# The Treasury of the Republic of Latvia

## Public Report for 2004

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# Minister of Finance introductory statement

The year 2004 was marked for the Latvian state and economy by the Euro-integration process. In a way, it was a test of our financial system as well, and I believe the test has been passed with excellence. Latvia's accession to the European Union has facilitated dynamic changes in each of the institutions under the Ministry of Finance subordination, and the Treasury has coped especially successfully, as the team of professionals employed by it has made the Treasury one of the most progressive public institutions in Latvia.

An important accomplishment of the Treasury achieved in 2004 is the introduction of new software for aggregating the local government reports, based on the latest I.T. technologies and using Internet in an on-line mode. This speeds up information flows achieving less bureaucracy, much more effective use of human as well as material resources. In 2005, the Treasury will have to continue working in this direction and I, as the Minister of Finance, believe that this is a very important priority.

An absolute novelty in the Treasury's work was the start of implementation of the Paying Authority functions for the European Union Structural Funds, Cohesion Fund and the Community initiative EQUAL following Latvia's accession to the European Union on May 1, 2004. This means that the Treasury had to certify the incurred expenditure, submits payment claims as well as receives payments from the European Commission. The capacity displayed by the Treasury in implementing this task in 2004 supports its ambitious goal to become the best and most progressive Treasury among the new Member States of the European Union.

July 1, 2005

**Oskars Spurdziņš**
Minister of Finance

# The Treasurer's Statement

The year 2004 in Latvia was marked by a rapid rise in economic activity, promoted by Latvia's integration in the European Union. The Treasury, the same as many other public administration institutions in Latvia, accomplishes new tasks as a result of the European Union accession as well as faces many new opportunities.

The Treasury is one of the first public administration institutions established during the first independent Republic of Latvia, and it celebrated its 85th anniversary in 2004. In the course of time, the Treasury's functions have been implemented by the Central Bank, commercial banks as well as the Treasury Department of the Ministry of Finance. In 1997, the Treasury renewed its operation as an independent public administration institution.

Latvian Treasury system is quite unique among the European Union Member States, as it incorporates a broad range of operational functions, including servicing of the central government budget, central government debt management, implementation of the functions of the Paying Authority for the European Union funds and management of the state funded pension scheme assets. Concentration of all the above functions has enabled the Treasury to attract knowledgeable and qualified specialists as well as create universal and effective payment and reporting systems.

The beginning of 2004 was a continuation of previously started activities and operations, yet in a different quality, i.e. setting as a basic future goal the achievement of a status of the best and most progressive Treasury among the new European Union Member States. On the road to the attainment of this ambitious goal, significant steps have been made: operational strategy of the Treasury for 2005–2008 has been approved, use of new financial instruments in debt management has started as well as implementation of new information technologies and successful operation of the Paying Authority for the European Union funds.

In order to achieve implementation of the strategic priority – orientation towards the clients, their needs and interests, the Treasury completed a client survey in 2004 to identify the level of client satisfaction with the services provided by the Treasury in the area of central government budget execution as well as the required future improvements. For the convenience of our clients, a project was implemented and, after receiving a favourable conclusion from a system environment security check conducted by an international audit company, the State Budget Information System's sub-system *eKase* was put into full operation, in order to provide Treasury services on the Internet. With *eKase* the Treasury ensures remote access to services for institutions financed from the budget and local governments, at the same time guaranteeing the required information security and confidentiality.

In 2004, the Treasury introduced new software for aggregating the annual and monthly reports of local governments, which is based on the latest technology achievements and uses the Internet in an on-line mode. This software ensures data accessibility not only to the staff of local governments and the Treasury, but also to the State Audit Office, Ministry of Finance and the Bank of Latvia and Intermediate Bodies for the European Union structural funds, thus providing an opportunity to reduce the paper document flows and speeding up information flows.

The State Audit Office, in cooperation with copyright protection organisation *Business Software Alliance* conducted a software compliance inspection in the Treasury and discovered that the Treasury's information and data processing systems software and related licence accounting data ensure a fair representation of the actual position and are compliant with the effective legislation of the Republic of Latvia. The legality of the software (licences) used by the Treasury was ascertained.

In order to improve the central government debt management, the financial resources required for financing of the central government budget deficit and refinancing of the central government debt commitments were ensured at the lowest possible costs and most advantageous terms, hedging the financial risks.

In 2004, the most significant achievement in the field of central government debt management was the successful issue of 10 year government bonds on the domestic and foreign market at the historically lowest primary placement rates. After the issue of bonds, the financial derivatives were used in central government debt management for the first time. In 2004, Latvia's general government debt was the third lowest among the European Union countries (14.4% of gross domestic product). The central government debt amounted to only 13.5% of GDP or 974.95 million lats.

The low level of the central government debt in 2004 was one of the factors securing the upgrade of Latvia's credit ratings. For example, the international rating agencies *Standard&Poor's* and *Fitch Ratings* upgraded Latvia's long-term foreign currency credit rating from BBB+ to A-, whereas the rating agency *Moody`s Investors Service* preserved the credit rating at the previous level or A2, which is, nevertheless, one notch higher than the one rated by *Standard&Poor's* and *Fitch Ratings* after the upgrade. In addition to that, *Fitch Ratings* upgraded also Latvia's short-term foreign currency credit rating up from F3 to F2 and the country ceiling from A to A+ in 2004.

From May 2004, the Treasury started implementing also the functions of the Paying Authority for the European Union structural funds, Cohesion Fund and Community initiative EQUAL. The main tasks of the Paying Authority are certification of incurred expenditure, submission of payment claims and receiving payments from the European Commission. In order to successfully implement the above functions, the internal procedures of the Treasury have been developed, prescribing all steps as well as the duties and responsibilities of staff. In order to establish the mutual duties, rights and responsibilities, agreements have been signed between the Treasury as the Paying Authority and the institutions involved in implementation of the European Union policy instruments.

The Treasury continued the management of the state funded pension scheme assets (second tier pensions) in accordance with the "State Funded Pensions Law" which assigns this function to the Treasury as the government agent. Taking into account that private asset managers have been engaged in management of the second tier state funded pensions for already two years, the Treasury's investment plan still occupies a stable niche and is one of the biggest state funded pension scheme assets manager, constituting 31.13% of the second tier assets, the annual yield being 5.36%.

In 2004, one of the biggest challenges for the Treasury was starting the work on implementation of a Quality management system compliant with the requirements of the international standard ISO:9001:2000.

Implementing the State programme for prevention and combating of corruption 2004–2008, the Treasury has successfully developed and implements an anti-corruption measures plan, with the view of identifying the potential corruption risks, evaluating them and introducing risk mitigation measures.

In order to ensure quality and safe central government budget execution and financial management process, improving the scope and quality of provided services by applying modern technologies, the need to review the current work organisation in the Treasury Units and required changes was identified in 2004. At the end of 2004, a working group set up for this purpose prepared a concept for review and optimisation of the functions of the regional Treasury Units and resources required for their implementation, which will be gradually introduced in the course of several years, concurrently with implementation of the new information technology projects.

The Treasury has ambitious plans for 2005: reorganisation of the government securities auction procedure, organising auctions at Riga Stock Exchange, continuation of effective debt management by refinancing disadvantageous loans as well as applying new financial instruments. For the convenience of our clients, *eKase* and other information systems will be further developed.

In the next years, the Treasury will continue to be client-oriented, aiming at maximum effect in using information technologies in servicing clients and central government debt management, and targeting at development of the fiscal policy, based on stability and attainment of the objectives established in the operational strategy.

July 1, 2005

**Irēna Krūmane**
the Treasurer

# Operational strategy 2005–2008 of the Treasury

Operational strategy 2005–2008 of the Treasury developed in 2004 serves as a basis for the Treasury's modernisation, preserving the current standards and operational efficiency and adjusting the Treasury's operation to the challenges of the new century.

The goal of the Treasury is to develop as a dynamic and modern organisation, competitive in the area of provided services, effectively and safely managing the finances entrusted to the Treasury's management in compliance with the interests of the state and its population.

The main priorities of the Treasury's operational strategy are:

1) orientation towards the client, client needs and interests;
2) maximally effective application of information technologies in client servicing and government debt management.

The strategy sets the main principles to be complied with in the Treasury's operation and development, when taking decisions in implementation of routine and long-term tasks, at the same time promoting the involvement of all Treasury staff in attainment of the established objectives. The Strategy establishes five priority areas for the Treasury's operations, and this report reflects the Treasury's performance in all those in 2004:

1) **central government budget execution**, aimed at economic management of the financial resources of the central government budget, identification of services required by the Treasury's clients, improvement of the quality of provided services in line with the best international financial management practice and applying modern technologies;
2) **central government debt and asset management**, ensuring the financing required for the purpose of financing the central government budget deficit and refinancing of the central government debt at the lowest possible costs, hedging the financial risks and taking into account the development of the Latvia's capital market and financial system;
3) **implementation of the Paying Authority functions for the European Union (hereinafter – EU) policy instruments**, to ensure compliance with the financial management requirements prescribed by the EU, applying them also to the financial management of the national financing, in order to ensure uniform financial management standards for all finances assigned to the Treasury's management;
4) **management of the state funded pension scheme assets**, to ensure maximum safety of invested funds assigned to management and at the same time attain as high as possible income level;
5) **corporate governance of the Treasury as a public administration institution** - in attainment of the strategic objectives, the Treasury complies with uniform institutional operation principles in quality management, personnel management, risk management, application of information technologies and information security.

# Legal status and structure of the Treasury

The Treasury is a direct administration institution subordinated to the Ministry of Finance, whose operational purpose is effective implementation of public administration functions in the area of public finance management in compliance with the requirements established by legislative acts, implementing organisation of central government budget execution, central government debt management functions and functions of the Paying Authority for the EU policy instruments and management of the state funded pension scheme assets.
The Treasurer manages the Treasury operations. The Treasurer is appointed and dismissed from the office by the Minister of Finance.

The Treasury has the following functions:

1) organising execution and financial accounting of the central government budget;
2) making payments and allocations from the central government budget revenue;
3) central government debt management;
4) management of the assets of the state funded pension scheme;
5) functions of the Paying Authority for the EU policy instruments established in legislative acts and the National Fund functions delegated by the National Authorising Officer;
6) other functions prescribed in legislative acts.

The legal status, functions, tasks, competence, rights and procedure for ensuring legality are determined in accordance with the Public Administration Law and Cabinet of Ministers regulations No. 677 “Regulation of the Treasury” issued on August 3, 2004.

The first Rules of Procedure of the Treasury were issued on December 3, 2004 pursuant to the Public Administration Law, prescribing the structure, work organisation of the Treasury, functions and tasks to be implemented by the Treasury.

## The Treasury's structure (31.12.2004)

With the expansion of the Treasury's functions and, consequently, operational capacity, new structural units were created in the Treasury:

**Risk Management Department –** to ensure implementation of the tasks established in the operational strategy in the area of risk management, taking over the functions of Information Security Service and, in addition to that, ensuring the management of strategic, operative, legal, human resources as well as business environment risks. The main task of the Department is to ensure timely identification, analysis of the Treasury's risks and establishing the required measures, in order to reduce the potential losses to an acceptable level and ensure maximum use of potential opportunities.

**International Cooperation Department –** established in connection with the EU accession and expansion of the range of related issues. Definition of new functions and tasks was promoted by the Treasury engaging in review and preparation of the draft national positions of Latvia, authority granted to the Treasurer to represent Latvia on the Board of Directors of the European Investment Bank as well as Latvia joining the Nordic Investment Bank. In addition, a need to review the functions of the Financial Resources Department was identified, splitting off organisation of international rating agency visits to Latvia and administration of the Republic of Latvia capital shares in international organisations to identify one structural unit to be in charge of cooperation with international institutions.

With a view of improving effectiveness of a uniform decision-making process, in accordance with the objectives set in the operational strategy, the following committees have been launched in 2004:

**Audit Reports Review Committee –** to improve the operation of the internal control system of the Treasury and promote effective implementation of the assigned Treasury's functions, thus facilitating attainment of the Treasury's strategic objectives, resource protection, development and maintenance of effective control measures. The committee reviews the findings and conclusions contained in internal audit and external auditors' reports on the Treasury's operation, recommendations included in the reports for operational improvements of the internal control system established in the Treasury and comments provided by the audited structural units concerning the facts discovered during audits. The committee is entitled to decide on potential measures for mitigation or prevention of the most significant Treasury's risks.

**Budget Monitoring Committee –** to ensure effective and efficient spending of central government basic budget financing granted for implementation of the assigned Treasury's functions. The task of the Committee is to ensure timely planning of the required expenditure, establish priorities for allocation of the granted financing and monitor effective spending. The decisions of the committee are binding to all structural units and staff of the Treasury.

**Debt Management Committee –** to promote effective debt management.

**Quality Management System Monitoring Committee –** to promote implementation of the Quality management system and ensure its monitoring, stimulate continuous improvement of the Treasury's operations as well as compliance of services with the clients' interests. The task of the committee is to define the quality policy and objectives of the Treasury, ensure their compliance with the strategy, policy and objectives of the Treasury, actively involve all level managers and staff in implementation of the quality policy and attainment of objectives.

**Risk Management Committee –** to ensure monitoring of the risk management system, review and evaluate the most significant risks and measures for their mitigation as well as monitor implementation of risk management plans and risk management process in the institution.

**Central Government Budget Accounting Committee –** to organise updating of implementation of the Treasury's budget accounting policy and ensure effective accounting policy change management. The operational objective of the Committee is to define the Accounting policy and its compliance with the accounting standards, establish the Accounting policy objectives and update the Accounting policy and facilitate compliance with the requirements established by the Accounting policy.

**Resource Liquidity Committee –** based on the Treasury's Regulations for Ensuring Liquidity, to monitor and evaluate implementation of these regulations, in order to ensure proper management of the financial resources. The operational task of the Committee is to monitor the liquidity of financial resources, to prevent payment and liquidity crises risks, improve the Treasury's regulations for ensuring liquidity and promote compliance of management of financial resources with the requirements set in the regulations.

**Personnel Management Committee –** to promote effective personnel management in line with the Treasury's functions and objectives. The task of the Committee is to implement personnel policy and strategy, actively involving all level managers and staff.

**Treasurer**

- **Deputy Treasurer**
  - Financial Resources Department
  - Financial Risk Management Department
  - Financing Department
  - Forecasting and Financial Planning Department
  - Budget Execution and Monitoring Department
- **Deputy Treasurer**
  - Reports Department
  - Informatics Department
  - Operations Department
- European Affairs Department
- State Funded Pension Assets Management Department
- Risk management department
- Office
- International Cooperation Department
- Legal Department
- Internal Audit Department
- Quality Management Deprtament
- Personnel Department
- Accounting Department
- Maintenance Division

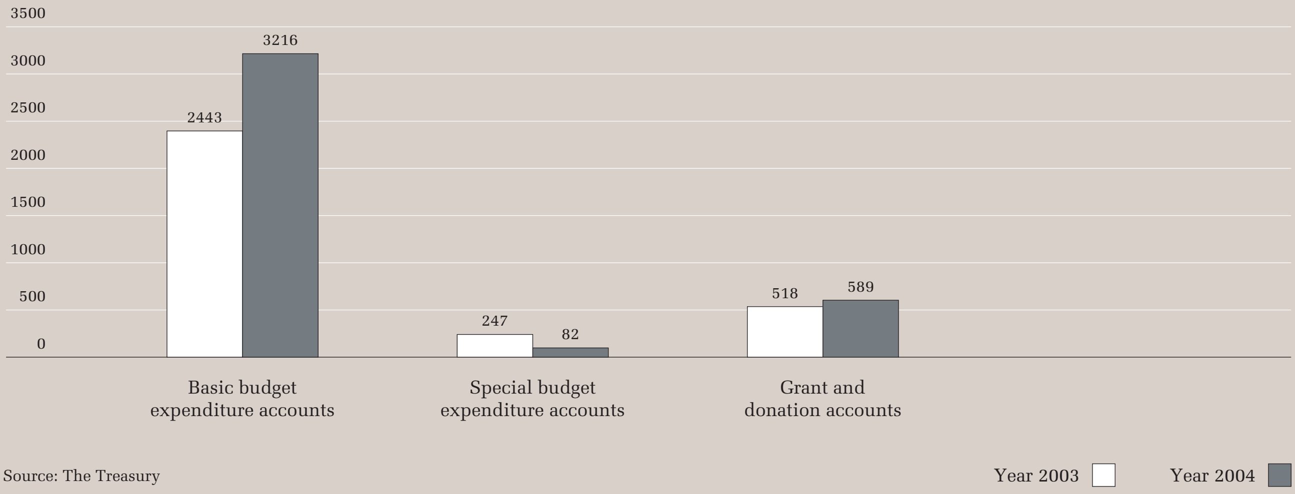
Treasury Units:
Aizkraukle, Alūksne, Balvi, Bauska, Cēsis, Daugavpils, Dobele, Gulbene, Jelgava, Jēkabpils, Jūrmala, Krāslava, Kuldīga, Liepāja, Limbaži, Ludza, Madona, Ogre, Preiļi, Rēzekne, Rīga, Saldus, Talsi, Tukums, Valka, Valmiera, Ventspils

# The Treasury's activities in 2004

## 1. Central government budget execution

In 2004, for the purpose of ensuring central government budget execution, the Treasury granted allocations in the amount of 2 240 717 768 lats, of which 1 630 800 727 lats to basic budget and 609 917 041 lats to special budget. Allocations were granted to 924 institutions financed from the budget, for which overall 3887 budget expenditure accounts were opened (679 accounts or 21.2% more than in 2003; see Chart 1). In 2004, the number of basic budget expenditure accounts increased by 773 accounts or 31.6% year-on-year, which is partly related to reorganisation of several non-profit organisations into central government organisations, the financing of which was, therefore, included in the central government budget. By contrast, the number of special budget accounts decreased by 165 accounts or 66.8%, which relates to the fact that in the law "On State Budget 2004" special budget was retained only for the Ministry of Welfare. The number of grants and donations accounts has grown by 71 account or 13.7%.

**Chart 1** *Number of central government budget expenditure accounts in 2003 and 2004*

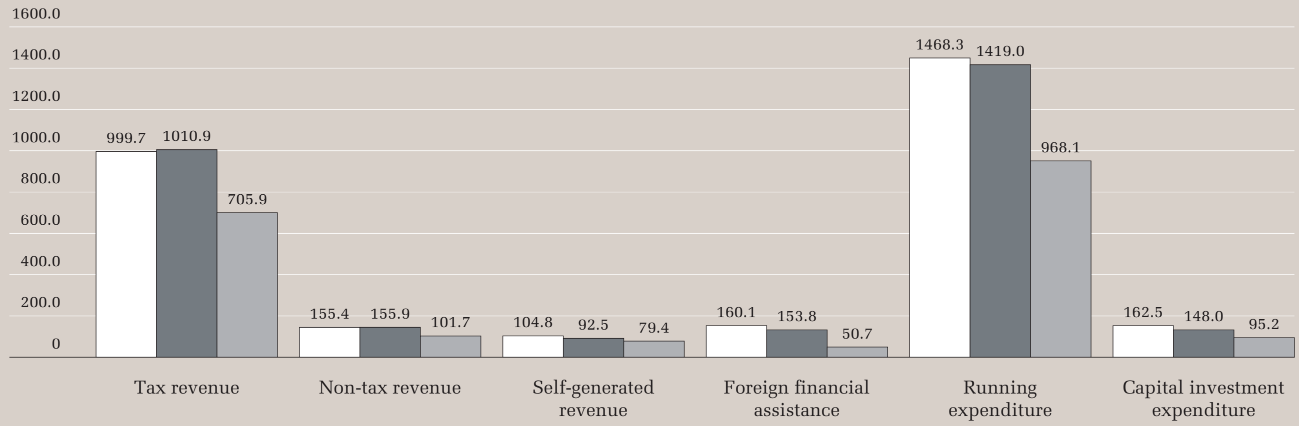



Source: The Treasury

In 2004, 363 central government basic budget revenue accounts were opened, which is 104 accounts or 40.2% more than in 2003. Starting from January 1, 2004, the Treasury fully introduced IBAN accounts, at the same time ensuring payment execution according to both – the old and the new account scheme. Quicker payment processing – the secondary clearing was introduced in 2004, allowing to speed up central government budget transfers.

In executing the central government budget, the Treasury processed 6 396 221 payment orders in 2004, which is 6.6% more than the number of payment orders processed in 2003. A significant rise in the number of payments in 2004 is related to disbursements from the EU funds to Latvian farmers and businesses.

**Chart 2** *Central government basic budget execution (in LVL million)*




Source: The Treasury

In 2004, the central government basic budget revenue amounted to 1 413 067 152 lats, which is below the amount planned in the budget law (1 420 081 549 lats), the ratio of the actual revenue against the plan being 99.5% (see Chart 2). Tax and non-tax revenue exceeded the 2004 plan – tax revenue was 11.2 million lats or 1.1% higher, whereas non-tax revenue was 0.5 million lats or 0.3% higher than planned. Revenue from service charges and other self-generated revenue, in turn, were 12.3 million lats or 11.7% lower than planned. Revenue from foreign financial assistance was the revenue item characterised by the highest underperformance falling short of the plan by 6.3 million lats or 3.9%.

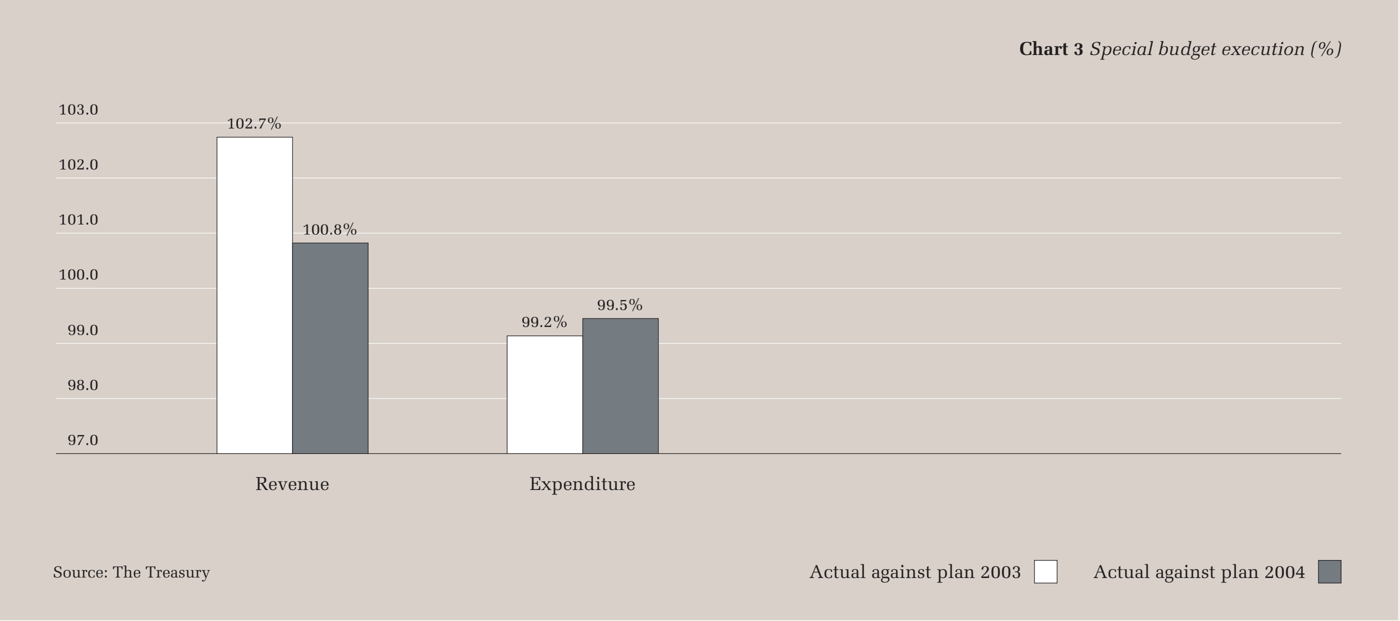
In comparison with 2003, basic budget revenue in 2004 was 475.5 million lats or 50.7% higher. In 2004, tax revenue was 43.2%, non-tax revenue 53.3%, self-generated revenue 16.5%, whereas revenue from foreign financial assistance 203.4% higher year-on-year.

Central government basic budget expenditure amounted to 1 566 973 825 lats in 2004, as opposed to the planned amount of 1 630 800 727 lats, the ratio of the actual expenditure against the plan being 96.1%. Running expenditure was 49.3 million lats or 3.5% less than planned, whereas capital investment expenditure was 14.5 million lats or 9.8% less than planned, as several projects co-financed from foreign financial assistance and scheduled for implementation in 2004 budget were not implemented.

In 2004, special budget revenue amounted to 657 959 691 lats, which is 5.4 million lats or 0.8% higher than planned, whereas in 2003 the central government special budget revenue amounted to 887 384 696 lats, which was 23 million lats or 2.7% higher than planned (see Chart 3). Special budget expenditure totalled 606 816 825 lats in 2004, which is 3.1 million lats or 0.5% less than planned. In 2003, special budget expenditure was 867 155 354 million lats, which is 7.3 million lats or 0,8% less than planned.

In 2004, the central government budget ran a fiscal deficit in the amount of 82.7 million lats, which is 1.12% of the gross domestic product (hereinafter – GDP). In 2003, the central government budget also ran a fiscal deficit in the amount of 91.1 million lats or 1.5% of GDP.

In 2004, in accordance with Article 32 of the law "On Budget and Financial Management", a Report on the Republic of Latvia Report on Central Government Budget Execution and Local Government Budgets 2003 was prepared and




after approval of the Cabinet of Ministers, together with the Republic of Latvia State Audit Office "Opinion concerning Report on the Republic of Latvia Report on Central Government Budget Execution and Local Government Budgets 2003" and "Statement on the Report on the Republic of Latvia Report on Central Government Budget Execution and Local Government Budgets 2003" submitted to the Saeima (Parliament) (3 volumes, 859 pages).

One of the most important tasks of the Treasury is aggregation of the local government budget reports. In 2004, the Treasury introduced new software for aggregating the annual and monthly reports of local governments, which is based on the latest technology achievements and uses the Internet in an on-line mode. This software ensures data accessibility not only to the staff of local governments and the Treasury, but also to the State Audit Office, Ministry of Finance and the Bank of Latvia and Intermediate Bodies for the European Union structural funds, thus providing an opportunity to reduce the paper document flows and speeding up information flows. Within the framework of this project, the Treasury ensured also the development of an electronic data exchange format in 2004, which provides an opportunity to prepare electronic data information for imports into the local government budget system from local government accounting programmes.

Future improvements of the software provide that in 2006 local governments will be able to submit and accept monthly reports in an electronic format, giving up the submission of a signed monthly reports to the Treasury in a paper format.

In accordance with part two of Article 30 of the law "On Budget and Financial Management", Cabinet of Ministers regulations No.999 "Procedure for Preparing Annual Reports of Central and Local Government Institutions" were prepared and approved on November 30, 2004. These regulations set the procedure for central and local government budget institutions to prepare annual reports, in order to inform the community of the allocated budget funding and its spending.

Information provided in the reports is mainly used for the following purposes:

1) preparation of consolidated general budget execution report in accordance with the requirements set by the law "On Budget and Financial Management";
2) preparation of a summary of the budget institutions reports in accordance with the requirements of the International National Accounts and European National Accounts system;
3) preparation of a summary of central and local government reports in accordance with the government financial statistics requirements of the International Monetary Fund.

In 2004, the Treasury conducted a client survey with a view of finding out whether the clients are satisfied with the services provided by the Treasury in the area of central government budget execution and what services they are expecting in the future. More than a half of the survey respondents admitted that cooperation with the Treasury had improved in comparison with the previous years, at the same time pointing out that has been certain ambiguity in budget execution process relating to application of the economic classification codes, and suggesting that the Treasury, in cooperation with the Ministry of Finance, should provide explanations for applying the codes. In 2004, 220 consultations on average per month were provided to central and local government institutions on issues concerning budget accounting and preparation of execution reports.

The operational strategy of the Treasury for the period 2005–2008 envisages improvement of the quality of services provided by the Treasury in line with the best international financial management practice and automation of transaction processing by applying modern technologies. Evaluation of the results of the client survey provided assurance to the Treasury that clients have a wish and opportunity to cooperate in a modern technological environment – transact daily operations (submit payment orders and receive information on account position) by using electronic means of communication. In line with the operational strategy and the results of the client survey, a project was implemented last year and, after receiving a favourable conclusion from a system environment security check conducted by an international audit company, the State Budget Information System's sub-system *eKase* was put into full operation, in order to provide Treasury services on the Internet.

With *eKase* the Treasury ensures remote access to services for institutions financed from the budget and local governments, at the same time guaranteeing the required information security and confidentiality. Using *eKase*, the Treasury' s clients can:

1) make payments;
2) check the results of implementation of payment instructions;
3) receive financial information on account position, implementation of the financial plans of the central government budget, statements of account turnover and monthly account summaries.

In the first half of 2005, the number of concluded *eKase* cooperation agreements was already approaching 500, and those Treasury' s clients use the *eKase* system for obtaining financial statements and submitting payment instructions for processing. Every day about 10% of the daily payment turnover of Riga Treasury Unit is received through the *eKase* system, and the project continues by extending the *eKase* system to the clients of the regional Treasury Units, as well as further development and upgrade of the system is planned, in order to ensure a comprehensive and functional budget payments system.

# 2. Central government debt and asset management

In 2004, the Treasury was very successful in managing the central government debt: low interest on borrowing was achieved, foreign exchange risk was prevented and a balanced composition of currency positions of the debt was attained.

In course of 2004, the Treasury implemented the Latvian Central Government Debt Management strategy approved by the Minister of Finance effectively and in a professional manner. Borrowing was made in line with the basic principles established in the Strategy as well as the financial derivatives were introduced and applied for the first time in debt management, in order to ensure compliance with the debt portfolio parameters prescribed by the Strategy.

Latvian Central Government Debt Management Strategy sets the central government debt management goals and objectives. The Strategy outlines the medium-term operations of the Treasury in managing the central government debt in line with the economic development trends as well as the situation on Latvian and global financial markets. The updated Latvian Central Government Debt Management Strategy was approved on April 15, 2004 by the Ministry of Finance decree No.324.

The Debt Management Strategy distinguishes between the debt portfolio management and the borrowing management. The goal of the central government debt portfolio management is to manage the financial risks of the central government debt portfolio, and several parameters of the central government debt portfolio structure have been set for the purpose of achieving this objective:

1) the share of the lats debt;
2) maturity profile;
3) the share of fixed rate;
4) average maturity;
5) duration;
6) currency composition for the net foreign currency debt.

The goal of the central government borrowing management is to ensure the availability of the necessary financial resources and their liquidity for financing the deficit of the central government budget and refinancing of the central government debt as well as borrowing on favourable terms and conditions. Several basic principles have been established for the purpose of achieving this objective:

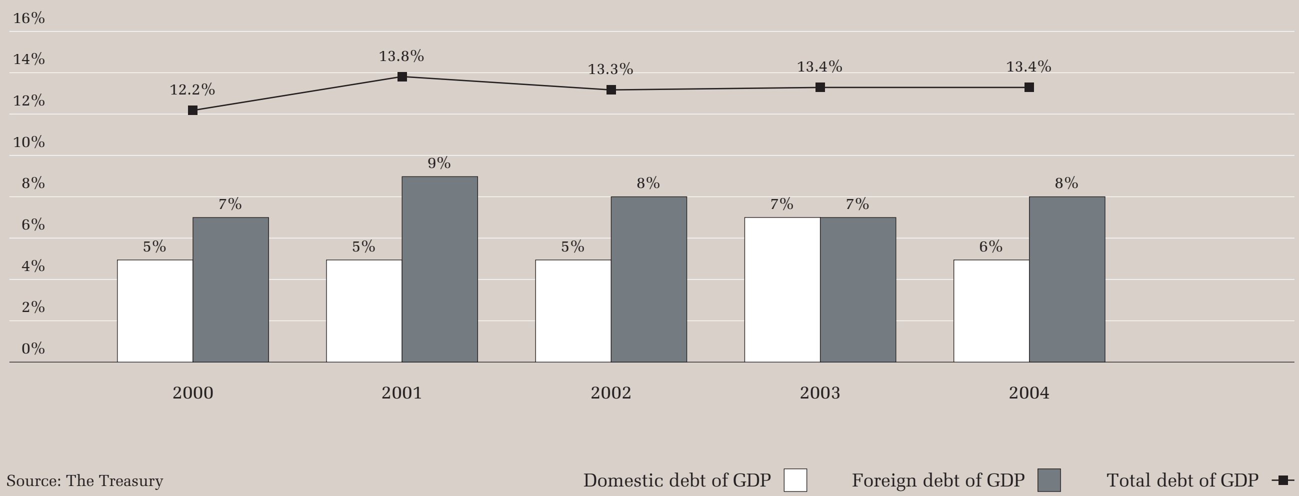
1) to ensure continuous opportunities for attracting financial resources;
2) to maintain the daily minimum liquidity reserve of the financial resources;
3) to perform each borrowing transaction in a professional manner;
4) to foster the development of financial markets;
5) when making in borrowing transactions, ensure also compliance with the basic principles of the central government debt portfolio management;
6) perform the very best appearance for Latvia as borrower.

# Historical development of the central government debt

As on December 31, 2004 the central government debt stood at 974.95 million lats or 13.4% of GDP, which is below the limit set by the law "On State Budget 2004" (1 058.7 million lats), because as the result of successful debt management and lower financing needs the amount of borrowing required for 2004 was reduced.

General government debt amounted to 14.4% of GDP on December 31, 2004, which is relatively low in comparison with the Maastricht criterion set for the member states of the Economic and Monetary Union (60% of GDP) and the third lowest figure among all EU member states.

**Chart 4** *Central government debt development (% of GDP)*




Source: The Treasury

During 2004, the central government debt grew by 128.67 million lats, mainly as a result of Eurobond issues (see Chart 4).

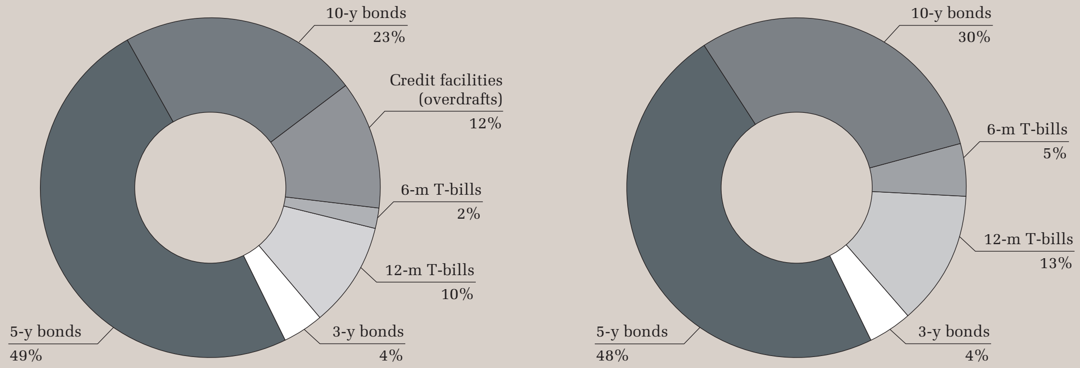
# Central government domestic debt

At the end of 2004, the domestic debt of the central government amounted to 422.97 million lats or 43% of the total central government debt. The foreign debt of the central government was 551.98 million lats or approximately 57% of the total central government debt.

In 2004, the shares of the various types of outstanding domestic government securities in the total domestic debt slightly changed (see Chart 5).

As on December 31, 2004, the outstanding amount of domestic government securities had grown by 49.06 million lats or 13.12% year-on-year, reaching 422.97 million lats. In 2004, the short-term loans (credit facilities) used in the fourth quarter of 2003 were repaid as well as the share of the long-term government bonds in the domestic debt portfolio of the central government expanded.

**Chart 5** *Domestic debt by type of borrowing (%)*



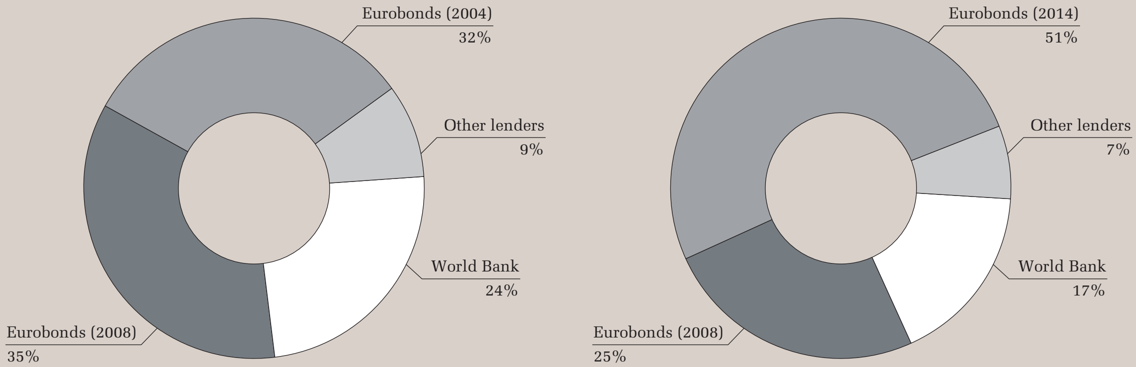

as at December 31, 2003 as at December 31, 2004

Source: The Treasury

## Central government foreign debt

As on December 31, 2004, the major part (76%) of the central government foreign debt consisted of borrowing on the capital market, i.e. Eurobonds maturing in 2008 and 2014 (see Chart 6).

**Chart 6** *Foreign currency debt by type of borrowing (%)*




as at December 31, 2003 as at December 31, 2004

Source: The Treasury

In 2004, the central government foreign debt grew by 132.35 million lats, mainly on account of the first 10 year Eurobond issue in the amount of 400 million euro in April 2004. At the end of 2004, the foreign debt of the central government reached 551.98 million lats.

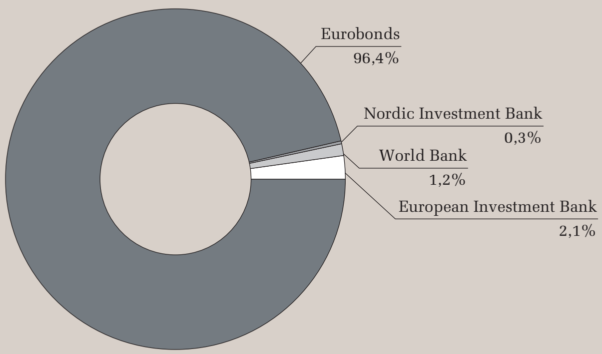
# Management of the central government borrowing

The goal of the central government borrowing management is to ensure the availability of the necessary financial resources and their liquidity for financing the deficit of the central government budget and refinancing of the central government debt as well as borrowing on favourable terms and conditions.

## Foreign borrowing

The major share (96.4%) of foreign borrowing made in 2004 consisted of Eurobond issue in the amount of approximately 400 million euro (see Chart 7).

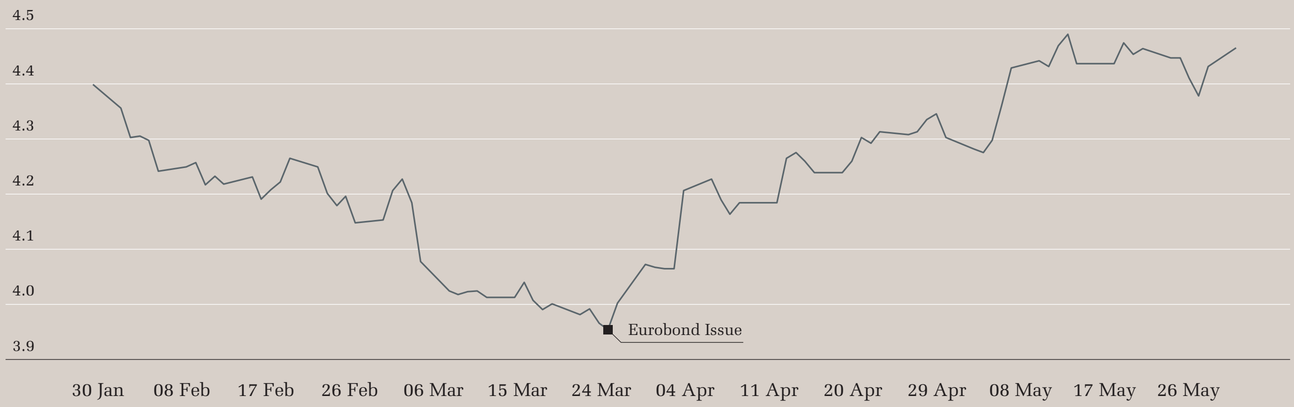
**Chart 7** *Foreign borrowing made in 2004 (%)*




Source: The Treasury

On March 25, 2004, under the lead management of *Citigroup*, one of the world's largest international investment banks, primary placement of historically largest amount and longest maturity (10 years) Eurobonds was conducted. The maturity of the Eurobonds (10 years) was selected in order to extend the yield curve of the Eurobonds and attract a wider range of investors. The major part of the proceeds from the issue was spent to redeem the Eurobonds issued on May 14, 1999 maturing on May 14, 2004 in the amount of 225 million euro. When issuing Eurobonds, the spread over the benchmark bond (in case of the Latvian Eurobonds those were the German government bunds) as well as the spread over swap rates that year was the lowest among EU applicant countries prior to the EU accession (43.7 and 28 basis points, respectively). Moreover, Latvia's borrowing costs were decreased also by the successfully chosen timing of the Eurobond issue, as the base rates used for pricing (10 year euro swap rates) were at the lowest level within the period of the last 10 months, and shortly after the issue was made they increased sharply (see Chart 8).

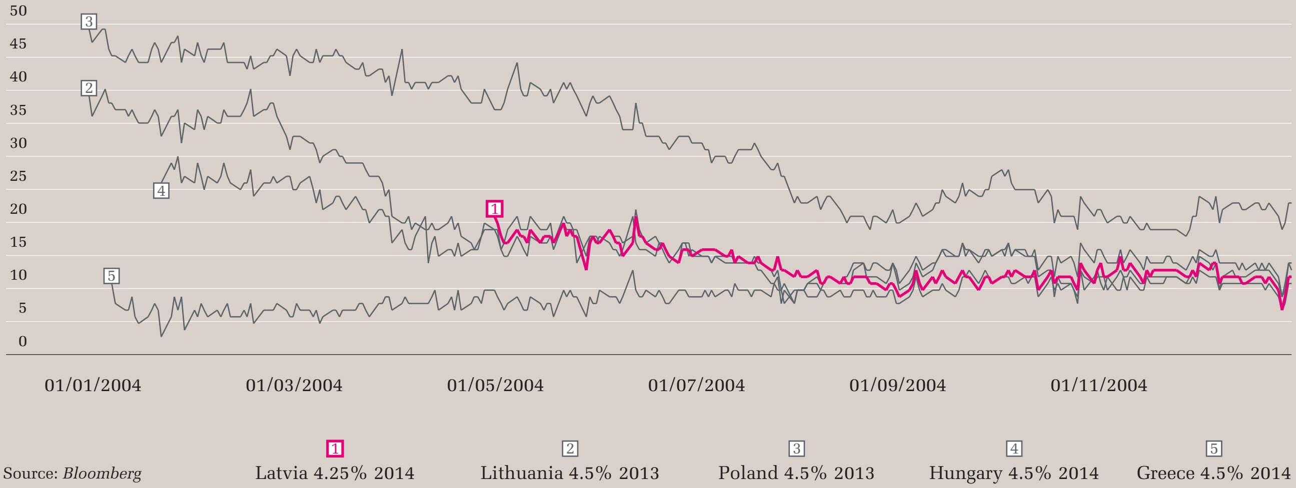
**Chart 8** *10 year euro swap rates 2004 (%)*




Source: *Reuters*

As can be seen from Chart 9, Latvia's spread above the euro swap rates continued to decline in 2004 and reached 10–12 basis points at the end of the year.

**Chart 9** *Eurobond spread performance over Swaps in the secondary market in 2004 (BP)*



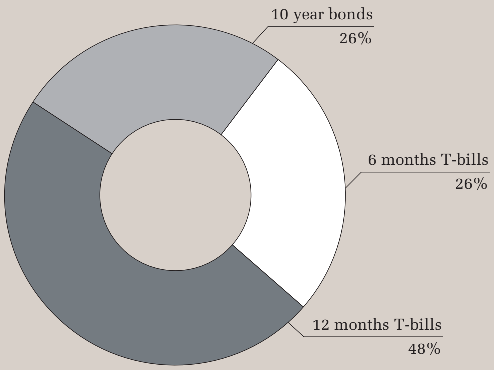

Source: *Bloomberg*

The result of 2004 Eurobond issue highlighted several things concerning the type of investors as well geographic distribution. The highest interest was displayed by banks on Latvia's Eurobonds, whereas from the geographic distribution point of view a significant increase of interest from German investors has to be noted.

**Domestic borrowing**

In 2004, instead of the planned domestic government security issues in the amount of 157.4 million lats borrowing in the amount of 111.4 million lats was made, as due to the central government budget execution results and because of lower financing needs not all offered securities were sold at several auctions. Moreover, changes were introduced to the domestic government securities issue and redemption calendar by cancelling the 10 year government bond issues scheduled for November and December 2004 in the amount of 30 million lats at nominal, thus preventing an increase in the central government debt.

**Chart 10** *Domestic borrowing made in 2004 by type of securities (%)*




Source: The Treasury

In 2004, the interest rates on the domestic government securities remained relatively stable. If initially they had a tendency to grow under a direct impact of the short-term interest rate raising measures implemented by the Bank of Latvia by increasing the refinancing rate on two occasions from 3 to 4 percent, at the final auctions of the year a slight decline in the interest rates was observed, which could be broadly explained by the expected re-pegging of the lats to the euro. The average interest rates on long-term bonds, in turn, declined at the auctions in comparison with the ones of 2003, remaining at a stable level of 4.86%–4.88%, and in secondary market falling even to the level of 4.40%–4.50% and preserving a downward trend.

## Central government debt portfolio management

The central government debt portfolio management activities are mainly aimed at hedging and prevention of financial risks, preventing uncontrolled growth of costs of financial resources. Therefore, the Central Government Debt Management Strategy sets several debt portfolio structure parameters that are constantly monitored, and with the help of adequate debt management instruments the required adjustments to the portfolio structure were ensured.

In order to improve and further elaborate the Central Government Debt Management Strategy, several adjustments were made in 2004:

1) duration (in years) was set at 3.25 (+/-0.25);
2) the share of fixed rates in the debt portfolio was set at 60-70%;
3) maturity profile of the debt as a (%) of total debt was set at: < 1 year < 25%, 3 years < 50%.

As the Strategy provides for application of the financial derivatives for attaining the goal of the Central Government Debt Management Strategy and meeting the objectives, in 2004, within the framework of the central government debt management the Treasury prepared an accounting policy for the financial derivatives for applying the financial derivatives, covering transaction implementation, registration and revaluation. At the same time, the required quality management system documents were prepared.

In order to deal with financial derivatives, the Treasury (Ministry of Finance) first signed ISDA (*International Swaps and Derivatives Association*) agreements with several banks, including the Bank of Latvia. These agreements are used in the international practice for foreign exchange, financial derivatives and other financial market deals.

Following application of the financial derivatives, as on December 31, 2004 the central government debt portfolio structure parameters set by the 2004 Central Government Debt Management Strategy were fully complied with, and the comparison between the actual parameters and those set in the Strategy is provided in Table 1.

**Table 1** *Compliance of the central government debt structure parameters with those established in the Strategy*

| Parameters | Actual debt structure parameters 31.12.2003 | | | | Actual debt structure parameters 31.12.2004 | | | | Structure parameters established in the strategy | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Share of the lats debt | 50% | | | | 43% | | | | > 40% | | | |
| Maturity profile (%) | < 1 year 32 | | < 3 years 22 | | < 1 year 15 | | < 3 years 35 | | < 1 year < 25 | | < 3 years < 50 | |
| Share of fixed rates | 75,6% | | | | 67,6% | | | | 60 - 70% | | | |
| Average maturity in years | 3,38 | | | | 5,29 | | | | 5 (+/- 0,5) | | | |
| Duration in years | | | | | 3,39 | | | | 3,25 (+/- 0,25) | | | |
| Currency composition (%) Net foreign curr. debt | EUR 85% | USD 9% | GBP 3% | JPY 3% | EUR 37% | USD 38% | GBP 12% | JPY 13% | EUR 37% | USD 38% | GBP 12% | JPY 13% |

Source: The Treasury

As for the period before repegging the lats the Strategy warranted that the currency composition of the net foreign currency debt should be established based on the SDR currency basket, with allowable deviation of (+/-) 10%, on April 2 and 5, 2004, simultaneously with making settlement for the Eurobonds, the Treasury and the Bank of Latvia conducted *FX forward* transactions, buying the euro and selling the US dollars, British pounds and Japanese yens with the value date of January 4, 2005, thus closing the open currency position of the net foreign currency debt and fixing it at the *forward* exchange rates of April 2 and 5, 2004. The concluded *FX forward* transactions eliminated the foreign exchange risk, and the currency composition of the net foreign currency debt was brought in line with the SDR currency basket composition.

From April 5, 2004 to December 31, 2004, as a result of exchange rate fluctuations, the net foreign currency debt in the lats terms grew by about 20 million lats. The gains from the *FX Forward* transactions, in turn, amounted to 21 million lats, offsetting the increase of the net foreign currency debt in the lats as a result of exchange rate fluctuations.

On December 23, 2004, the Treasury held an on-line enquiry with the banks with whom ISDA agreements had been signed and concluded a 10 year interest rate swap deal in the amount of 166 million euro with the bank offering the most favourable terms and conditions. As a result of this deal, the duration was decreased to 3.39 years, which is compliant with the allowable limit set in the Strategy. The deal enabled not only the reduction of the duration to 3.39 years, but also the share of fixed rate debt to 68%, which is compliant with the allowable limit set in the Strategy.

## Central government debt estimate for 2005

The central government debt development trends forecast is based on an assumption included in Latvian Convergence programme 2004–2007 that in the medium-term, with the economic conditions in Latvia improving, and at the same time the expenditure relating to Latvia's participation in the EU and NATO growing, the central government budget deficit will not exceed 2% of GDP.

It is expected that the resources required for ensuring the overall financing need, central government debt refinancing and financial liquidity will be attracted by using both the domestic financial market as well as foreign financial market instruments.

After repegging of the lats to the euro, the interest rates on borrowing in the national currency and the euro will probably continue to converge. The Treasury will continue to issue medium-term and long-term government bonds on the domestic market, by implementing bond issue programmes, as well as will consider the opportunity to implement buy-back and exchange programmes for the existing outstanding bonds, in order to attain the central government debt management objectives.

In 2005, drawdown from the existing international financial institution loans will continue to finance long-term investment projects, without ruling out the possibility of using alternative borrowing instruments to change the financing needs. In 2005, negotiations will continue with the European Investment Bank on signing the borrowing agreement granted in 2004 for ensuring the national co-financing for projects financed from the ES policy instruments.

Continuing the work on reducing the central government foreign debt service costs, the terms and conditions of all current foreign borrowing contracts are evaluated, in order to examine the possibilities and existing restrictions for early repayment of several loans by refinancing those loans with other, more advantageous loans, or, as much as possible, changing the provisions of borrowing contracts. In 2005, it is planned to start negotiations about cancelling the Second Programmatic Structural Adjustment Loan granted by the World Bank in 2000 but still unspent, as well as effect early repayment of several loans from international financial institutions, including the early repayment of the World Bank 2000 Programmatic Structural Adjustment Loan (PSAL 1) in the amount of 40.4 million US dollars and the remaining part of the Japanese International Cooperation Bank loan for which the contract was concluded on November 17, 1993, in the amount of 1 115 million Japanese yens or approximately 5.6 million lats.

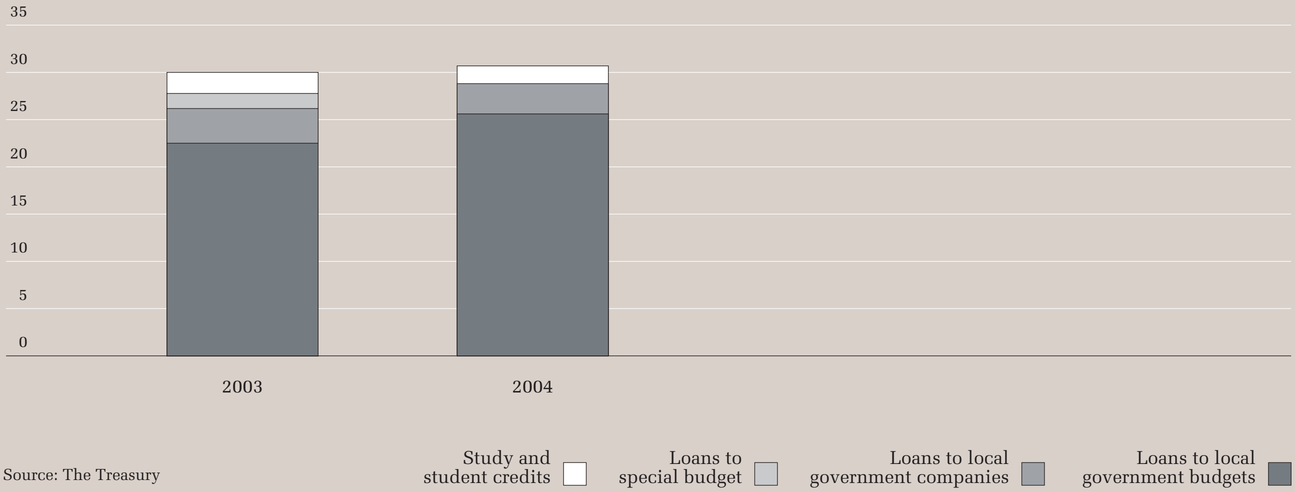
The Treasury forecasts that at the end of 2005 the central government debt will not exceed the maximum limit (1179.6 million lats) set in the law "On State Budget 2005" and will amount to approximately 1042.2 million lats or 12.8% of GDP.

## Central government budget lending

Every year, loans from the central government budget are granted in accordance with the provisions of the annual law on state budget. At the end of 2004, the total central government budget loan portfolio was 278 million lats.

The principal borrowers from the central government budget currently are the local governments and the beginning of their borrowing dates back to 1996. In 2004, 218 loan agreements were signed, of which 212 with local governments. In accordance with the signed loan agreements, the Treasury made disbursements in the amount of 30 million lats (or 500 thousand lats more than in 2003) in 2004, of which 25 million lats were disbursed directly to local governments.

**Chart 11** *Central government budget lending (in LVL million)*




Source: The Treasury

Looking at the loans signed in 2004 to local governments by purpose of loan, the majority of loans were granted to education (30%), budget and financial management (29%), transport and communications development (14%).

In 2004, lending rates continued to decline and are currently at their historical low. Interest rates on the lats lending are determined based on the domestic government securities with the longest maturity of 10 years. In 2004, the fixed rate on 10 year loans fluctuated from 5.6% to 5.36%, whereas the rate on 5 and 1 year loans was 5.15% and 4.01%, respectively.

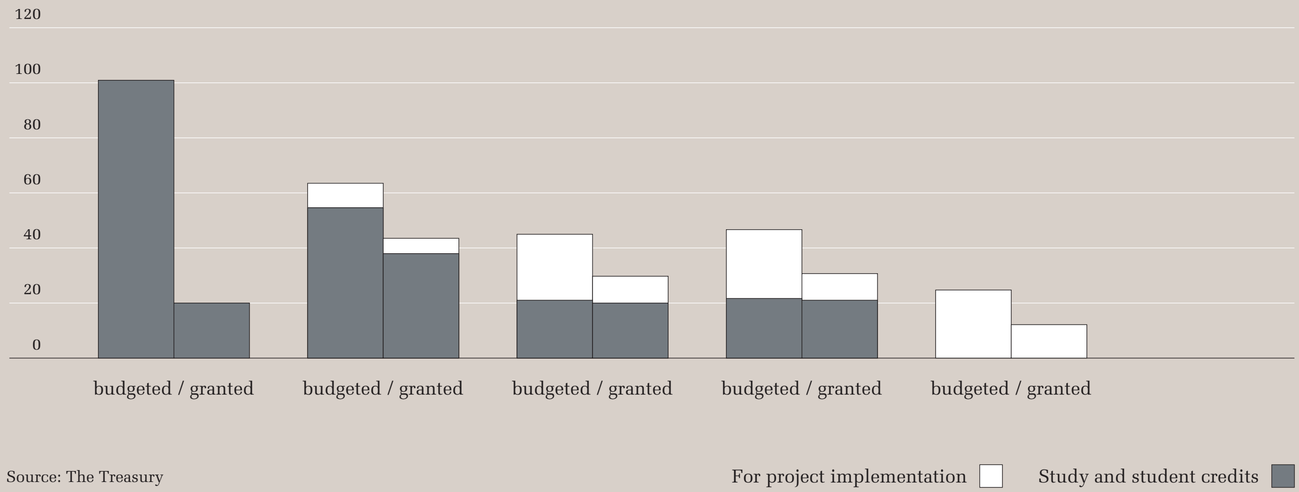
As part of the loan agreements were signed at a time when the longest maturity for available resources was 5 years, and for the first 5 years a fixed interest rate was set (from 8.28% to 9.32% per annum), in some cases the rates on previously granted loans were reduced based on a Minister of Finance decree.

To loans signed with local governments in 2004 financed from funding attracted by the European Investment Bank the floating rate of the European Investment Bank was applied and the interest rate on granted loans decreased from 2.61% to 2.58% during the year.

## State guarantees

All in all, 57 separate state guarantees have been issued for implementation of the Public Investment Programme projects and business support programmes, the first of them being granted in 1993. State guaranteed loans have been issued to support various sectors, including 25% to education, 16% to railroad sector, 14% to marine transport, 12% to promotion of small and medium-sized enterprise development. In 2004, only guarantees for study credits and student credits were issued. These types of credits were introduced in 2001 as a conceptually new higher education credits system (see Chart 12).

**Chart 12** *Government guarantees granted in 2000–2004 (in LVL million)*




Source: The Treasury

## Liquidity management

Based on the necessity established in the Latvian Central Government Debt Management Strategy to ensure availability of a daily minimum reserve of financial resources, in order to settle the financial liabilities of the central government in due time and in full amount, identify and prevent situations that could impair the liquidity of the financial resources, in 2002 the Treasury prepared "Treasury's Regulations for Ensuring Liquidity" (hereinafter – Regulations), setting the liquidity ensuring requirements and compliance procedure for those requirements in the Treasury. In 2004, a liquidity ratio was introduced in those Regulations, the purpose of which is to determine the optimum amount of the liquid resources in the medium-term, thus monitoring timely attraction of resources and reducing the liquidity and payments crises risks.

On April 4, 2004, upon receiving the proceeds from the Eurobond issue in the amount of 398.8 million euro, until May 14, 2004 when the Eurobonds issued in 1999 in the amount of 225 million euro were redeemed, the amount of the liquid resources increased above the established required liquidity. However, this was only a short-lived development as a considerable share of the attracted resources was placed on short-term deposits until the time when the Eurobonds issued in 1999 matured. Another part of the received funds (approximately 50 million lats) was used to repay the short-term foreign currency credit facilities (overdrafts) used in 2003, resulting in decrease of the amount of the free liquid assets. In 2004, the annual average actual deviation of the liquidity ratio from that established in the Regulations 23%, which is within the limits prescribed by the Regulations.
Taking into account that the Treasury has successfully settled the financial commitments of the central government in 2004 and ensured the financing of the fiscal deficit in the central government budget, the liquidity ratio target has been achieved, ensuring safe and effective management of the financial resources.

# 3. Implementation of functions of the Paying Authority for the European Union policy instruments

In accordance with the provisions of the EU Regulations, a Paying Authority is one or several national, regional or local institutions or bodies, chosen by the Member State to certify the incurred expenditure, submit payment claims (Declarations of Expenditure) and receive payments from the European Commission (hereinafter – EC).

The Paying Authority, like other institutions involved in implementation of the EU policy instruments, must ensure operation of the instruments in compliance with the European Community interests; ensure effective management and monitoring of structural funds in accordance with the provisions of the EU Regulations and guidelines.

The task of the Paying Authority in the process of verification of the submitted EU policy instrument claims or Declarations of Expenditure, is to get assurance on correctness, eligibility of expenditure incurred within the framework of projects and their compliance with the EU Regulations as well as the sufficiency of the management control systems or checks established by the Intermediate Bodies/ Managing Authority. In order to ensure the above, the Paying Authority has the rights to request the Managing Authority to implement additional controls in the Intermediate Bodies/ Managing Authority as well as conduct financial controls and audit.

The Treasury started to implement the Paying Authority functions from May 1, 2004:

1) in accordance with Cabinet of Ministers Regulations No. 200 of March 30, 2004 “Regulations on the EU Structural Funds Management” – for the EU Structural Funds (European Regional Development Fund, European Social Fund, Financial Instrument for Fisheries Guidance, Guidance section of the European Agricultural Guidance and Guarantee Fund);
2) in accordance with Cabinet of Ministers Regulations No. 298 of April 13, 2004 “Regulations on Procedure for Preparation, Approval, Implementation and Monitoring of Projects Financed from the European Union Cohesion Fund” – for the EU Cohesion Fund;
3) in accordance with Cabinet of Ministers Regulations No. 309 of April 15, 2004 “Regulations on the European Community Initiative EQUAL” – for the European Community Initiative EQUAL.

In order to implement the Paying Authority functions successfully, the internal procedures of the Treasury were elaborated in 2004, stipulating all the steps as well as the duties and responsibilities of the involved employees.

To establish the mutual duties, rights and responsibilities, agreements between the Treasury as the Paying Authority and the institutions involved in implementation of the European Union policy instruments were signed.

To ensure the financial management and certification of the Structural Funds, the following agreements were signed in 2004:

1) on July 9, an agreement between the Treasury as the Paying Authority and the Central Financing and Contracts Agency as a second level Intermediate Body on the financial management and expenditure certification of the European Regional Development Fund was signed;
2) on July 12, an agreement between the Treasury as the Paying Authority and the Rural Support Service on the financial management and expenditure certification of the Guidance section of the European Agricultural Guidance and Guarantee Fund (EAGGF) and the Financial Instrument for Fisheries Guidance (FIFG) was signed;

3) on September 2, an agreement between the Treasury as the Paying Authority and the State Employment Agency on the financial management and expenditure certification of the European Social Fund (ESF) was signed;
4) on September 6, an agreement between the Treasury as the Paying Authority and the Vocational Education Development Agency on the financial management and expenditure certification of the ESF was signed;
5) on August 20, an agreement between the Ministry of Finance as the Managing Authority and the Treasury as the Paying Authority on the EU Structural Funds management in compliance with the Single Programming Document and Programme Complement was signed.

In order to ensure unified requirements for institutions involved in the management of EU Structural Funds the Treasury elaborated unified principles and requirements, for verification of the EU Structural Funds reimbursement claims, payment order preparation, expenditure certification and other financial management measures.

Until May 1, 2004, the Treasury fulfilled the functions delegated by the National Authorising Officer to ensuring the financial management of ISPA financed projects. In order to ensure the financial management of projects funded from the Cohesion Fund, two tripartite agreements were signed in 2004:

1) on July 14, between the Ministry of Finance as the Managing Authority, the Treasury as the Paying Authority and Ministry of Transport as an Intermediate Body – on implementation and monitoring of transport infrastructure and technical assistance projects financed from the Cohesion Fund;
2) on July 16, between the Ministry of Finance as the Managing Authority, the Treasury as the Paying Authority and Ministry of Environment as an Intermediate Body – on implementation and monitoring of environmental infrastructure and technical assistance projects financed from the Cohesion Fund.

To ensure a unified procedure for opening accounts and effecting payments within the framework of projects financed from the Cohesion Fund, the Treasury elaborated a procedure for ensuring the financial management of the Cohesion Fund for involved institutions.

To ensure the financial management of the European Community initiative EQUAL, a cooperation agreement between the Treasury as the Paying Authority and the Ministry of Welfare as the Managing Authority on the procedure for ensuring of financial management and expenditure certification of the European Community initiative EQUAL was signed on November 11, 2004.

The Treasury elaborated principles and requirements to ensure the financial management of the European Community initiative EQUAL, including verification of the Structural Fund reimbursement claims, payment order preparation, expenditure certification and ensuring of other financial management measures.

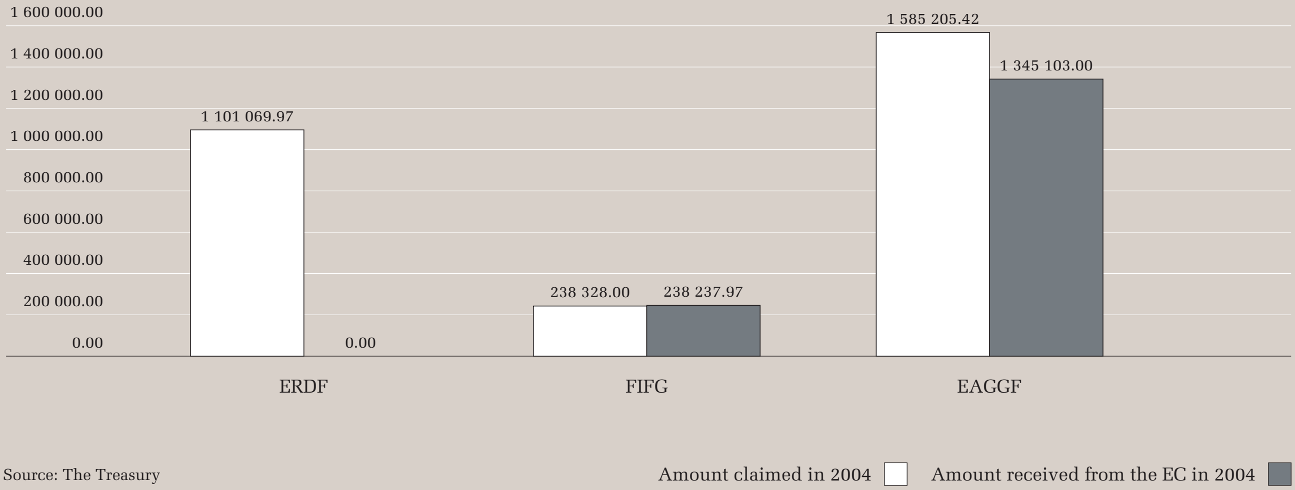
The signed agreements and documents prepared by the Treasury are one of conditions for the Intermediate Bodies/Managing Authority to be able to submit payment documents to the Treasury, and the Treasury as the Paying Authority to be able to make disbursements to the Final Beneficiaries/Contractors of the EU policy instrument funding. The agreements set a procedure for submission of Declarations of Expenditure, so that the Paying Authority can perform all the necessary checks, certify expenditure declared and send payment requests to the EC.

The following table displays advance amounts received from the EC under each of the funds after Latvia's accession to the EU and approval of the Single Programming Document:

| Table 2 *Advance amounts received from the EC in 2004 (EUR)* | | |
|---|---|---|
| **Fund / Initiative** | **Total EU funding 2004 – 2006** | **Advance amounts received from the EC until end of 2004** |
| ERDF | 369 202 000.00 | 36 920 282.60 |
| ESF | 138 698 000.00 | 13 869 800.00 |
| EAGGF | 93 333 000.00 | 9 333 300.00 |
| FIFG | 24 335 000.00 | 2 433 500.00 |
| EQUAL | 8 025 784.00 | 802 578.40 |
| Source: The Treasury | | |

Already starting from October 2004, the first payments within the framework of the European Regional Development Fund, Guidance section of the European Agricultural Guidance and Guarantee Fund and FIFG were made. In order to receive spent funding, Declarations of Expenditure were submitted to the EC and after the approval the EC transferred funding for some of them:

**Chart 13** *Certified EU Structural Funds Funding and Received EC Funding in 2004 (EUR)*




Source: The Treasury

Only at the end of 2004, the first EC decisions on granting of the Cohesion Fund financing were received. The payments so far have been made within the framework of already approved ISPA projects, which after accession to the EU are implemented in accordance with the Cohesion Fund Regulations. Starting from May 2004, the Treasury as the Paying Authority received and certified 19 Declarations of Expenditure within the framework of environment, transport and technical assistance projects and sent payment requests to the EC for the total amount of EUR 9 774 841.45, receiving funding from the EC in the amount of EUR 5 513 580.62. Projects have been selected within the framework of the European Community initiative EQUAL and the contracting process is ongoing; therefore, it can be forecasted that the first expenditure under this fund will be made in 2005, and the process of declaring expenditure and receiving funding from the EC can only happen in 2005.

The Treasury acts as a Paying Authority also for the European Economic Area and Norwegian government financial mechanisms. In 2005, it is planned to develop the legal framework for implementation and administration of those mechanisms.

# 4. Management of the assets of the state funded pension scheme

The Treasury manages the state funded pension scheme assets (second tier pensions) in accordance with the "State Funded Pensions Law" which assigns this function to the Treasury as the government agent.

Within the 12 months of 2004, the Treasury received for management purposes from the State Social Insurance Agency (hereinafter – Agency) state funded pension scheme assets in the amount of LVL 6 202 203 and redeemed investment plan shares in the amount of LVL 4 692 863. On December 21, 2004, the value of the "Treasury's investment plan" (hereinafter – Plan) amounted to LVL 14 975 098, LVL 2 151 405 higher than at the end of 2003.

**Table 3** *Funded pension scheme asset management activity results**

| | Quarter I 2004 | Quarter II 2004 | Quarter III 2004 | Quarter IV 2004 |
|---|---|---|---|---|
| Value of investment plan assets, in millions of lats | 13.296 | 13.849 | 14.644 | 14.985 |
| Time deposits, in millions of lats | 3.038 | 2.817 | 3.225 | 3.441 |
| Debt securities, in millions of lats | 10.155 | 11.032 | 11.418 | 11.341 |
| including government debt securities, in millions of lats | 9.104 | 9.960 | 10.288 | 10.194 |
| including mortgages, in millions of lats | 1.051 | 1.072 | 1.130 | 1.147 |
| Cash, in millions of lats | 0.103 | 0.000 | 0.001 | 0.203 |
| Investment plan commitments, in millions of lats | (0.009) | (0.069) | (0.009) | (0.009) |
| Value of investment plan assets, in millions of lats | 13.287 | 13.780 | 14.635 | 14.975 |
| Change, % against previous period | 3.61% | 3.71% | 6.20% | 2.32% |
| Value of an investment plan share, in lats | 1.1495148 | 1.1605140 | 1.1756076 | 1.1919155 |
| Change, % against previous period | 0.96% | 0.96% | 1.30% | 1.39% |
| Weighted average investment maturity, in years | 3.18 | 3.48 | 3.06 | 2.69 |

Source: The Treasury

* On the last date of the relevant quarter

Taking into account that private asset managers have been engaged in management of the second tier state funded pensions for already two years, the Treasury's investment plan still occupies a stable niche and is one of the biggest state funded pension scheme assets managers, managing 31.13% of the second tier assets. The investment plan has been able to maintain a sufficiently high yield, and at the end of the year the yield of one share of the investment plan from the start of operation (September 5, 2001) amounted to 5.36% per annum.

**Table 4** *Yield of investment plan**

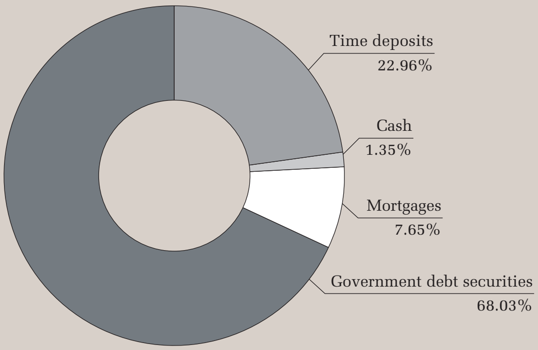
| 1 month | 3 months | 6 months | 1 year | 2 years | Since start of operation |
|---|---|---|---|---|---|
| 7.56% | 5.54% | 5.36% | 4.60% | 4.57% | 5.36% |

Source: The Treasury

* Annual % as on December 31, 2004, calculated using the Act/360 method.

In accordance with the Treasury investment plan's investment policy and restrictions established in the Law on State Funded Pensions, funds were invested in domestic government securities, mortgages and time deposits in banks. As on December 31, 2004, 22.96% of total investment plan assets were placed with banks; 68,03% of total assets were invested in domestic government securities and 7.65% in mortgages.

**Chart 14** *Investment portfolio (of the value of assets as on December 31, 2004)*




Source: The Treasury

In the last quarter of 2004, money market interest rates on lats funding dropped considerably. In 2004, 1 year RIGIBOR rate overall decreased by 0.22% points and amounted to 4.26% at the end of the year. Prices on the debt securities market, on the contrary, went up sharply at the end of the year, pushing the yields down. In 2004, the annual yield on short-term Treasury bills fluctuated from 3.23%–4.00%, medium-term securities 3.30%–4.10%, long-term securities 4.40%–5.10%, mortgages 4.75%–5.90%.

Overall yield of the Plan as on December 31, 2004 amounted to 4.60%, exceeding the corresponding maturity RIGIBOR rate. As on December 31, 2005, the value of one share of the investment plan was 1.1919155 and had increased by 19.18% since the start of operation. Successful performance results can be explained by low funds management costs and successfully combined investment portfolio. In 2005, the asset manager, preserving the current investment policy, will strive to ensure a yield that is adequate considering the financial market developments and provide maximum safety of investment.

The Treasury manages the state funded pension scheme assets by investing in low risk financial instruments and in compliance with investment diversification principle, as well as ensures adequate investment liquidity, so that to be able to execute the Agency's instruction to redeem shares of the investment plan in a timely manner. The Treasury has developed and electronically maintains a register of the shares of the investment plan, registering any actions involving shares of the investment plan, and provides information to the Agency and Finance and Capital Market Commission following the procedure set in legislative acts.

In accordance with the Cabinet of Ministers regulations and the prospectus of the Plan, in 2004 the Treasury received as remuneration for management of the investment plan assets 0.75% of the average annual value of the plans (net) assets.

# 5. Corporate governance of the Treasury as a public administration institution

## 5.1. The Treasury's financing and its spending

The Treasury's financing is comprised of:

1) grant from general revenue;
2) service charges and other self-generated revenue;
3) government loan service revenue consisting of 0.5% of the outstanding loans per annum;
4) government guarantees service revenue consisting of 0.1% of the outstanding loans per annum;
5) revenue from management of the assets of the state funded pension scheme consisting of 0.75% of the average asset value of the investment plan.

### Execution of the Treasury's budget

In 2004, the Treasury implemented the following basic budget programmes: "Budget execution and central government debt management", "Contributions to international organisations", "Compensation to rehabilitated citizens". Their purpose is to ensure implementation of the tasks assigned in the Treasury's Regulation, i.e. implementation of the annual law on state budget, central government debt and cash assets management, equalisation of the local government finances, receipt of the EU funding etc.

2004 budget structure, overall spending of funds and implementation of performance indicators in comparison with the previous year has been provided in Tables 5, 6, 7, 8, 9, 10, 11 and 12.

### Information on central government budget spending

**Table 5** *Assets and liabilities (aggregate balance sheet in LVL)*

| No. | | At start of year | At end of year |
|---|---|---|---|
| **1.** | **Assets** | 2 375 827 | 1 660 351 |
| 1.1. | Long-term investment | 1 798 648 | 767 183 |
| 1.2. | Current assets | 577 179 | 893 168 |
| **2.** | **Liabilities** | 2 375 827 | 1 660 351 |
| 2.1. | Equity | 2 294 992 | 1 634 960 |
| 2.2. | Payables | 80 835 | 25 391 |

Source: The Treasury

**Table 6** *Central government basic budget spending (summary for all programmes in LVL)*

| No. | | Previous year (actual implementation) | Reporting year | |
|---|---|---|---|---|
| | | | approved in the law | actual implementation |
| **1.** | **Revenue (total):** | 54 863 852 | 59 774 762 | 59 905 551 |
| 1.1. | grant from general revenue | 53 673 221 | 58 465 275 | 58 465 275 |
| 1.2. | special purpose grants | - | - | - |
| 1.3. | service charges and other self-generated revenue | 1 143 177 | 1 080 287 | 1 232 481 |
| 1.4. | foreign financial assistance | 47 454 | 229 200 | 207 795 |
| **2.** | **Expenditure (total):** | 51 519 873 | 59 644 762 | 57 699 163 |
| 2.1. | running expenditure (total): | 51 274 873 | 59 566 762 | 57 621 163 |
| 2.1.1. | wages and salaries | 1 525 868 | 1 764 536 | 1 764 536 |
| 2.1.2. | business trips | 26 885 | 38 122 | 38 122 |
| 2.1.3. | subsidies and grants | 1 535 048 | 6 910 000 | 6 061 391 |
| 2.1.4. | other running expenditure | 48 187 072 | 50 854 104 | 49 757 114 |
| 2.2. | capital investment expenditure (total): | 245 000 | 78 000 | 78 000 |
| 2.2.1. | capital purchases | 65 000 | 78 000 | 78 000 |
| 2.2.2. | capital repairs | - | - | - |
| 2.2.3. | investment | 180 000 | - | - |
| **3.** | **Employment** | | | |
| 3.1. | actual number of employed | 251 | - | 258 |
| 3.2. | average wage and salary | 506 | - | 570 |

Source: The Treasury

**Table 7** *Central government basic budget spending basic budget sub-programme “Budget execution” (in LVL)*

| No. | | Previous year (actual implementation) | Reporting year | |
|---|---|---|---|---|
| | | | approved in the law | actual implementation |
| **1.** | **Revenue (total):** | 2 889 063 | 3 364 762 | 3 495 551 |
| 1.1. | grants from general revenue | 1 743 454 | 2 055 275 | 2 055 275 |
| 1.2. | special purpose grants | - | - | - |
| 1.3. | service charges and other self-generated revenue | 1 143 177 | 1 080 287 | 1 232 481 |
| 1.4. | foreign financial assistance | 2 432 | 229 200 | 207 795 |
| **2.** | **Expenditure (total):** | 2 803 373 | 3 234 762 | 3 198 888 |
| 2.1. | running expenditure (total): | 2 558 373 | 3 156 762 | 3 120 888 |
| 2.1.1. | wages and salaries | 1 525 868 | 1 764 536 | 1 764 536 |

| | | | | |
|---|---|---|---|---|
| 2.1.2. | business trips | 26 885 | 38 122 | 38 122 |
| 2.1.3. | subsidies and grants | - | - | - |
| 2.1.4. | other running expenditure | 1 005 620 | 1 354 104 | 1 318 230 |
| 2.2. | capital investment expenditure (total): | 245 000 | 78 000 | 78 000 |
| 2.2.1. | capital purchases | 65 000 | 78 000 | 78 000 |
| 2.2.2. | capital repairs | - | - | - |
| 2.2.3. | investment | 180 000 | - | - |
| **3.** | **Employment** | | | |
| 3.1. | actual number of employed | 251 | - | 258 |
| 3.2. | average wage and salary | 506 | - | 570 |

Source: The Treasury

**Table 8** *Central government basic budget spending basic budget sub-programme "Central government debt management" (in LVL)*

| No. | | Previous year (actual implementation) | Reporting year | |
|---|---|---|---|---|
| | | | approved in the law | actual implementation |
| **1.** | **Revenue (total):** | 49 964 000 | 49 500 000 | 49 500 000 |
| 1.1. | grants from general revenue | 49 964 000 | 49 400 000 | 49 500 000 |
| 1.2. | special purpose grants | - | - | - |
| 1.3. | service charges and other self-generated revenue | - | - | - |
| 1.4. | foreign financial assistance | - | - | - |
| **2.** | **Expenditure (total):** | 47 181 452 | 49 500 000 | 48 438 884 |
| 2.1. | running expenditure (total): | 47 181 452 | 49 500 000 | 48 438 884 |
| 2.1.1. | wages and salaries | - | - | - |
| 2.1.2. | business trips | - | - | - |
| 2.1.3. | subsidies and grants | - | - | - |
| 2.1.4. | other running expenditure | 47 181 452 | 49 500 000 | 48 438 884 |
| 2.2. | capital investment expenditure (total): | - | - | - |
| 2.2.1. | capital purchases | - | - | - |
| 2.2.2. | capital repairs | - | - | - |
| 2.2.3. | investment | - | - | - |
| **3.** | **Employment** | - | - | - |
| 3.1. | actual number of employed | - | - | - |
| 3.2. | average wage and salary | - | - | - |

Source: The Treasury

**Table 9** *Central government basic budget spending basic budget sub-programme "Contributions to international organisations" (in LVL)*

| No. | | Previous year (actual implementation) | Reporting year | |
|---|---|---|---|---|
| | | | approved in the law | actual implementation |
| **1.** | **Revenue (total):** | 856 789 | 5 910 000 | 5 910 000 |
| 1.1. | grants from general revenue | 811 767 | 5 910 000 | 5 910 000 |
| 1.2. | special purpose grants | - | - | - |
| 1.3. | service charges and other self-generated revenue | - | - | - |
| 1.4. | foreign financial assistance | 45 022 | - | - |
| **2.** | **Expenditure (total):** | 773 630 | 5 910 000 | 5 408 385 |
| 2.1. | running expenditure (total): | 773 630 | 5 910 000 | 5 408 385 |
| 2.1.1. | wages and salaries | - | | |
| 2.1.2. | business trips | - | - | - |
| 2.1.3. | subsidies and grants | 773 630 | 5 910 000 | 5 408 385 |
| 2.1.4. | other running expenditure | - | - | - |
| 2.2. | capital investment expenditure (total): | - | - | - |
| 2.2.1. | capital purchases | - | - | - |
| 2.2.2. | capital repairs | - | - | - |
| 2.2.3. | investment | - | - | - |
| 3. | **Employment** | - | - | - |
| 3.1. | actual number of employed | - | - | - |
| 3.2. | average wage and salary | - | - | - |

Source: The Treasury

**Table 10** *Central government basic budget spending basic budget sub-programme "Compensation to rehabilitated citizens" (in LVL)*

| No. | | Previous year (actual implementation) | Reporting year | |
|---|---|---|---|---|
| | | | approved in the law | actual implementation |
| **1.** | **Revenue (total):** | 1 154 000 | 1 000 000 | 1 000 000 |
| 1.1. | grants from general revenue | 1 154 000 | 1 000 000 | 1 000 000 |
| 1.2. | special purpose grants | - | - | - |
| 1.3. | service charges and other self-generated revenue | - | - | - |
| 1.4. | foreign financial assistance | - | - | - |
| **2.** | **Expenditure (total):** | 761 418 | 1 000 000 | 653 006 |
| 2.1. | running expenditure (total): | 761 418 | 1 000 000 | 653 006 |
| 2.1.1. | wages and salaries | - | - | - |

| | | | | |
|---|---|---|---|---|
| 2.1.2. | business trips | - | - | - |
| 2.1.3. | subsidies and grants | 761 418 | 1 000 000 | 653 006 |
| 2.1.4. | other running expenditure | - | - | - |
| 2.2. | capital investment expenditure (total): | - | - | - |
| 2.2.1. | capital purchases | - | - | - |
| 2.2.2. | capital repairs | - | - | - |
| 2.2.3. | investment | - | - | - |
| **3.** | **Employment** | - | - | - |
| 3.1. | actual number of employed | - | - | - |
| 3.2. | average wage and salary | - | - | - |

Source: The Treasury

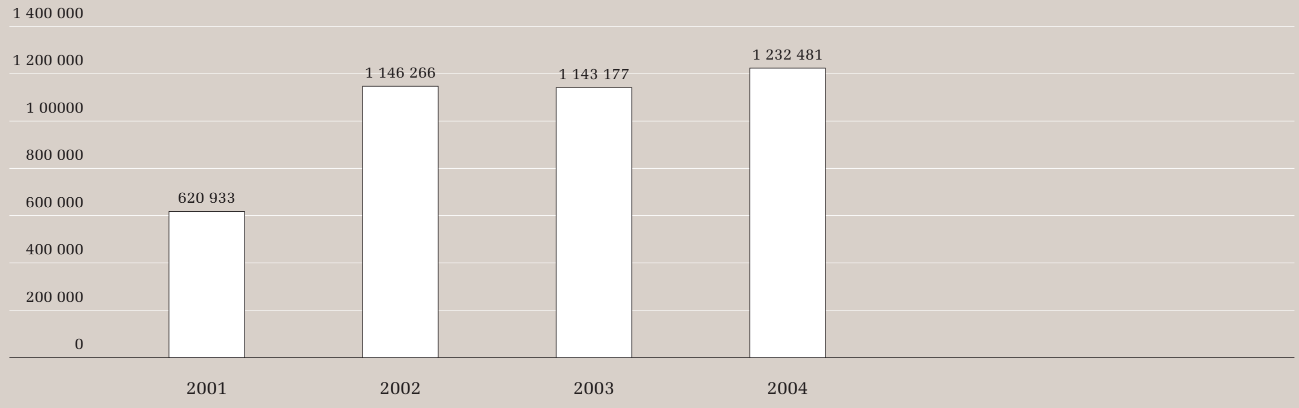
**Table 11** *Implementation of performance indicators of the basic budget sub-programme "The Treasury"*

| **No.** | **Performance indicators** | **Previous year (actual implementation)** | **Reporting year** | |
|---|---|---|---|---|
| | | | **approved in the law** | **actual implementation** |
| 1. | Maximum number of institutions | 1 | 1 | 1 |
| 2. | Maximum number of staff positions | 251 | 293 | 258 |
| 3. | Treasury's expenditure per one lats of granted central government budget allocations (LVL) | 0.002 | 0.001 | 0.001 |
| 4. | Treasury's expenditure per one lats of the serviced central government debt (LVL) | 0.004 | 0.003 | 0.003 |
| 5. | Report on central government budget execution and on local government budgets (their financial position) for the financial has been prepared | 1 | 1 | 1 |
| 6. | Official monthly Treasury reports "General government consolidated budget execution" have been prepared | 12 | 12 | 12 |
| 7. | Official monthly Treasury reports "Central government debt", "Foreign debt of the central government" and "Granted government guarantees" have been prepared | 12 | 12 | 12 |
| 8. | Number of implemented clients' payment documents (in millions) | 6 | 6.1 | 6.1 |

Source: The Treasury

| Table 12 *Service charges, their pricing, other self-generated revenue (in LVL)* | | | |
|---|---|---|---|
| **No.** | **Service charges and other self-generated revenue** | **Pricing** | **Actual revenue** |
| 1. | Government loan service revenue consisting of 0.5% of the balance of extended loans per annum | - | 992 420 |
| 2. | Government guarantees service revenue consisting of 0.1% from the balance of outstanding loans per annum | - | 134 591 |
| 3. | Revenue from the management of the assets of the state funded pension scheme consisting of 0.75% of the average asset value of the investment plan | - | 105 495 |
| 4. | Value of collected scrap metal paid in 2003 | - | - 25 |
| | Total | - | 1 232 481 |
| Source: The Treasury | | | |

**Chart 15** *Dynamics of the Treasury's Self-Generated Revenue (in LVL)*




Source: The Treasury

**Central and local government procurement**

Goods and services are procured in the Treasury in accordance with the law "On Procurement for the Central and Local Government Needs". Price quotes are invited and tenders organised. A tender committee has been established examining price quotes submitted by companies in writing, regulations etc. A public procurement registration book has been introduced where all the Treasury's purchases are registered. In 2004, the total number of purchases amounted to 28 (excluding the purchases under 1000 lats), whereas the total amount of concluded contracts was LVL 496 404 VAT exclusive (including purchases under 1000 lats – LVL 74 359 VAT exclusive).

## 5.2. Personnel management

The main value of the Treasury is its staff. The strategic aim of the Treasury in the area of personnel management is to provide the Treasury with qualified, educated and cooperative personnel, capable of qualitative and timely implementation of the Treasury's functions and attainment of the set strategic objectives, facilitating public confidence in effective and safe management of public finances.

The objective of the Treasury's personnel development is to create and effectively manage the human resource capital of the Treasury by investing in the professional development of the personnel.

In 2004, Personnel Management Committee was established, in order to improve and coordinate the personnel management process in line with the functions and strategic objectives of the Treasury as well as to implement the personnel policy, actively involving all level managers and staff.

**Personnel planning, selection and turnover**

Personnel planning is based on the annual development plan of the Treasury, taking into account the specific work assignments. The Treasury selects personnel by means of internal and external competition, evaluating the compliance of applicants with the requirements set by the Treasury. Personnel selection process in the Treasury is fair, providing equal opportunities to all applicants. The Treasury supports the employees wishing to participate in personnel selection competitions, ensuring their career development and personal development. In order to promote attraction of adequately qualified specialists, the Treasury cooperates with public institutions, sectoral associations, vocational education establishments and other cooperation partners. As on January 5, 2004, there were 259 staff positions in the Treasury (228 civil servant and 31 employee positions, including 8 manual workers), of which 8 vacancies. 13 civil servants/employees were on a childcare leave and 9 civil servants/employees were employed to replace them during their absence.

The following were established in 2004:

1) structural units:
   - transforming the Information Security Service – Risk Management Department,
   - International Cooperation Department.
2) positions:
   Director of Department (civil servant position):
   - in Risk Management Department (the position of the Head of the Information Security Service was liquidated),
   - in International Cooperation Department,

   Deputy Director of Department (civil servant position):
   - in Financial Resources Department,
   - in European Affairs Department (the position of the Deputy Director of the Legal Department was liquidated),
   - in the Quality Management Department,
   - in the Risk Management Department,
   - in the Financial Risks Management Department,
   - in the International Cooperation Department,

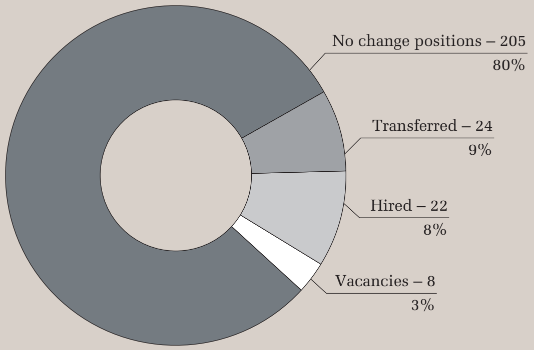
   Deputy Director of Department (employee, later – civil servant position):
   - in the Accounting Department,

   Senior Officer (civil servant position):
   - in the International Cooperation Department (two positions),

   Senior Expert (civil servant position):
   - in Riga Treasury Unit (two positions – Liepāja Treasury Unit accountant (employee) position and Riga Treasury Unit senior expert (employee) position has been liquidated),
   - in the Reports Department (two positions, one of them – through liquidating an expert (civil servant) position),
   - in the Foreign Currency Payments Unit of the Operations Department,
   - in the Risk Management Department,

   Expert (employee position):
   - in the Reports Department.
3) The title "senior inspector" in Riga Treasury Unit is changed to "senior expert".

**Chart 16** *Overview of staff positions (positions; %*)*



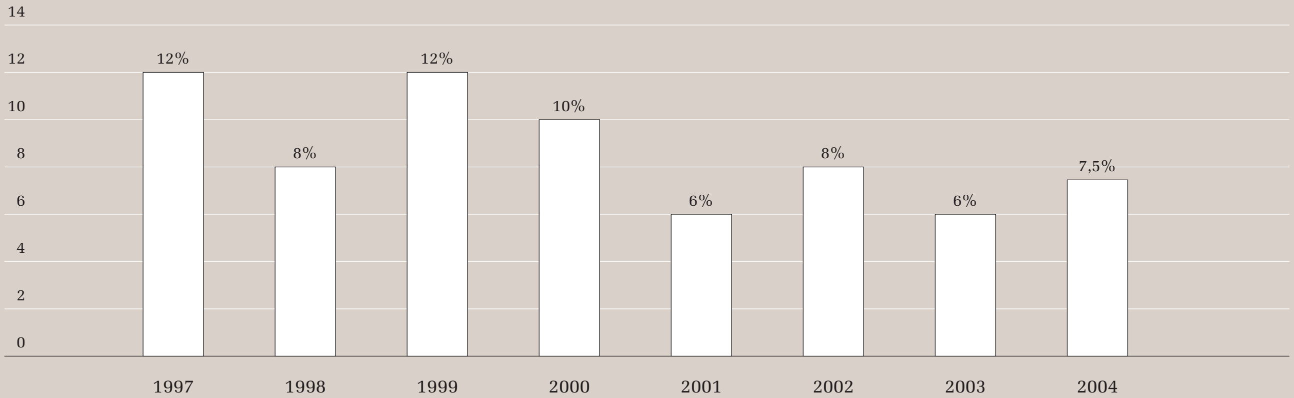

* Total number of staff positions – 259

Source: The Treasury

In 2004, for 25 (35 in 2003) vacancies 41 (47 in 2003) applicant selection competitions were announced (6 internal and 35 external), one competition was cancelled, 226 applications were registered, 29 selection committee meetings were held, in 8 competitions (2 internal and 6 open), due to the lack of adequate applicants meeting the Treasury's requirements, no candidate was selected. As a result of selection, the Treasury hired 22 new civil servants/ employees, 9 civil servants/ employees were transferred as a result of internal competitions, 15 – without competition, under rotation procedure (Chart 16). The Ministry of Finance hired a new Treasurer in an open competition.

Analysing personnel turnover in 2004, it has to be concluded that the number of vacant positions filled as a result of internal selection procedure and transfer has increased significantly. Of 46 filled vacancies, 24 were filled as a result of internal competition or rotation. In order to attract new staff to the Treasury, cooperation agreements have been signed with the Banking Institution of Higher Education, Stockholm School of Economics and Faculty of Economics of the University of Latvia with a view of potentially providing practical training to the students of these universities.

**Chart 17** *Personnel turnover (%, by years)*




Source: The Treasury

In 2004, 20 civil servants/employees left the Treasury, and the staff turnover was 7.5%. For comparison: 8% in 2002, 6% in 2003 (Chart 17). It is mostly young civil servants/employees who wish to leave, not yet sure about their employment preferences, and civil servants/employees with an employment record exceeding 7 years. Information obtained from interviews with dismissed staff is used in evaluating the Treasury's risks and developing the motivation system.

**Adaptation and evaluation of new civil servants/employees**

New employees start working in the Treasury for a trial period, during which they receive information required for implementation of their official responsibilities, learn about the history, functions and operational strategy. Upon the end of the trial period, the effectiveness of how the new employee has started work is evaluated and a decision whether he/she is compliant with the requirements set for the position is taken and feedback between the new employee and the direct manager organised.

In 2004, the performance and its results during the trial period of 13 new civil servants/employees were evaluated in the Treasury. The majority of the new employees were graded "C" (performance meets the requirements of the specific area). Considering the fact that the new employees had only worked in the Treasury for a trial period, this is a very good grade, showing that in the selection process applicants were chosen who were able to apply their professional knowledge in practice and successfully cope with the new work responsibilities.

Based on the results of the evaluation, the State Department of Civil Service granted the status of a civil servant to 17 civil servant candidates of the Treasury in 2004. Based on the results of the previous evaluation analysis and in order to improve the Treasury civil servants/ employees performance and the results evaluation process, internal regulations were developed and 3 workshops were organised where the Treasury civil servants/ employees were acquainted with the evaluation theory as well as had an opportunity to receive consultation and also conduct evaluation themselves. 39 civil servants/ employees attended the workshops.

**Organising the training process**

In order to ensure personnel development, enveloping planning and implementation of the professional development and career of staff, as well as integration of the strategic objectives of the Treasury into the professional objectives of the structural units and staff, training process is planned and organised in the Treasury. Personnel Department aggregates the training needs of staff and provided information about training programmes to the staff, as well as coordinates the training process. The duty of each employee is to independently improve his/ her professional competence, evaluate the attended training courses, share in knowledge obtained at training and effectively apply it in practice, thus ensuring effectiveness of the Treasury's spending on the training needs.

A Training needs table was prepared to improve the organisation of the training process, based on the results of civil servant/ employee questionnaire and in 2004:

1) 122 civil servants/ employees were sent on 68 various training courses;
2) 13 internal training workshops were insured, with the total participation of 211 civil servants/ employees;
3) training needs of civil servants involved in implementation of the Paying Authority functions have been identified and they have been submitted to the Ministry of Finance within the framework of an EU structural funds project;
4) 45 civil servants/ employees have attended 19 courses organised by the School of Public Administration;
5) 40 civil servants/ employees have attended the course "Information security" at the Baltic Computers Academy.

Qualifications and motivation of the Treasury's civil servants/ employees are improved through participations at training and workshops organised abroad, for example, training on implementation of the audit function within the framework of the structural funds organised within an EU Phare project by the European Funds Office of Wales (Cardiff (Britain)), training organised by *Moody's KMV Ltd* on bank credit risk analysis (London (Britain)), the course "Financial markets and new financial instruments" organised by the International Monetary Fund (Washington (USA)), workshop "Stability and Growth Pact: Evaluation of the Fiscal Requirements for the Monetary Union" organised by the European Public Administration Institute (Maastricht (the Netherlands)) etc.

**Prepared personnel management documents**

1) Regulations on ensuring practical training to students of higher education establishments in structural units of the Treasury (18.06.2004 decree No. 102);
2) The Treasury's Personnel Selection Regulations (05.07.2004 decree No. 111);
3) Regulations on Granting Additional Leave to the Treasury's Civil Servant'/ Employees (29.07.2004 decree No. 120);
4) Regulations on Familiarising the Treasury's Civil Servants, Civil Servant Candidates and Employees with their Official Responsibilities (24.09.2004 decree No. 154);
5) Regulations on Performance Evaluation of the Treasury's Civil Servants, Civil Servant Candidates and Employees (10.12.2004 internal regulations No. 1).

## 5.3. Quality management

**Identifying the level of the Treasury's client satisfaction**

In 2004, a client survey was conducted to identify the clients' wishes and needs, improve the Treasury's performance and quality of provided services.

As a result of the survey, information was obtained as to the clients' satisfaction with the services provided by the Treasury, their wishes for the future and opportunities of using electronic services. All the received proposals were collated and taken into account when continuing work on improvement of the Treasury's performance.

More than a half of respondents admitted/pointed out/provided an evaluation that the cooperation with the Treasury had improved in comparison with the previous years.

**Quality management system implementation in the Treasury**

In order to attain the strategic objectives of the Treasury, the Operational Strategy of the Treasury 2005–2008 defines uniform operational principles for the institution in the area of quality management. Quality management system ensures that services provided by the Treasury meet the clients' interests and requirements set in legislative acts, using the Treasury's improvement potential and available resources.

The Treasury launched implementation of a Quality Management System compliant with the requirements of the international standard ISO:9001:2000.

The quality policy of the Treasury is aimed at developing as a dynamic and modern organisation, competitive in the area of provided services, effectively and safely managing the finances entrusted to the Treasury's management in compliance with the interests of the state and its population.The quality policy of the Treasury is implemented, based on the Quality Management System, which is compliant with the international standard LVS EN ISO 9001:2000 "Quality management system. Requirements".

In 2004, a Quality Management System Monitoring Committee was established, with the task of ensuring compliance of the Treasury's quality policy and objectives with the Treasury's strategy and actively involving all level staff in implementation of the quality policy and attainment of its objectives.

To ensure the operational continuity of the Treasury, improvements of documents governing the Quality Management System continued in 2004. A special attention was paid to those regulatory documents, which had to be developed/updated due to ensuring and improving the implementation of the Treasury's functions acting as a Paying Authority, with a view of improving the EU policy instruments administration.

## 5.4. Internal control system

The internal control system of the Treasury was established, based on comprehensive basic elements of the internal control system: control environment, performance evaluation, risk management, control activities, monitoring and effective information flows and intercommunication.

The results of internal and external audits completed in 2004 confirms that overall established internal control system provides sufficient and reasonable assurance that the Treasury's assigned tasks are implemented in accordance with the strategic objectives, of performance efficiency, data correctness and reliability, compliance with legislative requirements as well as risk management and protection of the resources at the Treasury's disposal against potential losses. Recommendations provided as a result of internal audits completed in 2004 mainly relate to the need to implement additional IT security measures and improvement of the internal control system, taking into account the expansion of the operational functions of the Treasury.

In order to provide assurance to the Treasury as the Paying Authority of the effectiveness of the EU policy instruments management system, correctness, eligibility and compliance with the EU Regulations of the expenditure incurred within the framework of projects declared in payment orders, the Internal Audit Department conducted audits of the institutions involved in the EU policy instrument implementation in 2004.

In 2004, an audit of the Ministry of Finance as the Managing Authority was completed as well as the Rural Support Service as the second level Intermediate Body for the structural funds and recommendations were prepared for improvement of the EU structural funds management system and the payment process.

Twice a year a report is prepared on the internal audit findings and conclusions of the Internal Audit Department as well as recommendations to improve the internal control system developed as a result of those audits. In 2004, internal performance evaluation of the audit service of the Treasury was conducted and, as a result of that, implementation monitoring of audit recommendations was improved, ensuring that audit recommendations are implemented within the set timeframe.

In order to improve the operation of the internal control system of the Treasury and promote effective implementation of the assigned Treasury's functions, thus facilitating attainment of the Treasury's strategic objectives, resource protection, development and maintenance of effective control measures, an Audit Reports Review Committee was established in 2004. The committee reviews the findings and conclusions contained in internal audit auditors' reports on the Treasury's operation, recommendations included in the reports for operational improvements of the internal control system established in the Treasury and comments provided by the audited structural units concerning the facts discovered during audits. The Committee is entitled to decide on potential measures for mitigation or prevention of the most significant Treasury's risks.

## 5.5. Risk management

An increasingly larger number of organisations implement a risk management based approach in their strategic and daily operations, thus adding to the potential benefits and reducing the potential losses. In the reporting period, a decision to implement a risk management mechanism was taken in the Treasury as well. A Risk Management Policy was developed and approved in order to implement the idea. The purpose of the Policy is to ensure a universal and coordinated approach to the risk management process, enveloping all core processes of the Treasury as well as the projects implemented within the organisation.

To ensure implementation of the Risk Management Policy, the Risk Management Department was established whose main task is to ensure timely identification, analysis of the Treasury's risks and establishing the required measures, in order to reduce the potential losses to an acceptable level and ensure maximum use of potential opportunities.

A Risk Management Committee was established to monitor the risk management system, which reviews and evaluates the most significant risks and measures for their mitigation as well as monitors implementation of risk management plans and the risk management process in the institution.

When implementing the risk management mechanism, an initial assessment of the Treasury's risks was carried out and 20 most significant risks identified. A Risk Management Plan was developed for mitigating those risks, incorporating 48 risk mitigation measures. The Risk Management Committee evaluates implementation of the planned measures every quarter, at the same time reassessing and updating the list of the most significant risks. This process is used also to evaluate all newly-identified risks, highlighting those requiring mitigation measures to be included in the Risk Management Plan.

Successful operation of the Treasury depends on accurate and timely processing of financial information, therefore a special attention is paid to the risks relating to information technologies. This area in the Treasury is governed by the Information Security Policy, highlighting the most important principles, duties and responsibilities of staff in ensuring protection of information. Within the reporting period, the Treasury's official in charge of information security became one of the few holders of a CISSP (Certified Information Systems Security Professional) certificate in Latvia. This certificate is acknowledged worldwide as a "golden standard" in the field of information security.

Adequate risk management measures play a special role in project implementation. An example of that is the on-line payment system *eKase*, where very serious attention was paid to the system security aspects and potential risks in the process of its implementation. To ascertain the compliance of this system with the top security requirements, in addition to an internal risk assessment, several system penetration tests were run, inviting external IT auditors. Although the project implementation timeframe had to be extended, the system went live only after eliminating all identified risks.

A set of measures to adjust the Treasury's labour protection system to the changes in legislation governing this area and ensure effective management of the business environment risks were implemented during the reporting period. A special attention was paid to health protection of employees, ensuring primary health check-ups for all staff as well as providing health insurance to staff.

Implementing the State Programme for Prevention and Combating of Corruption 2004–2008, the Treasury developed and successfully implements an anti-corruption measures plan, with the view of identifying the potential corruption risks, evaluating them and introducing risk mitigation measures.

Risk management based approach is a relatively new process in the Treasury as well as in Latvia in general. Accumulating experience in this area, many aspects are identified requiring improvements in the next reporting period, in order to increase the risk management efficiency, timeliness and measurability of the achieved results.

## 5.6. Information technology system development

### Infrastructure

In 2004, ensuring the implementation of the Treasury's development plan measure *eKase*, the IT infrastructure was expanded by creating the operational production and testing environment for the *eKase*, which was required for starting to make payments on the internet as well as for further development of the system. In 2004, the Treasury also ensured that the Local government budget reporting system was run on the Treasury's servers.

### Licence inspection in the Treasury by the State Audit Office

The State Audit Office conducted an audit of compliance of computer software with the requirements of the Latvian legislative acts in the Treasury as a pilot project. The audit was implemented in cooperation with Latvia Committee of the public organisation *Business Software Alliance*.

Accounting of the Treasury's computer software (user licences) was audited, the Treasury's self-declaration forms for the used business applications and relevant licences were analysed and data contained therein compared against the actual situation with the workstations.

The State Audit Office audit concluded that the Treasury's information and data processing systems software and related licence accounting data ensured a fair representation of the actual position and were compliant with the effective legislation, and application of computer software (licences) in the Treasury was governed by internal legislative documents. The legality of the software (licences) used by the Treasury was also ascertained.

### Data warehouse

In 2004, the Treasury's data warehouse software was modified due to introduction of IBAN. The Operations Department regularly updated the data warehouse from the Treasury's databases.

### Local government reports

New software for annual and monthly reports of local governments was developed and implemented in the Treasury in 2004, which can be used to aggregate and submit local government reporting data to the Treasury. The most significant novelty is the application of the internet technologies, thus optimising the software installation, version upgrade and report submission processes. The software can be used also by those local governments that do not have an internet connection.

Aggregated information is also available to the Ministry of Finance, State Audit Office, Latvian Association of Local Governments and other institutions.

# The Treasury's development priorities for 2005

## Central government budget execution

Develop and improve the State Budget Information System's sub-system *eKase*, designated for providing Treasury services on the internet, in order to ensure a comprehensive and functional budget payments system. Start expansion of the *eKase*, extending it to the clients of the regional Treasury Units.

Launch a joint project with the State Social Insurance Agency (hereinafter – SSIA), in order to start transmitting benefits and pensions into the bank accounts or PNS (postal payment system) accounts of the SSIA clients, using the State Budget Information System's sub-system *eKase*, so that the SSIA can give up using the services of an intermediate bank. The benefit for the SSIA clients – cash inflows into the accounts will be quick and safe. The benefit for the SSIA – an opportunity to economise the central government budget funding. Ensure that this enormous number of payments can be handled (up to 500 000 per month, doubling the total number of other payments processed so far in the Treasury).

Ensure the development of methodological guidelines (Cabinet of Ministers regulations) concerning accounting for public administration institutions, local governments and their institutions in line with the Law on Public Administration Structure, relevant amendments made to the Law "On Budget and Financial Management" in 2004, requirements of the European Parliament and Council Regulations and the Regulation of the Treasury.

Continue the development of the local government annual and monthly reports aggregation software developed and implemented in 2004, which is based on the latest technology achievements and uses the internet in an on-line mode, so that starting from 2006 the local governments would be able to submit and accept monthly reports in an electronic format and give up submitting them to the Treasury in a paper format.

Ensure the Treasury data required for preparation of statistical information in compliance with the State Statistical Information Programme 2005 (Cabinet of Ministers December 21, 2004 regulations No. 1044 "Regulations on statistical information programme 2005"), incorporating the following groups:

1) statistical information to be prepared in compliance with the requirements of the EU legislation;
2) statistical information to be prepared on the basis of other regular requests of international organisations;
3) statistical information regularly prepared in line with domestic user requirements.

## Central government debt and asset management

Manage the central government debt in accordance with the Latvian Central Government debt management strategy updated in 2005.

In 2005, within the framework of debt management, work on implementation of such new instruments as debt securities repurchase and exchange programmes to manage the debt refinancing risk, as well as in cases of an additional need for financing use the opportunities offered by the international finance and capital market.

Introduce significant changes to the primary placement procedure of the government securities, transferring the organisation of primary placement tenders from the Bank of Latvia to Riga Stock Exchange and improving the government securities settlement system.

Plan short-term T-bills as well as medium-term and long-term bonds issues on the domestic financial market. Taking into account the historically low interest rates on the domestic government securities market, offer 5 and 10 year bond issues to investors.

Evaluate the possibilities of issuing the Republic of Latvia foreign government securities in line with the requirements of the electronic securities trading platform *NewEuroMTS* of the EU Member States, thus raising the liquidity of Latvian Eurobonds on the secondary market, making Latvia's image as a "borrower" more recognisable and also enhancing Latvia's borrowing opportunities on the international capital markets.

Continue the work commenced on reducing the service costs of the external government debt, evaluate the provisions of all existing external government borrowing agreements, in order to examine the opportunities and existing restrictions for the future early repayments of several loans by refinancing them with other, more advantageous loans or, as much as possible, change the terms and conditions of borrowing agreements.

In the area of asset management, improve the existing central government budget funds management procedure and cooperation with the Treasury's counterparties by expanding the range of counterparties and introducing electronic dealing platforms.

Organise annual visits of international rating agency analysts in Riga to upgrade Latvia's credit rating.

## Implementation of the functions of the Paying Authority for the European Union policy instruments

Improve the system for ensuring the functions assigned to the Paying Authority.

Participate in development of legislative acts required for implementation and administration of the European Economic Area and Norwegian government financial mechanisms and, after their approval, start disbursements within the framework of those mechanisms.

Participate in development of legislative acts required for implementation and administration of the Transition Facility programme and, after their approval, start disbursements within the framework of the programme.

## Management of the assets of the state funded pension scheme

Ensure a yield consistent with the financial market position and maximum security of investment.

Manage the pension capital with the lowest risk and ensure its constant growth in 2005. Act based on accounting compliant with the International Accounting Standards.

Manage the state funded pension scheme assets in accordance with a conservative management policy, investing in Latvia's government securities, mortgages, and making deposits with the leading Latvia' s banks. Ensure the Treasury's investment plan remaining the best of the conservative state funded pension scheme investment plans.

## Corporate governance of the Treasury as a public administration institution

Implement a quality management system in the Treasury that would be compliant with the requirements of the international standard ISO 9001:2000.

Introduce and conduct internal quality audits, in order to provide an assessment of the compliance of the Treasury's quality management system with the international standard LVS EN ISO 9001:2000 "Quality management system. Requirements" to provide assurance of compliance of the Treasury's operational processes with the requirements of legislative acts, Treasury management documents and documents governing the quality management system as well as evaluate the effectiveness and efficiency of the quality management system maintenance and improvement measures.

Introduce process management in the Treasury and establish the indicators characterising processes, in order to ensure effective management, monitoring and improvement of the Treasury's processes.

Update the Risk Management Policy.

Update the Information Security Policy.

Develop and implement Anti-Corruption Measures Plan of the Treasury.

Continue gradual implementation of the "Concept for review and optimisation of the functions of the regional Treasury Units and resources required for their implementation" developed in 2004, concurrently with implementation of the new information technology projects. In order to improve the Treasury Units' work with clients, ensure high quality and safe central government budget execution and financial management process and start gradual transition to providing on-line services to the Treasury Units' clients, offering opportunities to receive modern financial services, create a new structural unit to implement and develop *eKase* in the Treasury Units and address topical problem issues of the Treasury Units as well as supervise and coordinate their operation.

Update the Personnel Policy in accordance with personnel management principles established in the operational strategy 2005–2008 of the Treasury.