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STRATEGY
Rīga

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No. 5

Central Government Debt and Cash Management Strategy

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Terms Used

Transactions in financial derivatives – transactions, the value of which changes in response to changes in the value of another asset and are affected by one or several financial risks inherent in the underlying asset, and which are redistributed between the parties to the transaction.

Buyback transactions – repurchase transactions of fixed-income debt securities issued by the Republic of Latvia.

Counterparty – a domestic or foreign financial institution, or a foreign (debt management) public body, with whom the Treasury of the Republic of Latvia (hereinafter referred as the Treasury) enters into deals.

Fixed-income debt securities – securities (treasury bills, bonds, debentures etc.) other than subordinated debt securities, which ensure their owner a possibility of receiving income under pre-determined conditions (terms and rates, or algorithms for determining them).

Investment transactions – transactions acceptable for the investment of funds within the framework of cash management.

Domestic financial market – entering into financial transactions in Latvia, placing a public offer aimed at participants who use an electronic trading platform registered in Latvia, etc.

Cash – financial resources available on cash accounts of the Treasury.

Credit rating – the long-term credit rating determined by the international credit rating agency Moody's Investors Service (or the rating determined by S&P Global or Fitch Ratings agencies, which is equal to the classification determined by Moody's Investors Service).

Credit risk – a possibility that a counterparty, issuer of the financial instrument and/or its guarantor may not be able to perform its liabilities within a specified time limit and in full.

Credit Default Swap (hereinafter referred to as CDS) – a financial instrument, providing insurance against default risk by a particular institution.

Credit Support Annex (hereinafter referred to as CSA) – an annex to the International Swaps and Derivatives Association (hereinafter referred to as ISDA) master agreement, which is used for concluding derivative transactions on the interbank market by providing/accepting financial collateral (guarantee).

Liquidity risk – the risk of insufficient cash on the accounts of the Treasury for the timely fulfilment of the financial liabilities of the central government over the following 12 months for the full amount.

Counterpart – a domestic or foreign financial institution, or foreign (debt management) public body, with which the Treasury enters into or is ready to enter into deposit, account balance, currency purchase/sale, reverse repos of fixed-income securities, and investment transactions in fixed-income debt securities, if the transaction is made without delivery versus payment, transactions within the framework of cash management, as well as in financial derivatives and buybacks, if the transaction is performed without delivery versus payment, and transactions within the framework of central government debt and cash management.

Refinancing risk – inability to refinance the central government debt liabilities in the medium term under acceptable conditions.

Delivery versus payment (hereinafter referred to as DVP) – a form of settlement for fixed income debt securities trade transactions, where settlements with securities and cash are performed simultaneously, thus excluding the risk that fixed income debt securities are not supplied or cash is not paid.

Interest rate risk – a possibility that changes in interest rates may adversely affect revenues/expenditure. The risk occurs where a significant difference exists between assets and liabilities, sensitively responding to interest rate changes.

“Buy and hold” (hereinafter referred to as buy and hold approach) – a strategy applied to investments in fixed income securities, providing for the acquisition of securities with the purpose of holding them until maturity.

Collaboration partners – investors of debt securities, credit rating agencies, collaboration financial institutions (including the current and potential counterparties), including (debt management) public bodies of other countries.

Central government debt – gross debt received and unpaid by central government authorities (except merchants controlled by and funded from the central government, port and free-port administrations, special economic areas) in accordance with the institutional classification of sectors in the following financial instruments categories: debt securities (except financial derivatives), loans and deposits, including savings bonds, interest-free bonds, guarantee deposits, as well as deposits and account balances of clients (except central government authorities, i.e. social insurance authorities, but including merchants controlled and financed by central government, port and free-port authorities and special economic areas) placed at the Treasury.

Foreign exchange risk – a possibility that the euro value of assets/liabilities denominated in a foreign currency might shift in a negative direction as a result of currency fluctuations. Currency risk arises in the case of inconsistencies between the amounts of claims and liabilities in foreign currencies.

1. Goal of central government debt and cash management

- 1.1. Central government debt and cash management strategy (hereinafter the Strategy) determines the operations of the Treasury in the area of central government debt and cash management.
- 1.2. The Treasury shall regularly follow the progress of Strategy implementation and submit the Minister of Finance annual reports on the implementation of the Strategy.
- 1.3. Where circumstances occur, under which central government debt and cash management is not possible in compliance with the Strategy, and require immediate action as a result, derogations from the Strategy shall be allowed in agreement with the Minister of Finance.
- 1.4. **The goal of central government debt and cash management** is to ensure, in a timely manner, the availability of cash for financing requirement at the lowest possible debt servicing costs while hedging financial risks and at the same time contributing to the development of the domestic financial market.

2. Government Debt Portfolio Management

2.1. Goal and basic principles of central government debt portfolio management

- 2.1.1. **The goal of central government debt portfolio management** is to optimise the central government debt service costs over the long term while hedging financial risks of the central government debt portfolio.
- 2.1.2. The central government debt portfolio is managed in accordance with the following **basic principles**:
 - 2.1.2.1. the optimum central government debt portfolio structure shall be identified taking into account the financial risks (liquidity risk, debt refinancing risk, interest rate risk, foreign exchange risk) and the situation in financial markets; as well as counterparties' amount and term limits shall be supervised and managed with consideration of the counterparty credit risk;
 - 2.1.2.2. a balance shall be ensured between the costs of financial resources and financial risk hedging over the long term, setting risk hedging and prevention as a priority by allowing no uncontrolled increases in debt service costs;
 - 2.1.2.3. only such transactions are acceptable for debt portfolio management, which are at the same time based on known or predictable cash flows and assumptions on interest rate trends;
 - 2.1.2.4. methods and technologies recognised by international financial practice, and, where applicable, legal advice shall be used for debt portfolio management.

2.2. Tasks of central government debt portfolio management

- 2.2.1. In accordance with the specified goal and basic principles of central government debt portfolio management, the following **tasks** have been set out in regard to central government debt portfolio management:
 - 2.2.1.1. identify the specific central government debt portfolio **parameters** for the following variables of central government debt: maturity profile, net debt currency composition, interest rate structure, Macaulay Duration, outstanding amount of debt securities in the domestic financial market;
 - 2.2.1.2. monitor and appropriately manage **the central government debt maturity profile** in order to hedge the central government debt refinancing risk;
 - 2.2.1.3. monitor and appropriately manage **the net debt currency composition** in order to hedge the central government debt foreign exchange risk;
 - 2.2.1.4. monitor and appropriately manage the **interest rate structure and Macaulay Duration** in order to hedge the central government debt interest rate risk and optimise debt service costs over the long term;
 - 2.2.1.5. offer government debt securities in the domestic market in order to create an opportunity to take advantage of its borrowing potential and to simultaneously enable the functioning of the domestic financial market by providing investors with investment opportunities in domestic government securities;
 - 2.2.1.6. undertake regular monitoring of the identified debt portfolio parameters and, through the use of financial derivatives, new borrowings, debt buy back/swap tools or currency conversion, ensure the necessary compliance of the central government debt structure with the Strategy;

- 2.2.1.7. conduct the assessment and accounting of the efficiency of derivative financial instruments in accordance with internationally accepted hedge accounting practice;
- 2.2.1.8. conduct sensitivity analysis of the value of the central government debt portfolio on a regular basis, using up-to-date analytical tools in order to evaluate implementation efficiency and the consistency of the specified financial risk parameters and the Strategy;
- 2.2.1.9. regularly assess the optimisation opportunities of the central government debt servicing costs, using buyback and/or exchange transactions.

2.3. Parameters of the central government debt portfolio structure

2.3.1. In accordance with the set central government debt management goals and basic principles, and taking the central government debt composition and situation in the financial markets into consideration, the following **parameters** of the central government debt portfolio structure have been prescribed:

- 2.3.1.1. Outstanding amount of central government securities sold for initial placement in the domestic financial market at the end of the five-year period¹ is not less than the outstanding amount at the beginning of the five-year period
- 2.3.1.2. Maturity profile (%) of central government debt

up to 1 year	not more than 25%
up to 3 years	50%
- 2.3.1.3. Minimum share² of fixed interest rate

60%

- 2.3.1.4. Macaulay Duration (years)³

from 5.0 to 9.0

- 2.3.1.5. Net debt⁴ currency composition

total allowed deviation	100% EUR
allowed deviation for a single currency	+/- 5%

2.3.2. Deviation from the limits of the maturity profile, minimum fixed rate share in the debt portfolio and Macaulay Duration is permissible if the deviation does not cause additional financial risk.

¹ For a fixed period of five years (i.e. from the beginning of 2020, e.g. 2020-2024, 2025-2029, etc.), negative net borrowings are allowed provided that the parameter is met at the end of the five-year period (e.g. at the end of 2024, at the end of 2029, etc.). The parameter determines the minimum performance level, however, depending on the situation in the financial markets, the development prospects of the domestic financial market and borrowing costs therein, the amount outstanding at the end of the five-year period may be higher and shall be assessed and justified in the medium term funding plan.

² – fixed rate central government debt with a maturity over one year.

³ – during the period of low interest rates basically focusing on loans with longer maturities, hedging the risk of debt service cost increases over the long term, while during the period of high interest rates focusing on loans with shorter maturities, reducing the debt service costs in the medium term by accordingly increasing/reducing the Macaulay Duration (years) within the acceptable limits of the Strategy.

⁴ – central government debt at the end of the period less the amount of loans and receivables, where the impairment loss of guarantees is not taken into account (including Treasury's cash accounts, investments in deposits and fixed income securities, loans, receivables (including receivables of derivative financial instruments which are not classified as risky from the credit risk perspective)), and increased by provisions of guarantees as well as liabilities of derivative financial instruments which are not classified as risky from the credit risk perspective.

3. Central government borrowing and liquidity management

3.1. Goal and basic principles of central government borrowing and liquidity management

- 3.1.1. **The goal of central government borrowing and liquidity management** is to ensure timely and full availability of cash for covering the financing requirement, by maintaining continuous borrowing opportunities in the international and domestic financial markets on optimal terms and conditions.
- 3.1.2. Central government borrowing and liquidity are managed in accordance with the following **basic principles**:
 - 3.1.2.1. maximum flexibility shall be maintained for the selection of borrowing terms (time of borrowing, currency, amount, maturity) by ensuring compliance with liquidity risk management and central government debt portfolio structure parameters;
 - 3.1.2.2. when planning borrowing activities, attention shall not be focused on the comparative short-term advantages of borrowing conditions of each specific transaction, but rather on the development and enhancement of long-term borrowing opportunities in financial markets;
 - 3.1.2.3. when selecting the borrowing instruments and their terms and conditions, the possibilities of borrowing in public financial markets shall be primarily evaluated;
 - 3.1.2.4. bilateral borrowing and borrowing from international financial institutions shall be considered as additional borrowing opportunities;
 - 3.1.2.5. borrowing transactions shall be made by ensuring a balance between the favourable borrowing terms and diversification of the investor base, while promoting the liquidity of debt securities and taking the basic principles and tasks of central government debt portfolio management into account;
 - 3.1.2.6. when borrowing non-euro currencies, the use of financial derivatives for central government debt portfolio management shall be ensured simultaneously;
 - 3.1.2.7. methods and technologies recognised by international financial practice, and, where applicable, legal advice shall be used for borrowing and liquidity management;
 - 3.1.2.8. by facilitating the development of the domestic financial market and ensuring lower borrowing costs, take advantage of the borrowing opportunity in the domestic financial market, simultaneously with the government debt securities as a benchmark to ensure the liquidity, as well as the possibility to use the government debt securities yield curve as a reference point when pricing other public and private sector borrowing;
 - 3.1.2.9. faster borrowing (ensuring pre-financing) and simultaneous cash investments shall be allowed where financially beneficial at the moment of the decision and/or Treasury forecasts show that it is cost-effective from the overall perspective of debt management;
 - 3.1.2.10. activities in domestic and international financial markets shall be performed professionally, transparently, purposefully and timely, and contractual obligations shall be fulfilled in due time and amount.

3.2. Tasks of central government borrowing and liquidity management

- 3.2.1. In accordance with the specified goal and basic principles, the following **tasks** have been set for central government borrowing and liquidity management:
 - 3.2.1.1. organise the borrowing activities in accordance with the medium term Funding Plan;
 - 3.2.1.2. ensure, within liquidity management, continuous borrowing opportunities;
 - 3.2.1.3. define benchmarks for central government borrowing and evaluate the efficiency of the borrowings made in financial markets against the defined benchmarks;
 - 3.2.1.4. maintain a regular offer of securities on the domestic financial market, i.e., offering bonds to institutional investors and, with support from primary dealers, assessing the range of financial instruments offered, and, in addition, ensure an offer for individual investors in the domestic financial market;
 - 3.2.1.5. make public announcements about the medium-term borrowing strategy and, in accordance with the situation in financial markets, provide as much information as possible about the auction plans of central government securities in the domestic market.

4. Cash investment

4.1. Goal and basic principles of cash investment

- 4.1.1. **The goal of cash investment** is to ensure financially effective cash management in accordance with the basic principles of investment, providing liquidity risk management and complying with the most profitable investment terms for acceptable investment transactions.
- 4.1.2. Cash investment shall be based on the following **basic principles**:
- 4.1.2.1. cash management shall only be performed by the Treasury and the transfer of funds for management by another manager shall not be acceptable;
 - 4.1.2.2. a balance between the hedging of liquidity and financial risks and maximum profitability shall be ensured for cash investment, considering hedging of liquidity and financial risks as the most important;
 - 4.1.2.3. within the framework of cash investment, to only perform such transactions, which can be registered in the Treasury management system and objectively evaluated by means at the Treasury's disposal;
 - 4.1.2.4. within the framework of cash investment, only such transactions shall be acceptable that are at the same time based on known or predictable cash flows and assumptions on interest rate trends;
 - 4.1.2.5. to achieve the cash investment goal, transactions where the term is greater than 3 months shall only be acceptable under the condition that the positions established by them can be liquidated;
 - 4.1.2.6. when making an investment in a non-euro currency and acquiring that currency for an investment transaction, the use of financial derivatives for currency risk management shall be ensured simultaneously with the initial investment transactions;
 - 4.1.2.7. when performing a transaction, the most beneficial transaction terms shall be ensured, using the transaction term inquiry method for the conclusion of transactions (except transactions on the regulated market – stock exchange and specialised trading platforms, providing an automatic comparison of profitability of transaction terms), except for in cases where the investment of funds is determined by other basic principles and pre-agreed with the Minister of Finance;
 - 4.1.2.8. simultaneous cash investment and borrowing within the framework of liquidity management shall be acceptable where financially beneficial at the moment of the decision and/or Treasury forecasts show that it is profitable from the overall perspective of cash management;
 - 4.1.2.9. the principle of preservation of cash shall be followed, not allowing the entire cash flows received from investment to be less than the initial investment amount, except for a financial market situation where the financially most profitable investment transaction available has negative profitability;
 - 4.1.2.10. investments in fixed-income debt securities shall only be made within the framework of the buy and hold approach generating certain profitability at the end date of the investment.

4.2. Cash investment tasks

- 4.2.1. In accordance with the specified goal and basic principles, the following **tasks** have been set for cash investment:
 - 4.2.1.1. to comply with the parameters of investment structure;
 - 4.2.1.2. define benchmarks for cash investment transactions and regularly evaluate the investments made in the financial markets against the defined benchmarks.
- 4.2.2. For the achievement of the goal and implementation of tasks of cash investment in compliance with the basic principles for cash investment, **use of the following investment transactions** shall be acceptable:
 - 4.2.2.1. deposits for a definite or indefinite period of time (term or demand deposits), incl. account balances;
 - 4.2.2.2. investments in fixed-income debt securities;
 - 4.2.2.3. transactions with fixed income securities buying and repurchase;
 - 4.2.2.4. buy-back transactions.

5. Financial risk management

- 5.1. **The goal of financial risk management** is to not permit the uncontrolled increase of government debt service costs and to hedge the default risk of transactions concluded within the framework of the Strategy.
- 5.2. Financial risks shall be managed in accordance with the following **basic principles**:
- 5.2.1. manage counterparty credit risk by setting restrictions to the investment structure to be determined in accordance with the internal rules of the Treasury;
 - 5.2.2. the currency exposure of net currency debt shall be managed to restrict currency risk;
 - 5.2.3. manage the interest rate structure and Macaulay Duration in order to hedge the central government debt interest rate risk;
 - 5.2.4. manage the central government debt maturity profile in order to hedge the central government debt refinancing risks;
 - 5.2.5. within the framework of liquidity risk management, identify factors which may cause the occurrence of liquidity risk, and take timely measures to eliminate the liquidity risk by ensuring the availability and sufficiency of funding for the fulfilment of financial obligations;
 - 5.2.6. counterparty transactions on the non-regulated market (over-the-counter or across organised trading platforms), wherever possible, shall be made on the basis of the agreements concluded.
- 5.3. In accordance with the goal and basic principles of financial risk management, the following **tasks** have been set for financial risk management:
- 5.3.1. to determine and update restrictions for the cash investment structure, as well as to control the performance thereof;
 - 5.3.2. to undertake counterparty credit risk evaluation on the basis of credit rating and other risk assessment criteria used in the practice of international financial management (such as financial analysis indices etc.);
 - 5.3.3. for the hedging of credit risks, determine, follow and monitor:
 - 5.3.3.1. permissible types, limits, volumes and term limits of counterparty transactions;
 - 5.3.3.2. regional and sectoral/industry issuer limits for investments in fixed-income debt securities;
 - 5.3.3.3. credit rating category limits for counterparties and investments in fixed-income securities;
 - 5.3.4. to determine liquidity ratios for liquidity risk management and ensure their performance in accordance with the Treasury's Regulations for Liquidity Provision;
 - 5.3.5. to determine the central government debt portfolio structure parameters for refinancing, currency and interest rate risk management, and ensure their compliance in accordance with Paragraphs 2.2.1.2–2.2.1.4;
 - 5.3.6. to assess the need for an additional cash reserve to be maintained in the medium term in addition to liquidity ratios, taking the fiscal risks and the central government debt refinancing risk into account, and to include that reserve in the Funding Plan for the medium term.
- 5.4. In order to attain the goal and implement financial risk management as well as implement its tasks, **the application** of the following **financial derivatives with or without the collateralisation of guarantees** is allowed:

- 5.4.1. foreign exchange forwards;
 - 5.4.2. forward rate agreements;
 - 5.4.3. interest rate swaps;
 - 5.4.4. currency swaps;
 - 5.4.5. cross-currency and interest rate swaps;
 - 5.4.6. cash flow swaps;
 - 5.4.7. options.
- 5.5. In order to minimise counterparty risk, ensure more profitable derivatives covenants, and at the same time broaden the scope of the counterparties and increase cooperation limits, the conclusion of credit support agreements and corresponding transactions that involve collateral is allowed in line with liquidity management requirements.
- 5.6. Financial risks affecting cash management and central government debt management shall be reviewed on a regular basis.

6. Collaboration partners` relationship management

6.1. Goal and basic principles of debt securities investor relationship management

- 6.1.1. **The goal of debt securities investor relationship management** is to promote diversification of the central government debt securities investor base, thus limiting the refinancing risk in the long term.
- 6.1.2. Debt securities investor relationship management shall be based on the following **basic principles**:
 - 6.1.2.1. transparency and regularity of information is ensured: availability of updated, verified and reliable information about Latvia, promoting its trustworthiness as an issuer in the international financial market;
 - 6.1.2.2. ensuring the purposeful selection of the investor base of debt securities and communication process with them.

6.2. Tasks of debt securities investor relationship management

- 6.2.1. In accordance with the goal and basic principles of debt securities relationship management, the following **tasks** shall be set for debt securities investor relationship management:
 - 6.2.1.1. ensure regular and updated publications about central government debt management, informing them about developments and trends in the Latvian economy, financial and fiscal indicators and current events in debt management matters;
 - 6.2.1.2. conduct the regular assessment of the international government debt securities investor society in order to purposefully target the current and potential investor society buying bonds from similar issuers, and organise face-to-face and remote meetings with them;
 - 6.2.1.3. cooperate with other national authorities for the implementation of joint activities abroad, aimed at the marketing of Latvia as a safe and secure place for foreign direct investment.

6.3. Goal and basic principles of credit rating agency relationship management

- 6.3.1. **The goal of credit rating agency relationship management** is to coordinate the credit rating process and promote the development of credit rating.
- 6.3.2. Credit rating agency relationship management is based on the following **basic principles**:
 - 6.3.2.1. transparency and regularity of information ensured: provision of timely, updated, verified and reliable information to credit rating agencies about Latvia to be fully and correctly reflected in the reports published by the agencies about the credit rating assigned;
 - 6.3.2.2. a coordinated approach to the submission to credit rating agencies of information and opinions drawn by national authorities.

6.4. Tasks of credit rating agency relationship management

- 6.4.1. In accordance with the goal and basic principles of credit rating agency relationship management, the following **tasks** shall be set for credit rating agency relationship management:
 - 6.4.1.1. to organise regular visits of representatives of credit rating agencies to Latvia, remote communication and mutual information exchange, as well as evaluate

the conformity of draft reports by credit rating agencies to the information provided previously;

- 6.4.1.2. in cooperation with members of the working group (representatives from Ministries and national authorities) established by the Prime Minister for the improvement of cooperation with international credit rating agencies, to inform the Cabinet of Ministers about proposals and the required actions to improve the credit rating, as well as factors that may downgrade the credit rating;
- 6.4.1.3. to maintain active cooperation agreements with credit rating agencies, agreeing on mutually beneficial terms and conditions and credit rating fees;
- 6.4.1.4. to ensure and coordinate the submission to credit rating agencies of updated information about the economy of Latvia, financial and fiscal ratios and debt management matters.

6.5. Goal and basic principles of relationship management with collaborating financial institutions

- 6.5.1. The **goal** of relationship management with collaborating financial institutions is to regularly ensure the widest, safest and most reliable range of financial institutions possible for collaboration with the Treasury which would ensure competitive terms for the performance of financial transactions.
- 6.5.2. Relationship management with collaborating financial institutions shall be based on the following **basic principles**:
 - 6.5.2.1. transparency and regularity of information ensured: availability of updated, verified and reliable information to the current and potential collaborating financial institutions of the Treasury regarding the economy of Latvia, financial and fiscal indicators and debt management matters, promoting its trustworthiness as an issuer on the international financial market;
 - 6.5.2.2. coordinated action ensured to expand collaboration with the current collaborating financial institutions of the Treasury and to establish contractual relations with potential collaborating financial institutions of the Treasury in the area of central government debt and cash management.

6.6. Tasks of relationship management with collaborating financial institutions

- 6.6.1. In accordance with the goal and basic principles of relationship management with collaborating financial institutions, the following **tasks** shall be proposed for relationship management of collaborating financial institutions:
 - 6.6.1.1. to maintain regular communication with the current collaborating financial institutions, providing them with regular and updated information about central government debt management;
 - 6.6.1.2. to examine, on a regular basis, the possibilities to increase cooperation in the area of central debt and cash management with the current collaborating financial institutions;
 - 6.6.1.3. to expand the range of collaborating financial institutions, informing the potential collaborating financial institutions about the required actions to establish contractual relations for collaboration in the area of central government debt and cash management and develop collaboration in the collaboration areas identified;

- 6.6.2. to use methods and technologies recognised in international financial practice for relationship management with collaborating financial institutions;
- 6.6.3. to maintain collaboration with government debt management agencies of other countries for sharing experience and information and closing of possible transactions.

7. Final provisions

7.1. With coming into force of this Strategy, the Central Government Debt and Cash Management Strategy No. 17 of 12 February 2018 is repealed.

7.2. Sub-paragraph 2.2.1.7 of the Strategy shall be applicable from the moment when amendments to Cabinet Regulation No. 87 of 13 February 2018 “Accounting Procedures in Budget Institutions” enters into force determining the application of hedge accounting.

Treasurer

(signature*)

K. Āboliņš

*The document has been signed with a secure electronic signature

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