will be completed with the Bank of Latvia and LCD joining T2S and launching the settlement platform (projected in June 2015). In 2011, the Bank of Latvia continued its involvement in T2S project by steering the T2S User Group along with the LCD, participating in the ECB Working Group on T2S as well as promoting the development of T2S project at the Bank of Latvia.**

**In 2011, the assessment of the impact of T2S on the Bank of Latvia functions and processes was completed.**

To promote integration of Latvia's securities settlement systems into the harmonised process of securities settlement of the EU Member States, the Bank of Latvia engaged in T2S Project. The settlement of securities transactions will be harmonised and cross-border settlement costs incurred by the securities market participants will be reduced as a result of implementing the above Project. The Bank of Latvia overseers continued to steer the T2S User Group by coordinating the cooperation among the representatives of the LCD, Bank of Latvia, FCMC, Treasury and ACBL. The representatives of the

<sup>2</sup> Draft Regulation of the European Parliament and of the Council of 16 December 2010 establishing technical requirements for credit transfers and direct debits in euro and amending Regulation (EC) No 924/2009, COM (2010) 775.

respective institutions, within the scope of their competence, coordinated the assignments regarding the implementation of T2S Project.

The goals of the above Project accomplished by the overseers in 2011 have been described in Appendix 4 hereto.

## 6. THE OVERSIGHT PROJECT "THE SOCIAL COSTS OF RETAIL PAYMENT INSTRUMENTS"

**In 2011 the Bank of Latvia along with the national central banks of 14 other EU Member States and ECB continued its participation in the international project coordinated by the ECB – a survey The social costs of retail payment instruments: a European perspective. The objective of the project is to identify the social costs incurred by the general public in relation to the use of retail payment instruments (such as cash, payments with credit and debit cards, credit transfers and direct debits).**

Overseers engaged in the above project of oversight by coordinating it and compiling the relevant data in order to promote public awareness of the cost efficiency of different payment instruments. Other structural units of the Bank of Latvia were also involved in the above project.

Within the project, particular attention was paid to overall improvement of the data quality and work with respondents in 2011. Two additional phases of survey were conducted (the number of retailer respondents grew from 15 to 29). The ECB held meetings with the representatives of the central banks of the participating Member States, including the Bank of Latvia overseers with whom the potential solutions for the compiled data extrapolation were discussed. A number of additional data extrapolations were performed and the derived data were most consistent with the payment statistics data which, as reported by credit institutions, the Bank of Latvia compiles on a regular basis. The overseers made additional analysis of the data reported by retailers: by retail trade sectors and in line with the size of the company, and also performed data extrapolation.

## 7. LEGISLATIVE AMENDMENTS

In March 2011, upon request by the FCMC, the Bank of Latvia issued an opinion on the amendments to the LCD Regulation No 11 "On Data Exchange". The amendments were made since the LCD launched a new service for the data exchange, *MessageHub*. The LCD has used FTP server until now. The overseers consulted with the Information Systems Department of the Bank of Latvia prior to issuing the relevant opinion. Other CSDs of the Baltic States also intend to launch the *MessageHub* solution. The above amendments were approved at the meeting of the Management Board of the LCD and became effective on 30 March 2011.

On 30 April 2011, the amendments to the Law "On Payment Services and Electronic Money" and Law "On Credit Institutions" took effect. The Bank of Latvia approved the "Regulation for Compiling Credit Institution and Electronic Money Institution Payment Statistics Report" on 12 May 2011 (hereinafter, the Regulation, in effect as of 20 May 2011), since pursuant to the amendments made to the above Laws, the term "credit institution" did not cover electronic money institutions. As compared with the Bank of Latvia Regulation No 3 "Regulation for Compiling Credit Institution Payment Statistics Report" of 15 March 2007, under the present Regulation the terminology is arranged in



accordance with the amendments made to the above Laws, and revisions are made pursuant to the provisions of the Cabinet of Ministers Regulations No 108 "Regulations for Drafting Laws and Regulations" of 3 February 2009. With a view to achieving common requirements regarding the Bank of Latvia regulations, the requirement to prepare the Report in two copies is deleted from the Regulation and a new registration classifier code of statistics reports and draft questionnaire forms (VSPARK 27002042) is assigned to the "Regulation for Compiling Credit Institution and Electronic Money Institution Payment Statistics Report" in accordance with the CSB requirements. The above Regulation did not involve changes in the scope and structure of the data to be reported; hence the draft Regulation had not to be agreed with the ECB.

In view of the recent financial market crisis, EU wide activities are planned with the aim of promoting more transparent and stable financial system. As regards the securities settlement systems, the EC has commenced the development of legal framework covering the CSDs and stipulating the harmonisation of the securities settlement procedure in the EU. As regards the measures taken by the EU, a draft *European Market Infrastructure Regulation* (EMIR) was developed with respect to over-the-counter financial derivatives, central counterparties and trade repositories. Upon request by the Ministry of Finance of the Republic of Latvia, the Bank of Latvia (the overseers) provided comments on the final version of the EMIR on 15 June 2011 in order to prepare Latvia's position regarding the liquidity of central counterparties, clearing of financial derivatives and access provisions. On 16 June 2011, upon request by the Ministry of Finance of the Republic of Latvia, the Bank of Latvia provided consultation to the Ministry of Finance of the Republic of Latvia on the performance of the function of the central counterparty by the CSD pursuant to the ESCB-CESR recommendations.

## **8. COOPERATION WITH OTHER INSTITUTIONS**

### **8.1 Cooperation with the ECB**

In 2011, the overseers continued to participate in the ECB working groups dealing with a wide range of issues related to the oversight of payment systems and securities market infrastructure. At the working group meetings held by the Oversight Working Group (WGO) of the ECB Payment and Settlement Systems Committee (PSSC) and Payment Systems Policy Working Group (PSPWG), the overseers and representatives of other central banks of the EU Member States debated about the issues pertaining to the oversight of payment instruments and infrastructures and addressed issues related to the SEPA Project. The overseers took part in the ECB Securities Experts Working Group (SEWG), albeit in 2011 the above Group did not perform any activities attributable to non-euro area countries. The Bank of Latvia, in the capacity of a member of the SEWG, took part in the survey conducted by the central bank of Cyprus on the CSDs with a bank's license. On 26 and 27 May 2011, the overseers in cooperation with experts from the International Relations and Communication Department of the Bank of Latvia, held a meeting of the PSPWG in Riga. In 2011, the overseers participated in the European Forum on the Security of Retail Payments, newly established by the ECB.

In July 2011, upon request by the Oversight Working Group of the PSSC, the overseers along with the LCD provided information on statistical data of DENOS for the survey on system based interdependencies.

## **8.2 Cooperation with the World Bank**

On 15 November 2011, upon invitation by the World Bank, the overseers had a meeting with the World Bank expert within the framework of the development module of the Financial Sector Assessment Program. Providing answers to the questions posed by the World Bank, the overseers, within the scope of their competence, furnished information on the operation of payment systems and the related financial instruments. The overseers, upon request by the World Bank, shared information on the system assessments conducted in line with the international standards and recommendations. The World Bank pointed out in the report that a proficient and effective structural unit of the oversight has been established at the Bank of Latvia.

## **9. INFORMATION TO THE PUBLIC**

The Bank of Latvia Annual Report, Financial Stability Report and the Bank's website presented information on the development of payment instruments and their infrastructure and work performed by the Bank of Latvia with respect to the payment system oversight. Information on the annual statistics of Latvia's securities settlement system is published in the ECB Statistical Data Warehouse.

## **10. THE BANK OF LATVIA'S PAYMENT AND SECURITIES SETTLEMENT SYSTEM POLICY**

In 2011, the oversight of the payment and securities settlement systems was conducted in accordance with the objectives and assignments stipulated by "The Bank of Latvia's Payment and Securities Settlement System Policy" for each component of the national payment and securities settlement system: systemically important payment and securities settlement systems, clearing and retail payment systems and payment instruments.

## APPENDIX 1. OVERVIEW OF THE ASSESSMENT OF THE EKS COMPLIANCE WITH THE CORE PRINCIPLES

"The Bank of Latvia's Payment and Securities Settlement System Policy" approved by the Bank of Latvia Council Resolution No 189/6 of 13 January 2011, states that the responsibility for a safe and efficient operation of retail payment systems shall be assumed by operators of payment systems and their participants, and they shall ensure maximum compliance of the system operation with the Core Principles. The above Core Principles shall be applied to the retail payment systems to the extent that the system efficiency is not impaired.

The EKS is the Bank of Latvia net settlement system ensuring the clearing of the credit transfer orders and cash refund orders submitted by the participants in lats, clearing in euro of the SEPA credit transfer orders and SEPA payment return orders submitted by the participants and addressed to them and received from other SEPA payment system, submission of debit and credit instructions consistent with the net positions to the SAMS for clearing in lats, submission of payment instructions to TARGET2 to reserve a prepayment and refund their balance, submission of debit and credit instructions consistent with the net positions to TARGET2 for execution of clearing in euro. The EKS is the only operating payment system in Latvia ensuring clearing (net settlement) for bulk retail credit transfers in lats and euro.

The oversight measures of the EKS are consistent with the breakdown of the clearing and retail payment systems by significance as stipulated by the ECB "Oversight Standards for Euro Retail Payment Systems" of June 2003, i.e. the EKS has to comply with Core Principles I and II and VII–X.

In the second half of 2011, the overseers conducted the assessment of the EKS against the above six Core Principles pursuant to the assessment methodology incorporated into the ECB document *Terms of Reference for the assessment of euro systemically and prominently important payment systems against the applicable Core Principles for Systemically Important Payment Systems* (hereinafter, the Assessment provisions). The assessment only covers the EKS. The overseers applied the following scale for the purpose of assessment: observed, broadly observed, partly observed and not observed. During the assessment the overseers and operators discussed all issues related to the Core Principles. The assessment was based on the analysis of the EKS operation related document and replies to the assessment questions given, taking into account the commentaries and proposals by the operators and experts from other structural units of the Bank of Latvia involved in the above process. The above document provides the opinion of the overseers on the EKS compliance with the Core Principles.

### **Core Principle I. The system should have a well founded legal basis under all relevant jurisdictions.**

*1.1 Legal infrastructure is specified clearly (for instance, the governing jurisdiction, applicable laws, statutes, court practice, agreements, regulations and procedures).*

The legal framework for the EKS is based on legal relationship. The EKS participant agrees to the "System Rules for Participation in the EKS" by entering into the agreement on participation in the EKS and undertakes to act in accordance with the above Rules and the signed agreement. The "System Rules for Participation in the EKS" do not create any rights in favour of or obligations in relation to any entity other than the Bank of Latvia and participants.

The "System Rules for Participation in the EKS" explicitly state the governing jurisdiction. Pursuant to the above Rules, the bilateral relationship between the Bank of Latvia and a participant is governed by the legal acts and place of performance regarding the legal relationship between the Bank of Latvia and the participant shall be the Republic of Latvia.

The Bank of Latvia, in the capacity of the EKS operator, operates in accordance with the legal acts of the Republic of Latvia.

*1.2 Legal framework is clearly identified and accountable (for instance, the Settlement Finality Directive (SFD) has been implemented in the jurisdiction of the location of the relevant system, the moment of finality and irrevocability has been defined, contract law is explicit, potential legal risks arise from the relevant jurisdictions rather than the one governing the system).*

The Settlement Finality Directive has been implemented in Latvia pursuant to the Law "On Settlement Finality in Payment and Financial Instrument Settlement Systems" (hereinafter, the Law "On Settlement Finality"). The Law "On Settlement Finality" applies to all systems (including the EKS) operated by the central banks. Pursuant to the provisions of the Law "On Settlement Finality", the "System Rules for Participation in the EKS" stipulate the entry moment of payments into the EKS and moment of irrevocability of such payments. The "System Rules for Participation in the EKS" also provide for the liability regime regarding the Bank of Latvia and a participant.

An applicant participant registered in the EEA and willing to join the EKS shall submit to the Bank of Latvia a capacity opinion stating that the obligations arising from the EKS System Rules are legal, valid and binding. A non-EEA applicant participant acting through a branch established in the EEA shall submit to the Bank of Latvia a country opinion stating that the participation of such foreign institution in the EKS is not contrary to the national legislation.

*1.3 Legal issues are appropriately addressed to provide for the implementation of the rules and procedures and predictability of consequences (for instance, the developing of a system subject to the SFD; specific legal situations in case of access by foreign participants).*

The EKS is a system maintained by the central bank and hence is safeguarded pursuant to the Law "On Settlement Finality". The Law "On Settlement Finality" provides for the netting and settlement finality, their legal power in the system and the right to dispose, at their own discretion, of the collateral which has been provided in relation to the participation in the system or transactions with the central bank, as well as in the case of insolvency proceedings of a participant.

To become a participant in the EKS, an institution established in the EEA shall submit a capacity opinion (such opinion contains assessment of a participant's legal capacity to enter into and carry out its obligations under the "System Rules for Participation in the EKS"). To become a participant in the EKS, a non-EEA institution shall submit a capacity opinion (such opinion contains assessment of a participant's legal capacity to enter into and carry out its obligations under the "System Rules for Participation in the EKS" and states that the participant's participation in the EKS is not contrary to the national legislation). Credit institutions which are not established in the EEA or have not opened their branch in the EEA are not eligible to become participants in the EKS.

The participant shall notify the Bank of Latvia of any change in its legal capacity and relevant legislative changes affecting the issues covered by the country opinion in relation to it. The participant shall immediately inform the Bank of Latvia if an event of default occurs in relation to it.

**Conclusion.** The regulatory documents and agreements of the EKS create a stable and appropriate legal basis for the operation of the EKS in the Republic of Latvia. The EKS thus observes Core Principle I.

**Core Principle II. The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.**

*2.1 Documentation related to the financial risk management (such as, credit and liquidity risks) should be clearly specified.*

Appendix 1 "System Rules for Participation in the EKS" to the Bank of Latvia's Council Regulation No 183/3 "Regulation for the Participation Procedure in the Bank of Latvia's Electronic Clearing System" of 9 September 2010 and agreement "On Participation in the EKS" stipulate the operation of and participation in the above system.

The "System Rules for Participation in the EKS" stipulate the general principles for the EKS operation and settlement in the clearing cycles, requirements for the participation in the system, obligations of the parties upon the execution of payments and exchanging of information, operation of the system in contingency situations, the system's operating hours, fees as well as mutual liability of the parties. Hence the "System Rules for Participation in the EKS" and the agreement on participation in the EKS can be deemed to provide complete understanding of risks they may incur in relation to their participation in the system. The above documents are publicly available on the Bank of Latvia's website.

*2.2 The documentation of the financial risk management and containment is updated, comprehensive and accountable.*

The "System Rules for Participation in the EKS" were approved on 9 September 2010 (recent amendments took effect on 21 November 2011). Legal documents of the system are updated upon making any amendments affecting the functionality of the system or the rights and obligations of the parties in the system.

Pursuant to the "System Rules for Participation in the EKS", the Bank of Latvia is entitled to amend the System Rules unilaterally, notifying the participant thereof in writing. Amendments are deemed to have been accepted by the participant, unless it expressly objects within 14 (fourteen) days. Discussions were held with the participants regarding the amendments made so far and support extended to the above amendments by ACBL prior to their approval by the Council of the Bank of Latvia.

*2.3 The system operator/owner provides adequate monitoring and support to enable the participants and other stakeholders (for instance, providers of infrastructure services) to understand the regulations regarding the financial risk management and containment.*

Pursuant to the "System Rules for Participation in the EKS", the Bank of Latvia maintains a system support desk to assist the participants encountering difficulties in

connection with the EKS operation. The system operators ensure daily technical and informative support to the participants in the system by providing consultations thereof. The participant in the system is responsible for the training of the recently hired staff. The Bank of Latvia organises educational sessions for the purpose of training the system participants, where necessary.

*2.4 The key regulations for the financial risk management and containment are publicly disclosed subject to the potential confidentiality restrictions.*

The agreement on the participation in the EKS and "System Rules for Participation in the EKS" are publicly available on the Bank of Latvia's website and provide an insight into the financial risk management. The above also stipulate the requirements for the information confidentiality in relation to the confidentiality of particular information received from the system participants and other data.

**Conclusion.** The regulations and agreements regulating the EKS operation are explicit, accountable and consistent with the present operation of the system, and provide a clear understanding of the system's impact on the financial risks related to the participations in the EKS. Hence the EKS observes Core Principle II.

**Recommendation.** The regulations or other regulatory documents do not stipulate the cooperation with the participants and arrangements regarding the amendments made thereto. The Bank of Latvia agrees with the participants on the provision of consultations and making amendments to the regulations in accordance with the principles of best practice. The above has proved positive until now. However, Paragraph 2.2.7.c) of the Assessment provisions suggests that such consultation and process of agreeing shall be stipulated by the regulations or procedures providing clear understanding to the participant of the Bank of Latvia's discretion in relation to the consultation and agreement-reaching process. To promote transparent relationship between the Bank of Latvia and EKS participants, the overseers propose to define the process of consulting and agreeing on the amendments to the regulations, incorporating the above in the EKS System Rules.

**Core Principle VII. The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.**

*7.1 The system operator, participants and any stakeholder third party have agreed on a set of the security rules and service level of operations to be complied with by all participants in the system. The present policy and offered level of service are compliant with the international standards of confidentiality, reliability and authentication, non-rejection and availability of information as well as the auditing of processes and procedures.*

The security considerations, policy, procedure and level of service are all taken into account during the development of the system and system has been upgraded and maintained appropriately. Information and security of information systems are monitored at the Bank of Latvia in accordance with the principles of best practice, considering the Bank of Latvia's needs, specific operation and organisational structure as well as the recommendations of the ECB and *Information Security Forum* regarding the security of information and information systems. Business continuity management is organised in accordance with the principles of best practice, taking into account the

Bank of Latvia needs, specific operation and organisational structure as well as the ECB recommendations for the business continuity management.

The system operator consults with the system participants during the development and upgrading of the system and also during the interim stages, frequently organising such consultations at the ACBL. One of the major factors determining the design, offered services and functionality of the systems is the opinion voiced by credit institutions. The "System Rules for Participation in the EKS" which are binding on the participants, stipulate a set of the security provisions for the EKS and service level of its operations.

*7.2 Where new technologies are used, the consequences for security and operational reliability should be well understood and discussed.*

The security policy and service levels are revised in view of the changes in the market and technologies.

*7.3 The goals of the security policy, policy and procedures have been established and are comparable with the importance of the payment system in terms of transaction volume and value.*

The goals and procedures of the system security policy are established, defined and implemented by Operational Continuity Officer and Information Systems Department of the Bank of Latvia, and the above are comparable with the importance of the EKS in terms of transaction volume and value.

*7.4 Responsibility for the information security has been clearly defined.*

All information is overall processed at the Bank of Latvia, encompassing all regulatory documents adopted by the Bank of Latvia on information security.

*7.5 The system operator conducts risk management on a regular basis and reports the relevant results to the owner of the system.*

The experts in business continuity and EKS perform the security audit and risk analysis of the systems on a regular basis. The development of market and technologies is taken into account upon assessing the system's security.

The results of the system's security assessment and risk analysis are reported to the Board of the Bank of Latvia on a regular basis.

*7.6 The system is exposed to ongoing and independent security audit.*

The system's security policy, procedures and compliance thereof are subject to a regular internal audit. Several internal auditors are also competent in the area of information systems.

*7.7 Operation and technical procedures are versatile, detailed and well documented.*

The system's operation and technical procedures are detailed and well documented in the "Functional Specifications of the Electronic Clearing System (EKS) of Latvijas Banka".

The service levels, alternative routing options and arrangements regarding the disruptions of the operations are stipulated by the Bank of Latvia agreements concluded with the providers of telecommunications services.

The "System Rules for Participation in the EKS" and "Functional Specifications of the Electronic Clearing System (EKS) of Latvijas Banka" provide information to the participants in the system on the operational risks they are exposed to upon such participation.

Performing a day-to-day work, the system operator monitors the availability of the system and notices that a system's participant has failed to furnish information or the system's participant himself/herself informs the operator on the problems encountered when transmitting the files.

*7.8 Changes are fully tested, authorised and documented.*

The development, testing and acceptance testing are conducted in isolated environment where platforms analogous to the live environment are used. All changes to the systems are tested by the information system related experts, while the operator conducts the acceptance testing of information systems, with other system participants also taking part, where necessary. All the above processes are subject to the procedure established for the information system development, also describing the implementation of changes in the systems in live environment.

To participate in the EKS, a new participant shall meet the stipulated technical and operational requirements. To verify the new participant's capacity to comply with the above requirements, the check-up tests are conducted and after successful completion of the above the participant is granted the participation status in the EKS.

*7.9 Capacity requirements are incorporated into the system's design and are monitored and updated, where necessary.*

The impact of changes on the system's high-speed operation is tested upon introducing such changes to the system. The speed of system's operation in a live environment and capacity of the system's hardware are periodically monitored.

*7.10 Administration and operation of the system should be provided by an adequate number of well-trained employees.*

The EKS operation is enabled by the Bank of Latvia experts in information technologies and operations who provide an ongoing monitoring of the system's operation in order to identify and eliminate the deviations from the standard operation of the EKS on a timely basis. At the Bank of Latvia, the number of employees is sufficient for providing secure and efficient operation of the EKS, with experts in the relevant areas replacing each other, where necessary, thus enabling the operation of the EKS in abnormal and contingency situations. The operation of all payment systems, including the EKS, maintained by the Bank of Latvia is monitored by a number of operational experts, while technical support is provided by a number of experts in information technologies.

*7.11 Operational and security-related incidents are reported, recorded, analysed and monitored respectively.*

Operational disruptions of the EKS are recorded in the Bank of Latvia Incident register and evaluated accordingly, taking into account their impact on the EKS operation.



Consistent information on the operational disruptions of the EKS is available since the launch of the EKS. In 2008, the Bank of Latvia established a single Incident register providing the storing of information on an incident and its prevention and notifying the relevant staff in electronic form thereof.

*7.12 The regulation for the business continuity stipulates that the agreed service levels are met where one or more components of the system fail as well as in the event of one of the several plausible scenarios in line with the system's importance.*

The "Bank of Latvia Business Continuity Policy" stipulates the goal of the Bank's business continuity management, core principles and the procedure for implementation and oversight thereof. The EKS business continuity procedures ensure continuous operation of the EKS and recovery of its operation in the stipulated time-frame where any of the system's components or resources is not available.

Arrangements with the EKS participants, including the business continuity management procedures, are drafted in view of the core principles stipulated by the "Bank of Latvia Business Continuity Policy".

*7.13 The business continuity arrangements are well-documented and tested on a regular basis.*

The business continuity management system established at the Bank of Latvia is organised in accordance with the principles of best practice. The "Bank of Latvia Business Continuity Policy" approved by the Council of the Bank of Latvia stipulates the goal of the business continuity management, core principles and the procedure for implementation and oversight thereof. The Board of the Bank of Latvia has approved the "Procedure for Managing the Continuity of the Bank of Latvia's Operation", stipulating the procedure for organising and implementing the operational continuity management by complying with the provisions of the policy document, and measures for providing the continuity of critical processes (including the EKS) and ongoing accessibility of critical resources and their restoration, time-frame of such restoration as well as the list of stand-by working stations incorporating the information on the minimum number of stand-by working stations needed for the implementation of such critical process and crisis management where the permanent working stations are not accessible, location of such working stations and equipment.

The EKS business continuity measures are tested on a regular basis, including the conducting of the EKS operation from the stand-by working stations, and documented pursuant to the "Procedure for Managing the Continuity of the Bank of Latvia's Operation".

*7.14 The business continuity measures include crisis management, dissemination of information and analysis and management of unspecified risks.*

Detailed procedures for incident management (including the EKS) are established at the Bank of Latvia. Such procedures provide timely identification of incidents and informing the respective employees thereof as well as timely and appropriate elimination of incident and its consequences and recording the process of such elimination. The employees carrying out day-to-day measures for providing the continuity of critical processes (including the EKS) are responsible for the incident management. Where an incident escalates, Operational Continuity Officer of the Bank of Latvia takes part in the incident management by coordinating the relevant measures

for the incident elimination, including also the involvement of other experts. Press Secretary of the Bank of Latvia, together with other experts, furnishes information to the participants, customers, central and local government institutions, foreign institutions and organisations, general public and mass media on such incident and consequences thereof.

**Conclusion.** The EKS ensures a high degree of security and operational reliability in standard situations, as well as in an emergency, thus the EKS observes Core Principle VII.

**Core Principle VIII. The system should provide a means of making payments which is practical for its users and efficient for the economy.**

*8.1 The system meets the needs of the users with respect to the system participants and payment service customers (such as, technologies, operational hours, procedures, technical operation, business continuity), and procedures for the revision and restoration of the service level.*

At the time of assessment, the EKS is the only fully automated operating payment system in Latvia ensuring clearing (net settlement) for bulk retail credit transfers in lats and euro. The EKS was developed and further development-related changes were implemented in close cooperation with the credit institutions and other participants, taking into account their recommendations and wishes regarding the range of services and operational principles.

*8.2 As regards the design of the system and its evolution, the needs of all types of users are taken into consideration (for instance, via involvement, consultations or coordination of the plans).*

Wishes and recommendations of all participants are reviewed by the Bank of Latvia in cooperation with the ACBL during the process of upgrading and development of the EKS.

*8.3 Resources are allocated efficiently.*

All operational disruptions of the system are recorded in the Incident register and analysed. The availability of the system is calculated annually on the basis of the above; i.e. the percentage of the settlement in the EKS executed within the time-frame stated in the "System Rules for Participation in the EKS".

The capacity of the system is sufficient and would enable the processing of a considerably larger volume of payments than currently processed. The reserve capacity is not cumbersome and large unnecessary investment has not been required.

There are no substantial constraints to the system's operation. The EKS has been developed into a sufficiently safe and efficient system consistent with the needs of the retail payments.

The fee setting policy stipulates full recovery of costs without profit during the five year depreciation period. This policy has been discussed with the participants. The EKS is not subsidised with income from other systems, and other systems are not subsidised with income from the EKS operation.

The message forms used in the EKS are consistent with the SWIFT message forms, hence facilitating the participation in the system.

*8.4 Pricing policy (cost recovery method, pricing based on market, subsidising) is communicated to the participants.*

Prior to transforming the EKS into a SEPA compliant system, the costs policy and principles were debated about with the EKS participants and concept of the above issues was agreed on. The above information is not disclosed to general public.

**Conclusion.** The EKS is an efficient net settlement system providing services in line with the demand by private persons and SMEs, thus the EKS observes Core Principle VIII.

**Core Principle IX. The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.**

*9.1 Connection/cut-off criteria should be clearly and explicitly described and publicly available.*

The "System Rules for Participation in the EKS" stipulate the criteria for connection and cut-off.

*9.2. The procedures for connection/cut-off are explicitly stated in the System Rules and are disclosed to the participants and potential participants.*

The "System Rules for Participation in the EKS" describe the application procedure and obligations of the parties upon joining the system and terminating the participation therein.

*9.3 The criteria for connection/cut-off are objective and based on the relevant risk and efficiency considerations and do not impair competition among the participants.*

Pursuant to the "System Rules for Participation in the EKS", uniform criteria for the connection to the system and termination of participation are stipulated for all participants. The only difference regarding the access provisions is stipulated for the institutions which may be admitted by the Bank of Latvia to be the EKS participants (treasury departments of a central or regional government operating on the money markets, public sector bodies authorised to hold customer accounts, and investment firms established in the EEA), pursuant to Paragraph 12 of the "System Rules for Participation in the EKS". As regards the above participants, the Bank of Latvia may, upon assessing risks and regulatory requirements, agree in writing with such participant on the sufficiency of funds for the settlement of payments in the EKS.

*9.4 Compliance criteria are monitored on a regular basis.*

The access criteria of the EKS are not related to risk criteria, thus the Bank of Latvia need not conduct an ongoing monitoring of compliance thereof. Where the participant might no longer meet the criteria for institutional participation (license has been suspended or other restrictions imposed), the Bank of Latvia is promptly notified thereof pursuant to the Agreement with the FCMC, and may suspend or terminate the participant's participation in the EKS.

**Conclusion.** The criteria for the participation in the EKS are objective and accountable and permit fair and open access for its participants, thus the EKS observes Core Principle IX.

**Core Principle X. The system's governance arrangements should be effective, accountable and transparent.**

*10.1 The governance principles are clearly defined.*

The Bank of Latvia is the owner and operator of the EKS. The Payment Systems Department of the Bank of Latvia ensures the EKS operation and performs the EKS oversight. The Information Systems Department of the Bank of Latvia cooperates with the Payment Systems Department, ensuring technical maintenance of the system, communication network and servers.

The Bank of Latvia internal procedures, the Bank's regulations, Law "On the Bank of Latvia" and other legal acts explicitly regulate the decision-making procedures and operational and control functions.

The Bank of Latvia makes amendments to the regulatory documents in cooperation with the system participants and ACBL. The Council of the Bank of Latvia approves the regulatory documents of the EKS and such documents are publicly available on the Bank of Latvia's website.

In the event of disputes and errors, the disputes are resolved, taking into account the rights and obligations of the parties stipulated by the "System Rules for Participation in the EKS".

*10.2 The governance arrangements are transparent.*

The management structure of the Bank of Latvia, the operator and owner of the EKS and management information are publicly available on the website. The operational function is distinct from the oversight function: the Payment Systems Operations Division is responsible for ensuring the EKS operation, whereas the Payment Systems Policy Division is in charge of the EKS oversight.

10.3 The management of the system's operator is clearly accountable for the operation to the owner and financial community at large, and such responsibility is clearly defined.

The system's operator reports to the Board and the Council of the Bank of Latvia on the results of the system's operation and development plans. Independent internal audit also performs the oversight and auditing of the EKS operation. Independent Operational Continuity Officer monitors the process of risk management at the Bank of Latvia, including the EKS.

*10.4 The main decisions are taken after consulting all stakeholders.*

Almost all participants in the EKS are the members of the ACBL. Thus the Bank of Latvia cooperates with the system participants, with the ACBL providing the communication channel first. Consultations are held with other participants individually or by inviting them to attend the meetings organised by the Bank of Latvia and ACBL.

All changes are implemented in the EKS in cooperation with the participants, and support is provided by the participants in writing prior to the implementation of such changes.

In addition to official consultations, the EKS support desk provides consultations to the participants on the operation-related issues. Where necessary, explanatory information is sent to all participants or meetings are held.

*10.5 The owners reveal the goals and key decisions to the operators, users, overseers and any other stakeholders.*

The development goals of the system, the plans and decisions are discussed with the operators, users and overseers at verbal consultations and mutually documented correspondence.

Since the Bank of Latvia is both the owner of the system and its overseer, the overseers are involved in all the EKS development related projects already from the very beginning. Information is exchanged among the above participating stakeholders via the internal communication channels.

10.6 The governance is effective since the management is motivated to achieve certain objectives for the system, its participants and public at large, and it is appropriately qualified and competent.

The management activities are audited by the Internal Audit Department of the Bank of Latvia on a regular basis. The Internal Audit Department is independent from the Bank of Latvia management and it reports to the Governor and Audit Committee of the Bank of Latvia. Moreover, external auditors (international auditing company) and the State Audit Office of the Republic of Latvia conduct the auditing of the Bank of Latvia annually. The above audit is directed towards the Bank of Latvia financial operations; however, the external auditor and the State Audit Office of the Republic of Latvia are entitled, at their discretion, to conduct the audit of the entire Bank of Latvia operation.

**Conclusion.** The Bank of Latvia ensures transparent, accountable and efficient management of the EKS, thus the EKS observes Core Principle X.

The overseers deem that the EKS observes Core Principles I, II and VII–X. The overseers suggest that the recommendations regarding Core Principle II should be taken into consideration to the extent that the efficiency of the EKS is not affected.

## **APPENDIX 2. THE BANK OF LATVIA REPORT ON THE SELF-ASSESSMENT OF THE JSC ITELLA INFORMATION SYSTEM**

"The Bank of Latvia's Payment and Securities Settlement System Policy" approved by the Bank of Latvia Council Resolution No. 189/6 of 13 January 2011, states that the responsibility for a safe and efficient operation of retail payment systems shall be assumed by operators of payment systems and their participants, and they shall ensure maximum compliance of the system operation with the Core Principles. The above Core Principles shall be applied to the retail payment systems to the extent that the system efficiency is not impaired.

JSC *Itella Information* provides diverse payment related services, including the processing of interbank direct debit payments, ensuring the straight-through processing of invoice data related to the payments executed among customers, companies and credit institutions. Credit institutions execute cash settlement of automatic payments outside the JSC *Itella Information* system in line with the settlement practice established by each credit institution. The JSC *Itella Information* system is used by two groups of participants: credit institutions where the direct debit payments comprise one of the payment services offered to its customers and companies which receive direct debit payments via the JSC *Itella Information* system for the provided services. JSC *Itella Information* is the owner and operator of the JSC *Itella Information* system. The JSC *Itella Information* system is the sole system in Latvia providing the processing of interbank direct debit payments.

Hence the JSC *Itella Information* system is deemed to be a systemically prominent retail payment system. Pursuant to the ECB "Oversight Standards for Euro Retail Payment Systems" of June 2003, the systemically prominent retail payment systems shall be compliant with Core Principles I, II and VII–X.

In the second half of 2010, JSC *Itella Information* performed the self-assessment of the JSC *Itella Information* system against the above six Core Principles, pursuant to the provisions of the ECB document *Terms of Reference for the assessment of euro systemically and prominently important payment systems against the applicable Core Principles for Systemically Important Payment Systems* (hereinafter, the Assessment provisions) of April 2008. The self-assessment refers to the JSC *Itella Information* system only. The overseers applied the following scale for the purpose of assessment: observed, broadly observed, partly observed and not observed. During the self-assessment the employees of JSC *Itella Information* and the Bank of Latvia dealt with all issues related to the Core Principles, and self-assessment of JSC *Itella Information* was completed in spring 2011. In 2011, the overseers assessed the compliance of JSC *Itella Information* system with the Core Principles on the basis of the self-assessment made by JSC *Itella Information*. The Bank of Latvia report is based solely on the replies submitted by JSC *Itella Information*. Reporting on the self-assessment, the Bank of Latvia took into consideration that JSC *Itella Information* is a commercial company which has to comply with corporate regulations, hence JSC *Itella Information* cannot meet some of the provisions of the Core Principles stipulating the publishing of commercially safeguarded information.

Pursuant to the "Bank of Latvia's Payment and Securities Settlement System Policy", the Bank of Latvia provides consultations to operators of retail payment systems on risks associated with payment systems, and the Bank of Latvia may present its opinion on the compliance of a particular payment system with the Core Principles and

recommendations for improving the operation of such payment system. The Bank of Latvia is independent upon performing the oversight function. The present document provides the Bank of Latvia opinion on the self-assessment of the JSC *Itella Information* system.

**Core Principle I. The system should have a well founded legal basis under all relevant jurisdictions.**

The relationship between the participants in the JSC *Itella Information* system and JSC *Itella Information* is established in the signed agreement (hereinafter, the Cooperation Agreement) and Appendices thereto. The Cooperation Agreement is signed with each participant separately. The sample Cooperation Agreement is not publicly available; however, it is made available upon request by a potential participant in the JSC *Itella Information* system. Provisions of "The Civil Law of the Republic of Latvia" and Law "On Payment Services and Electronic Money" regulate the Cooperation Agreement. The JSC *Itella Information* system is not deemed to be a system in the meaning of the Republic of Latvia Law "On Settlement Finality in Payment and Financial Instrument Settlement Systems".

Assessment of the JSC *Itella Information* system: observed.

Opinion of the Bank of Latvia. The Bank of Latvia agrees with the assessment of JSC *Itella Information* and is of the opinion that the JSC *Itella Information* system **observed** the provisions of the present Core Principle. In view of the fact that there are no foreign participants in the JSC *Itella Information* system, the compliance of the JSC *Itella Information* system with the core issue of the Assessment provisions regarding legal provisions for foreign participants is not assessed – *Legal basis should be well founded to provide that the system rules and procedures are legally enforceable and predictable, including specific legal provisions for ensuring the access for the system of foreign participants* (1.3 core issue of the Assessment provisions).

**Core Principle II. The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.**

The content of the Cooperation Agreement is similar for each type of participant in the JSC *Itella Information* system, be it a credit institution or a company, however, the information incorporated into the Appendix to the Cooperation Agreement may differ with respect to each participant in the JSC *Itella Information* system, subject to the agreement reached with each participant. The procedures of the JSC *Itella Information* system referring to the service activities and financial risks and other information describing the operation of the JSC *Itella Information* system have been incorporated into the section of the Cooperation Agreement subject to changes, i.e. Appendix thereto. Hence it is not possible to verify whether all participants in the JSC *Itella Information* system have a common understanding about the operation of the above system and its impact on financial risks incurred by them through participation in the JSC *Itella Information* system. Moreover, the information on the procedures of the JSC *Itella Information* system stipulated in the agreement signed by another participant in the above system which might impact the financial risks of the participants in this system is not available to such participants. Information about the operation of the JSC *Itella Information* system in contingency situations is not incorporated into the Cooperation Agreement. Customer Service Department of JSC *Itella Information* provides

explanation of the system's operation to the participants in the JSC *Itella Information* system and helps in dealing with current issues and solving problems.

Assessment of JSC *Itella Information*: observed.

Opinion of the Bank of Latvia. The Bank of Latvia is of the opinion that the JSC *Itella Information* system **broadly observes** the above Core Principle. The JSC *Itella Information* system does not provide full compliance with one of the core issues of the Assessment provisions – *The documentation of the system management and risk containment is updated, comprehensive and accountable* (2.2 core issue of the Assessment provisions).

Instruction. To facilitate a common and clear understanding of the JSC *Itella Information* system participants about the overall operation of this system and financial risks they may incur due to the procedures applied to other participants of the JSC *Itella Information* system, the Bank of Latvia points out that it is necessary to incorporate the information describing the operation of the JSC *Itella Information* system and affecting all participants, including the procedures related to the service activities and financial risks, into the Cooperation Agreement which is not subject to change, thereby providing that it is similar for all participants in the JSC *Itella Information* system. Moreover, the Bank of Latvia proposes to incorporate into the Cooperation Agreement the information on the JSC *Itella Information* system's operational provisions in contingency situations.

**Core Principle VII. The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.**

The technical and operational procedures of the JSC *Itella Information* system are incorporated into the Cooperation Agreement. The security policy and procedures of the JSC *Itella Information* system have been established in accordance with the standard ISO 27001. Developing the safe communication channels for the purpose of information exchange are discussed with the participants in the above system. The internal security rules are also revised due to the changing technologies of information storage, accessibility or exchange. The Board of JSC *Itella Information* defines the main priorities of the security policy. The JSC *Itella Information* system does not outsource services to third parties. JSC *Itella Information* intends to conduct internal audit of the JSC *Itella Information* system annually. The functional specification of the JSC *Itella Information* system is an internal document. The changes in the above system are tested separately. The JSC *Itella Information* system provides high accessibility. The goals of its business continuity are stated in the plan for the elimination of the incident consequences. JSC *Itella Information* plans to test the plan for the elimination of the incident consequences. The defined goals provide for timely compliance with the obligations stipulated by the Cooperation Agreement. Alternative media channels and operational sites are to be provided for the *Itella Information* system.

Assessment of JSC *Itella Information*: broadly observes.

Opinion of the Bank of Latvia. The Bank of Latvia agrees with the assessment of JSC *Itella Information* and is of the opinion that the JSC *Itella Information* system **broadly observes** the provisions of the present Core Principle. The JSC *Itella Information* system does not provide full compliance with one of the core issues of the Assessment provisions – *The business continuity plan of the system is documented and tested on a regular basis* (7.13 core issue of the Assessment provisions).



Instruction. The Bank of Latvia points out that the tests of the business continuity plan should be conducted in order to ensure contingency arrangements of the JSC *Itella Information* system for timely completion of daily processing in contingency situations.

**Core Principle VIII. The system should provide a means of making payments which is practical for its users and efficient for the economy.**

Effective interbank direct debit payments are provided for the participants and users of the JSC *Itella Information* system. The operation of the JSC *Itella Information* system is improved on a regular basis, reaching the critical minimum of the information processing. Cost-effectiveness of the JSC *Itella Information* services is assessed on a monthly basis. The service fee is applied to the transaction of direct debit payments and based on the costs of JSC *Itella Information*. All changes in the JSC *Itella Information* system are discussed with the participants, albeit the changes put forth by the participants are only debated about with the respective participant in the JSC *Itella Information* system individually. Other participants in the JSC *Itella Information* system are notified of such changes and may choose to implement them or not. The employees of JSC *Itella Information* conduct regular analysis of the efficiency ratios of the JSC *Itella Information* system.

Assessment of JSC *Itella Information*: broadly observes.

Opinion of the Bank of Latvia. The Bank of Latvia agrees with the assessment of JSC *Itella Information* and is of the opinion that the JSC *Itella Information* system **broadly observes** the provisions of the present Core Principle. The JSC *Itella Information* system does not provide full compliance with one of the core issues of the Assessment provisions – The needs of all types of users are taken into consideration upon the designing and development of the system, for instance, by sharing expertise, conducting consultations and coordinating the development plans (8.2 core issue of the Assessment provisions).

Recommendation. To ensure that interests of all participants in the system are taken into consideration during the development of the JSC *Itella Information* system, the Bank of Latvia recommends conducting consultations prior to the planned changes (including the changes put forth by the participants which may affect other participants) with all participants in the JSC *Itella Information* system.

Additional recommendation on Core Principle VIII. The Bank of Latvia points out that the time-frame for the payment execution stipulated in the Law "On Payment Services and Electronic Money" provides for the payment execution until the end of the following business day as of January 2012. Thus the time-frame for executing the transactions of direct debit payments in the JSC *Itella Information* system should be revised by the end of 2011, to enable its participants to comply with the new requirements of the Law "On Payment Services and Electronic Money" at the beginning of 2012.

**Core Principle IX. The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.**

Credit institutions and companies registered in the Republic of Latvia may join the JSC *Itella Information* system, if they provide the service of automated invoicing to their customers and have opened an account with a credit institution in Latvia. JSC *Itella Information* points out that uniform criteria for joining the system or terminating the

participation are applied to each group of participants in the JSC *Itella Information* system; however they are not publicly disclosed and provisions for such joining, including the service fee, are discussed individually with each potential participant in the JSC *Itella Information* system.

Assessment of JSC *Itella Information*: broadly observes.

Opinion of the Bank of Latvia. The Bank of Latvia agrees with the assessment of JSC *Itella Information* and is of the opinion that the JSC *Itella Information* system **broadly observes** the present Core Principle. The JSC *Itella Information* system does not provide full compliance with one of the core issues of the Assessment provisions – *The criteria for joining and terminating the participation in the system are objective and based on the relevant risk and efficiency assessment, and they do not impair competition among participants* (9.3 core issue of the Assessment provisions).

Instruction. The Bank of Latvia points out that the participation criteria should be incorporated into the Cooperation Agreement and made available to the potential participants of JSC *Itella Information* to enable fair and open access to the system. The geographical restriction stating that only credit institutions and companies registered in the Republic of Latvia may join the JSC *Itella Information* system, should be eliminated in the context of the EU single market as well.

**Core Principle X. The system's governance arrangements should be effective, accountable and transparent.**

JSC *Itella Information* is the owner and operator of the JSC *Itella Information* system and system's governance arrangements are explicitly defined. Information on the above is available subject to the Cooperation Agreement and is monitored by the Board of JSC *Itella Information*. The decision-making process related to the JSC *Itella Information* system is a set of internal procedures, with seldom involvement of the JSC *Itella Information* system's staff. Reports on the operation of the JSC *Itella Information* system and the required upgrading are submitted to the Board of JSC *Itella Information*. The management control is stipulated by the regulations and procedures of corporate governance. The JSC *Itella Information* system was launched in line with the elaborated business plan; however, the strategic plans are not provided in writing.

Assessment of JSC *Itella Information*: broadly observes.

Opinion of the Bank of Latvia. The Bank of Latvia agrees with the assessment of JSC *Itella Information* and is of the opinion that the JSC *Itella Information* system **broadly observes** the provisions of the present Core Principle. The JSC *Itella Information* system does not provide full compliance with one of the core issues of the Assessment provisions – *The owners of the system provide communication of information on the key objectives and decisions to the operators, users, overseers and other stakeholders* (10.5 core issue of the Assessment provisions).

Recommendation. To enhance the governance arrangements of the JSC *Itella Information* system, the Bank of Latvia proposes that upon developing the strategic plans of the JSC *Itella Information* system the above plans should be presented in writing and participants in the JSC *Itella Information* system should be notified of the major development issues regarding the above system to the extent that it does not affect the commercially safeguarded information.

**Conclusions.** The Bank of Latvia deems that the JSC *Itella Information* system **observes** Core Principle I and considers that it **broadly observes** Core Principles II and VII–X. The Bank of Latvia points out that it is necessary to enhance compliance with Core Principles II, VII and IX in order to ensure compliance of the system with the Core Principles. The Bank of Latvia also suggests that the recommendations regarding Core Principles VIII and X should be taken into account to the extent that the efficiency of the JSC *Itella Information* system is not affected.

### APPENDIX 3. THE SEPA PROJECT ASSIGNMENTS ACCOMPLISHED BY THE OVERSEERS

The Bank of Latvia's overseers continued to steer the NSWG in 2011, coordinating the cooperation among the representatives of the payment market supply side (ACBL, SJSC *Latvijas Pasts*, FDL, JSC *Itella Information*, Latvian Information and Communications Technology Association) and representatives of the demand side (the Consumer Rights Protection Centre, MVKAKP, LDDK, Treasury, Ministry of Finance of the Republic of Latvia and Bank of Latvia). The representatives of the respective institutions and associations coordinated, within the scope of their competence, the current assignments for the integration into SEPA. The MPSWG performed the supervision of the NSWG.

The overseers monitored the drafting of Version 3.0 of Latvia's National SEPA Plan. Version 2.0 of Latvia's National SEPA Plan was amended by incorporating the information on:

extension of the deadline for launching the SEPA direct debit payment infrastructure (SEPA direct debit system of JSC *Itella Information*) until 1 January 2013;

the decision on maintaining the SEPA creditor identifier in the databases of the Enterprise Register of the Republic of Latvia as of the euro changeover day;

the plan of the ACBL to resume the discussion on developing a version of *FiDAViSta* (common standard for financial data exchange) after the draft Regulation COM (2010) 775 of the European Parliament and of the Council of 16 December 2010 establishing technical requirements for credit transfers and direct debits in euro and amending Regulation (EC) No 924/2009 (Regulation on SEPA Migration End-date) has been adopted and to approve a national standard compliant with the UNIFI (20022) XML standard for the customer-to-bank domain in the first half of 2013, and to extend the deadline for accomplishing the introduction of the bank-to-bank domain of the SEPA credit transfers until the end of 2011;

the progress made in implementing the security standard for the points of sale in the second domain of SEPA Card Framework, inter alia the recommendations to all SEPA card framework stakeholders approved by the Sub-group of SEPA Card Framework, as well as the support of the Sub-group of SEPA Card Framework to the initiative to introduce a European card, and changes in the domestic interbank card payment processing in Latvia based on bilateral interbank arrangements;

the accomplished task of supplementing websites of Latvian credit institutions with SEPA information and the information on SEPA issues included in the workshops for credit institution employees. On 16 September, the SEPA Working Group of the ACBL reviewed Version 3.0 of Latvia's National SEPA Plan and NSWG approved the above on 22 November.

Proposals for high level SEPA implementation measures for amending Appendix 1 "Action Plan for Introduction of the Single European Currency in Latvia" to Latvia's National Euro Changeover Plan have also been revised in line with the above changes in the time frame and submitted to the MPSWG along with Version 3.0 of Latvia's National SEPA Plan on 6 December 2011. In 2011, the overseers drafted Progress Report No. 6 and Progress Report No. 7 of NSWG for submission to the MPSWG.

The overseers coordinated the process of summing up the opinions of stakeholders of the NSWG engaged in SEPA draft Regulation and submission of the above to the Ministry of Finance of the Republic of Latvia and PSPWG:

on 7 January, the overseers in cooperation with experts from the SEPA Working Group of the ACBL, reviewed the SEPA draft Regulation, ascertaining that the Latvian credit institutions would be able to comply with the requirements of the SEPA Regulation, given the expected dates of such SEPA requirements. The potential solutions for the standards of customer-to-bank domain and procedure for further cooperation with LDDK were also debated about at the SEPA Working Group of ACBL;

a statement of the ACBL that credit institutions identified no constraint to the transposition of the Regulation in Latvia was presented in the opinion of the NSWG about the SEPA draft Regulation expressed during the written consultation held from 4 February until 11 February, as well as the impact on budget items was complemented by the tasks of adjusting the information system to enable the processing on-us payments of the Treasury of the Republic of Latvia in line with the SEPA requirements and the modifications to be made to the respective internal systems of the government budget institutions and local government institutions, including the SRS and SSIA, in accordance with the SEPA requirements. It was also indicated that the functions of the Consumer Rights Protection Centre (one of the competent authorities of the Regulation) would increase;

in the written consultation on the potential niche payments in Latvia held from 17 February until 23 February, the representatives of the NSWG approved that there were no niche payments in Latvia;

in the written consultation held from 23 September until 27 September on the issues dealt with at the three-party negotiations (the EC, the European Parliament and Council), the following were discussed: setting the fee for the relayed links and a single end date for both payment instruments – SEPA credit transfers and SEPA direct debit payments. The overseers took part in an ad hoc meeting of the SEPA Working Group of the ACBL, reviewing the outcome of the three-party negotiations and defining objections with respect to the requirements of the communication campaign and development of BIC database. In addition, the overseers pointed to the fact that migration dates are not set for the payment systems of non-euro area Member States; in the recurrent written consultations on further activities regarding the three-party negotiations and taking into consideration the gradual revisions to the SEPA Regulation, the NSWG raised objection to the development of BIC database and also pointed to the potential risks to the users of IBAN-only requirements, i.e. where the customer only specifies IBAN (without BIC), the risk of erroneously executed payments aggravates. Recurrent consultations were held during October and November.

To monitor the implementation progress of SEPA payments in the payment system of Latvia, the overseers proceeded with the compilation of SEPA credit transfer indicators, SEPA direct debit indicators and SEPA indicators of SEPA Card Framework.

In the second half of 2011, 1 937.8 thousand or 95.0% of credit transfers made in euro were SEPA credit transfers, i.e. those compliant with the SEPA requirements in the bank-to-bank domain. Credit transfers made to third countries and urgent credit transfers in euro executed via large-value payment systems are excluded from SEPA credit transfers.

In the second half of 2011, only one Latvian credit institution executed SEPA direct debit payments. Internal payments of a credit institution were assessed to be the SEPA direct debit payments – 32 payments in the total amount of 6.0 thousand lats. Interbank direct debit payments were processed via the JSC *Itella Information* system which was not SEPA-compliant yet and hence the payments processed therein could not be assessed as compliant with the SEPA requirements.

The four main indicators of SEPA Card Framework were as follows in Latvia at the end of 2011: 1) 1 207 ATMs of Latvian banks (100%) had migrated to Europay-Mastercard-Visa (EMV) and were compliant with the SEPA requirements; 2) 24.5 thousand POS terminals (99.3%) had migrated to EMV; 3) 1 826.4 thousand debit cards (99.2%) were compliant with the EMV Standard and SEPA requirements; and 4) 329.7 thousand credit cards (99.3%) were compliant with the EMV Standard and SEPA requirements. At the end of 2011, migration to the EMV Standard cards was not completed due to the fact that some Latvian credit institutions issued cards without EMV microchip in 2011.

In 2011, 60.4% of all euro and lats payments with cards were based on the EMV Standard. At the end of 2011, 97.8% of Latvian e-merchants (553) used 3D Secure technologies in e-commerce environment and 50.5% of all cards were registered for 3D Secure technology. In the second half of 2011, 42.2% of e-commerce transactions executed in the country were consistent with the requirements of *3D Secure* technologies.

In 2011, the overseers were engaged in the following key activities of SEPA Project.

The overseers coordinated the participation of Latvian companies in the survey on SEPA payments conducted by the European Business Test Panel from 17 January until 14 February. MVKAKP, LDDK and LIKTA were involved in providing further suggestions and information in the survey. Overall, 358 companies took part in the above survey, including eight from Latvia. The main results showed the market's "wait and see" approach consistent with the issue of SEPA Regulation currently debated about.

On 18 January and 3 February, the overseers held meetings with Euro Project Manager and other experts from the Ministry of Finance of the Republic of Latvia and shared their expertise in coordinating the SEPA Project and the related task of the Ministry of Finance of the Republic of Latvia in the area of e-invoicing service. Aigars Jaundālders, a former member of the NSWG and member of the EC Expert Group on e-invoicing, was present at the meeting held on 3 February, where he expressed opinion on the potential scope of the Latvian Working Group on e-invoicing.

To ensure the security of retail payments, the ECB established the European Forum on the Security of Retail Payments (the European Forum) at the end of 2010 and beginning of 2011. The European Banking Authority, the national central banks and supervisory institutions of the EU Member States as well as the representatives of the EC and Europol would participate in the above Forum. The representatives of the payment sector were to engage in discussing the recommendations presented by the European Forum. On 3 February 2011, the overseers held a meeting of the NSWG to state the priorities of the retail payment security in Latvia and notify the European Forum thereof. Experts from the Financial and Capital Market Commission (FCMC) participated in the ad hoc meeting of the NSWG, since one of the aims of the European Forum was to promote cooperation among the overseers of payment systems and supervisors of

payment service providers in the field of payment security. The NSWG established the following priorities in line with the issues raised at the European Forum: 1) card payments: card payments: companies deemed it necessary to address the security issues related to the card payments executed via Internet; banks in turn expressed concern as to whether a need to set an end-date only for the implementation of smart cards was commercially reasonable in Europe; 2) remote payments: experts of the FCMC pointed out that e-commerce was developing in close cooperation with credit institutions in Latvia. "Regulations on Information Systems Security of the Financial and Capital Market Participants" also incorporating a two-factor authenticity of the submission of payment orders in the customer-to-bank domain and, to a large extent, complying with the international data security standards, are binding on credit institutions. The opinion of the FCMC on e-banking stipulates a prohibition or tight regulation and supervision of the payment intermediation services in a customer-to-internet banking domain in order to ensure that the means of customer authentication are unavailable to other persons. On 14 February 2011, the European Forum was notified on the opinion expressed by the NSWG. The European Forum convened its first meeting on 22 February and second – on 20 June. The generalised priorities of the Member States were debated about at the meeting of the Forum and a decision was taken to proceed with two priorities regarding the work of the European Forum commenced in 2011: e-banking and drafting security recommendations for card payments via Internet. It was decided to establish Sub-groups for dealing with both issues. The NSWG held a meeting on 27 June and debated about Latvia's replies regarding the survey on the execution of card payments via Internet. The overseers sent the opinion of the NSWG to the European Forum on 30 June. On 5 August, the overseers in cooperation with the Payment Cards Committee of the ACBL provided the adjusted data. At the third meeting of the European Forum on 29 September, the members of the Sub-groups presented information about the market exploration activities and drafted the general plans for the recommendations. The draft recommendations were debated about at the Fourth European Forum on 1 December. At the European Forum, the overseers commented on the recommendations regarding the problem issues dealt with previously in Latvia, including the potential new task of overseeing the payment technologies allocated to the overseers, the mandatory nature of tight authentication, the principle of *comply and explain*. On 29 November prior to the meeting of the European Forum, the overseers held a meeting with experts from the Payment Cards Committee of the ACBL and consulted with experts from the IT Department of the FCMC. To draft the final opinion of Latvia on the developed draft recommendations, the overseers held ad hoc meetings – with experts from the IT Department of the FCMC on 13 December and with experts from the Information Systems Department of the Bank of Latvia on 20 December. Latvia's opinion was drafted by experts from the IT Department of the FCMC, and overseers forwarded the above opinion to the European Forum.

On 28 February, the overseers in cooperation with the Accounting Department of the Bank of Latvia finalised the Bank of Latvia's self-assessment in line with the SEPA requirements for banks in the capacity of the service providers and payment service users.

From 4 March until 8 April, the overseers in cooperation with experts from the International Relations and Communication Department of the Bank of Latvia, coordinated the work of the SEPA communication experts and agreed on the SEPA communication activities for future periods. However, MVKAKP declined the potential incorporation of two issues regarding the SEPA small and medium-sized enterprises into the general survey conducted by the Ministry of Economics of the Republic of Latvia.

On 3 May, the overseers coordinated the drafting of SEPA communication report and submission of the above to the NSWG. The overseers organised the translation of two EPC brochures in Latvian: for IT service providers and for consumers. On 20 May, the overseers in cooperation with experts from the Account Service and maintenance Division of the Payment Systems Department of the Bank of Latvia, the International Relations and Communication Department of the Bank of Latvia, Treasury and Ministry of Finance of the Republic of Latvia organised a workshop at the Bank of Latvia, with SSIA also taking part therein.

From 21 until 29 March, the overseers coordinated the consultation of LDDK and ACBL on the customer-to-bank domain within the NSWG. LDDK provided commentaries and proposals to restore *FiDAViSta* with the codes specifying transaction types, applying ISO 20022 standard. However, LDDK declined the above option of restoring *FiDAViSta* until the adoption of the SEPA Regulation.

From 7 April until 12 April, the overseers coordinated the ECB survey on implementation of the ECB recommendation on the issuance of all cards as smart cards only (without magnetic stripe) as of 2012. The Payment Cards Committee of the ACBL declined such option in its reply mainly because of a contradiction with the effective requirements of VISA and *MasterCard*. Other banks of the EU Member States, excluding the banks of Luxembourg expressed similar opinion. The ECB supplemented the above recommendation with a requirement that banks provide the blocking of magnetic stripe for transactions outside the EU. The Payment Cards Committee of the ACBL commented that the above requirement was disproportionate for small banks. On 10 November, the overseers presented their opinion at the PSPWG and also sent it to COGEPS during the written consultation in November.

The overseers organised the drafting of the Bank of Latvia opinion on the SEPA creditor identifier as well as summed up the replies submitted by JSC *Itella Information*, LCD, ACBL and Enterprise Register of the Republic of Latvia to MPSWG. On 12 April, the overseers in cooperation with experts from the SEPA Working Group of the ACBL also put this item on the agenda. On 13 April, the overseers presented the above issue to the Board of the Bank of Latvia. On 18 April, the overseers debated about this issue with Euro Project Manager. On 9 May, MPSWG decided that SEPA creditor identifier would be maintained in the databases of the Enterprise Register of the Republic of Latvia as of the euro changeover day.

On 12 May, 17 August and 26 October, the overseers convened the meetings of the Sub-group of SEPA Card Framework of the NSWG. The Sub-group of SEPA Card Framework continued its work commenced in the previous period (development of liability shift procedures in case of fraudulent transactions, the second domain of SEPA Card Framework requirements for merchants, etc.) as well as approved several recommendations for card framework stakeholders:

on 12 May invited consumers to apply for the service "Secure payments on the internet" offered by Latvian banks free of charge;

on 19 September invited merchants to read the information on "Safe e-shop certificate" awarded by the Latvian Merchant Association.

On 18 May and 9 November, the EC organised the Sixth and Seventh Forum of SEPA National Working Groups, where the overseer, expert from the Bank of Latvia, also represented Latvia. The migration process of SEPA core products in each Member State



and SEPA management issue were dealt with at the Forum. The representative of Latvia, along with the representatives of other countries, presented the relevant progress reports on the SEPA Project in Latvia.

From 3 June until 9 June, the overseers participated in the PSPWG work stream on interoperability of infrastructures, engaging in drafting the working papers.

From 29 June until 10 August, the overseers prepared a reply of the NSWG regarding the EPC consultation on amendments made to the EPC Scheme Rulebooks, as well as participated in the meeting of the SEPA Working Group convened by the ACBL on 28 June 2011, at which the EPC proposals were addressed. The overseers published information on the changes of the EPC Rulebooks on the SEPA Latvia website.

On 28 July, the overseers organised the complementing of the national SEPA Latvia website with the SEPA barometer. The SEPA barometer discloses information on the survey of households "The Monetary and Banking System in Latvia" conducted by SIA *Factum* in May 2011 in order to ascertain the credit institution customers' awareness of SEPA. 37% of respondents were aware of the new euro payment instruments of SEPA. It is also positive news that in comparison with 2010 the share of well-informed persons has increased twice (from 1.7% to 3.4%);

On 17 October, cooperating with the NSWG, the overseers commented on the potential issues on the agenda of e-SEPA workshop held by the SEPA Council, recognising the positive aspect of the workshop – the section focussing only on public authorities which are interested in secure, immediate and guaranteed cashless payments.

The overseers ensured that the topical information on the SEPA Project was available on SEPA Latvia website throughout the year.

#### **APPENDIX 4. THE ASSIGNMENTS OF "TARGET2-SECURITIES" PROJECT ACCOMPLISHED BY THE OVERSEERS**

To promote integration of Latvia's securities settlement systems into the harmonised process of securities settlement of the EU Member States in euro, the Bank of Latvia engaged in T2S Project. The settlement of securities transactions will be harmonised and cross-border settlement costs incurred by the securities market participants will be reduced as a result of implementing the above Project. The Bank of Latvia oversees continued to steer the Latvian T2S User Group by coordinating the cooperation among the representatives of the LCD, Bank of Latvia, FCMC, Treasury and ACBL. The representatives of the respective institutions, within the scope of their competence, coordinated the assignments regarding the implementation of T2S Project. The overseers proceeded with the work in the T2S Concept Development Working Group (the Bank of Latvia T2S Working Group) established pursuant to the order issued by the Board of the Bank of Latvia on 12 August 2010 "On the Bank of Latvia's Project TARGET2-Securities". The Bank of Latvia T2S Working Group was assigned the task of developing the T2S Project Concept, incorporating the assessment of the impact of T2S on the Bank of Latvia functions and processes.

In 2011, the overseers were engaged in the following key activities of T2S Project.

On 18 January, the overseers held a meeting with the representatives of LCD and FCMC and debated about the necessity to remove the limitation of the legal acts effective in Latvia – for the LCD to outsource the securities settlement to the Eurosystem. The above is one of the provisions of the T2S Framework Agreement which the CSD is to sign upon joining T2S system. The overseers also consulted with the ECB regarding the above issue.

On 14 February, the overseers took part in the joint meeting of the Nordic-Baltic T2S National User Groups addressing diverse crucial problems encountered by each country during the preparation for migration to T2S. The overseers debated about the issue of limitation of the legal acts, topical for Latvia, and received information that T2S Framework Agreement will be supplemented with a reference stipulating that the Agreement takes effect subject to the receipt of permission from the Regulator. It means that the termination of the Agreement is provided for, where the Regulator prohibits the CSD from commencing the settlement in T2S.

On 28 February, Bank of Latvia T2S Working Group completed the assessment of the impact of T2S on the Bank of Latvia functions and processes. The LCD incorporated the Section provided by the Bank of Latvia into the *Assessment of TARGET2-SECURITIES impact on Latvian market community* (Latvia's Assessment of T2S), sent to the ECB on 29 March.

On 1 March, the overseers participated in the meeting of the NUG secretaries convened by the ECB where the representatives of the ECB outlined the overall development of T2S Project and pointed out that all stakeholders should perform internal planning of T2S budget in 2011.

On 18 March, the topical issues of T2S Project received from the T2S Working Groups were dealt with at the meeting of the Latvian T2S User Group, Latvia's Assessment of T2S was approved and a decision taken to resume the work of Market Implementation Group (MIG) coordinated by JSC Swedbank. MIG shall ensure the compliance with the above standards since their implementation is an essential prerequisite for T2S operation

and these standards have to be introduced until the testing of T2S is commenced. The participants of the meeting made presentations about the functionality of T2S.

On 10 June, the following issues were addressed at the meeting of the Bank of Latvia T2S Working Group: the uncertain position of the participants of Latvia's securities market regarding the participation in T2S and identified potential amount of funds to be allocated by the Bank of Latvia for financing T2S investments upon joining the euro area, pursuant to the decision of the Governing Council of the ECB, that would affect further implementation of the Bank of Latvia T2S Project, and other topical issues among them. A decision was taken at the meeting to submit an interim report to the Board of the Bank of Latvia, providing information about the progress of the project.

On 16 June, the T2S Framework Agreement regarding the CSD, the plan for the approval of its final version and time frame for signing the Agreement by the central banks planning to participate in T2S with the settlement in the national currency were debated about at the meeting convened by experts from T2S National User Group. The above participants were presented the structure and process of drafting the *Business Process Description* (BPD) of T2S. The BPD shall serve as a basis for assessing the required changes in the processes and information systems of the Bank of Latvia.

On 17 June, the Payment Systems Department of the Bank of Latvia participated in the meeting convened by the Eurosystem and national central banks of TARGET2 for the purpose of briefing them on the tasks and functions related to a successful migration of the securities markets to T2S. *Currency Participation Agreement Schedule 2 T2S Programme Planning and Monitoring* shall serve as a basis for developing the Bank of Latvia T2S Project plan.

In accordance with the recommendation issued by the ECB on 13 May, the overseers sent to the ECB the supplemented assessment of the impact of T2S on the Bank of Latvia functions and processes on 29 July, as well as they sent a letter to the LCD regarding the development scenarios in case the LCD postpones the migration to T2S.

In September, the LCD approved the supplemented *Assessment of TARGET2-SECURITIES impact on Latvian market community* and sent it to the ECB for review.

At the meeting convened on 12 September, the overseers debated with the LCD about the development model of the LCD operation in T2S. The LCD briefed on the meeting of the CSDs of the Baltic States scheduled on 22 September regarding the plans of migration to T2S.

At the meeting of the Latvian T2S User Group convened on 26 October, the LCD furnished up-to-date information about T2S Project, including the postponement of commencing the T2S operation until June 2015, additional costs incurred by the CSDs migrating in 2019 or later and other information. The LCD presented the proposed models of its operation in T2S providing for closer integration of the CSDs of the Baltic States as well as notified of the common decision-reaching process regarding the decision of the CSDs of the Baltic States on the participation in T2S. The LCD presented the model of processing securities events on T2S platform. The Market Operations Department of the Bank of Latvia presented the settlement model of monetary policy operations in T2S environment.

On 17 November, the overseers took part in the meeting of the NUG secretaries convened by the ECB. The representatives of the ECB briefed on the overall

development of T2S Project, including the decisions of the Governing Council of the ECB, issues of reconciling securities, recent documentation of T2S and solutions of T2S interoperability. The overseers provided information on the work of the Latvian T2S User Group, the latest meeting where the topical issues of T2S Project were raised, and the issues of T2S Framework Agreement. The overseers furnished information about the meeting of the CSDs of the Baltic States, the presentation of the models of the LCD operation in T2S as proposed by the LCD, which would form the basis of the decision taken by the participants of the LCD on the migration to T2S, and the fact that the decision of the LCD would depend on the decisions taken both by its customers and credit institutions and shareholders of *NASDAQ OMX* since the securities infrastructures of the Baltic States are closely related. The next task of the Latvian T2S User Group is the *T2S Feasibility Assessment* to be completed by 29 June 2012. The above assessment incorporates legal, functional, technical, and organisational and market readiness. A high-level adaptation plan for T2S has to be elaborated and potential barriers to the process of migration to T2S have to be identified.