Baltikums Bank

Baltikums Bank AS 2014 Capital Adequacy Assessment Process Report

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1. Baltikums Bank AS: general description, core lines of business, overview of current financial situation and strategic planning

1.1. Baltikums Bank AS (hereinafter referred to as the Bank) is a credit institution registered in the Republic of Latvia that operates in order to satisfy client demand for dynamic, contemporary and exclusive service, providing elaborate client-oriented financial services unavailable from other banks. The Bank's mission is to provide its shareholders with capital gains consistent with the Bank's performance, and to motivate its employees according to a system that accounts for their achievements and encourages continual introduction and provision of promising state of the art financial services.

1.2. The long-term purpose of the Bank's operations is to establish contemporary banking services and solutions that are in high demand because they enhance the activities of its clients, maintaining and increasing their wealth.

1.3. The target clientele of the Bank is consistent with its core development avenues:

- 1.3.1. high net worth individuals, large and medium-sized businesses that require a comprehensive range of capital and asset management services;
- 1.3.2. international trade and service companies and merchants;
- 1.3.3. financial organisations and institutional investors in need of professional settlement services and access to financial market operations.

1.4. The Bank offers an exceptionally wide range of banking products and services suitable for its target client base. Operational priorities are specified based on the Bank's current business model and competence, and allow operation in a highly competitive environment by observing a cautious risk management policy.

1.5. The Bank's business priorities in the long term are the following:

- 1.5.1. advisory;
- 1.5.2. banking;
- 1.5.3. investment.

1.6. Retail (mass sector) banking services are not a core line of business for the Bank.

1.7. In accordance with the Bank's core lines of business, the Bank does not limit its operations to a specific country or region but conducts business on international markets. The Bank's geographical interests concern the following regions:

- 1.7.1. private persons (individuals and private capital companies) from European Economic Area (EEA) and Commonwealth of Independent States (CIS) countries;
- 1.7.2. corporate entities registered worldwide that are actually owned by private persons (individuals and private capital companies) from EEA and CIS countries, or ones that conduct business activities in these countries.

1.8. Maintenance of adequate capital and the Bank's risk management strategy:

- 1.8.1. a crucial aspect that the Bank addresses with a great deal of attention is meticulous and sensible risk management. The Bank's strategy entails undertaking of financial as well as non-financial risks;
- 1.8.2. a priority for the Bank is maintaining and increasing the assets of its clients and shareholders while maintaining the Bank's highly reputable standing. The Bank is targeted towards deriving a profit by undertaking a reasonable degree of commercial risk;
- 1.8.3. the general approach to risk management entails undertaking only those risks which are clear to the Bank and which the Bank is able to manage efficiently. The Bank undertakes a moderate degree of interest rate, foreign exchange, country and market risks. Aware of the potential fluctuations within its resource base, the Bank keeps a large amount in liquid assets available to maintain its liquidity risk at a moderate level. In terms of credit risk, the Bank knowingly targets investments for which it clearly understands the risks, thereby affording concentration of some specific investments across its lending priorities and fixed-income securities issued in Eastern Europe. The Bank devotes significant attention to reputation risk and operational risk, deeming only minimal degrees of these risks to be acceptable;
- 1.8.4. in its operations, the Bank applies a broad framework for controlling risks, implementing advanced information technologies where suitable;
- 1.8.5. in planning its operations and management of risk, the Bank considers, analyses, evaluates and documents potential Bank development scenarios conditional on various trends that might affect its external environment, observing in particular the development of macroeconomic scenarios in the countries in which it plans to do business, assessing potential impact on the Bank's operations, potential development trends in a number of target industries, amendments to legislation, regulations and standards, the actions of competitors, and other factors that have a significant effect on achievement of the Bank's goals;

1.8.6. the Bank is subject to an increased individual capital requirement because its business is largely related to servicing non-resident clients (which is significant compared to the 8% capital requirement specified in the Capital Requirements Regulation (CRR, EU Regulation 575/2013)); therefore, the Bank maintains a capital adequacy ratio that can ensure adherence to the individual capital requirement even if some scenarios manifest wherein the Bank would suffer considerable losses;

1.8.7. The Bank's capital adequacy targets are specified in the Bank's strategy. To ensure the level of capital specified in the strategy, the Bank conducts capital adequacy planning for a term of 3 years, by preparing its financial budget and planning its financial indicators accordingly. The Bank also specifies quantitative targets for each risk.

1.9. Planned financial situation:

1.9.1. the Bank will diligently develop its key performance indicators, paying particular attention to maintaining them in a balanced fashion;

1.9.2. the Bank plans to remain a medium-sized credit institution in Latvia that will implement financial services ranking among the best within the Latvian banking system in terms of quantity, and strives to become one of the best banks in Eastern Europe;

1.9.3. considering the selected strategy, the Bank has the following key sources of income:

1.9.3.1. settlement service fees and related payments;

1.9.3.2. loan interest income;

1.9.3.3. fee income from transactions with financial instruments;

1.9.3.4. income from financial market activities – primarily focusing on investments in fixed-income securities;

1.9.3.5. income from servicing financial organisations and institutional investors;

1.9.3.6. income from client lending service and payment card fees;

1.9.3.7. foreign exchange income;

1.9.4. key objectives for the next 1-4 years:

1.9.4.1. increasing the Bank's gross revenue;

1.9.4.2. maintaining return on equity of at least 15%-20% through operational excellence, although adopting conservatism, caution and risk mitigation as the basis for sustainable profits;

1.9.4.3. increasing the Bank's net worth, also using subordinated capital;

1.9.4.4. commencing regular payment of dividends equal to no more than 50% of net profit for the preceding year;

1.9.5. optimising the structure of companies on its balance sheet, eliminating unprofitable entities and concentrating on the selected lines of business:

1.9.5.1. actively diversifying the Bank's resource base, sources of financing, and increasing the total amount of financing. If possible, expanding the term structure of the Bank's liabilities and reducing the cost of resources;

1.9.5.2. achieving at least 2/3 of the Bank's total income from sources other than interest on its non-speculative investments.

2. Major risks for the Bank and procedure of managing them

2.1. The Bank identifies risks that have a major impact on its operations annually, within the framework of its capital adequacy assessment procedure, as a prerequisite for capital adequacy assessment at the end of a year:

2.1.1. risk identification is performed by the Bank's Investment Committee (IC) using the expert method, involving outside experts where necessary;

2.1.2. during risk identification, the risks that are considered include those accepted by the Bank and those related to the Bank's actual transactions, products and services provided, regions of operation etc., as well as risks related to planned activities, including new products and services, regions of operation, expansion of business, amendments to regulatory enactments etc.;

2.1.3. as a criterion for determining the significance of a risk, the Bank is guided by the degree of potential losses if a risk manifests itself. The Bank believes that any potential losses in excess of EUR 500 000 (five hundred thousand euros) are significant and represent a major risk;

2.1.4. the Bank acknowledges the following risks as major:

2.1.4.1. credit risk (including concentration risk);

- 2.1.4.2. market risks (debt securities price risk, non-trading portfolio interest rate risk, currency risk);
- 2.1.4.3. liquidity risk;
- 2.1.4.4. operational risk;
- 2.1.4.5. reputational risk, strategy and business risk;

2.1.5. During the internal capital adequacy assessment as of 31.12.2014, the following risks were identified as major with regard to the Bank's actual activities and activities planned in 2015:

- 2.1.5.1. credit risk related to corporate loans, including concentration risk and country risk;
- 2.1.5.2. credit risk related to cash balances on correspondent accounts, interbank loans and interbank settlements, including concentration risk and country risk;
- 2.1.5.3. credit risk related to the Bank's investments in debt securities and loans secured by debt securities, including concentration risk and country risk;
- 2.1.5.4. price/market risks related to the Bank's investments in debt securities;
- 2.1.5.5. operational risk;
- 2.1.5.6. strategy and business risk, money laundering and terrorist financing (ML/TF) and reputational risks;
- 2.1.5.7. risk of changes in regulatory requirements.

2.2. General guidelines for risk management procedure:

2.2.1. The Bank's core principles regarding risks that it undertakes, the acceptable degrees of risk and the procedure of managing them are described in the relevant risk management policies (Credit Risk Management Policy, Liquidity Management Policy, Non-financial Risk Management Policy etc.). Risk management policies are revised no less than once per year and approved by the Board and the Council. The Board of the Bank ensures regular notification of the Council about implementation of the risk management policies within the Bank;

2.2.2. major decisions regarding acceptance and management of risks are made by the Bank's committees – Credit Committee, Investment Committee, Non-financial Risk Management Committee, and Client Activity Compliance Control Committee;

2.2.3. everyday risk management within the Bank is ensured by structural divisions independent from business (i.e. provision of financial services and client service). Furthermore, to ensure independent evaluation of the efficiency of these structural divisions, the Bank maintains an Internal Audit Service;

2.2.4. the activities of Bank employees are specified in the Bank's internal procedures, which are revised on a regular basis and subsequently approved by the Business Processes Committee;

2.2.5. for the purposes of ensuring operation and managing risk, the Bank has established an in-house reporting system that is improved continually; the Bank's risk management policies and procedures specify the procedure for generating and submitting such reports;

2.2.6. the Bank applies various activities and methods to mitigate accepted risks, as mentioned in sections 2.3-2.7 of this report. The Bank does not utilise derivative instruments to hedge its risks. While performing interbank transactions to buy or sell currencies and some other activities, the Bank uses small volumes of netting (mutual offset of claims and liabilities);

2.2.7. in order to satisfy capital adequacy requirements, the Bank has introduced an internal capital adequacy assessment procedure (described in detail in section 3 of this report).

2.3. Credit risk:

2.3.1. Credit risk refers to the Bank's potential losses (or reduced profits) if a client, counterparty or issuer fully or partly defaults on its obligations to the Bank, as well as potential losses (reduced profit) from falling prices on debt securities and other securities, or worsening credit capacity of the issuer of such securities. The Bank's credit risk is related to issued loans, claims on counterparties, investments in debt securities and other financial instruments whose price depends on the credit capacity of any legal entity, or on any other sort of claim;

2.3.2. Credit risk management is performed in accordance with the Credit Risk Management Policy approved by the Council of the Bank;

2.3.3. Decisions on granting loans, credit lines, overdrafts (credit) and guarantees to clients that represent a credit risk to the Bank, are made by the Bank's Credit Committee on the basis of the regulation on its operations and the Credit Policy. Decisions on granting a loan in excess of the specified amount require further approval from the Board of the Bank. Minor amounts may be granted as specified in the Bank's Credit Policy or by other means;

2.3.4. The Bank's principles regarding target markets and products for lending, loan conditions, trade finance terms conditions, loan documentation, loan accounting procedure and loan granting procedure are specified in the Bank's Credit Policy;

2.3.5. Management of credit risk related to loans includes evaluation of the credit capacity of potential borrowers by the Financial Analysis and Financial Risk Management Department on the basis of the Methodology for Assessing Borrower Credit Capacity and Potential Losses for the Bank; the Financial Analysis and Financial Risk Management Department also regularly analyses borrower financial standing following issue of loans, allowing the Bank to react in a timely manner to impaired financial standing of its borrowers;

2.3.6. In order to mitigate the credit risk it assumes, the Bank requires borrowers to provide collateral. Collateral is valuated considering the requirements specified in the Bank's Credit Policy – assessing the market value of collateral, options for alienation, the pledgor's property rights, proneness to wear&tear or obsolescence, operation agreement, possibility of insurance, liquidity of the collateral. The Bank mostly accepts collateral in the way of funds, solvent persons' guarantees and sureties, liquid securities, real estate, fixed assets, goods, rights of claim; collateral is valuated at 70-90% of the balance value (or valuation provided by a third-party appraiser) of the relevant asset. The credit capacity of insurance companies that insure collateral is evaluated by the Financial Analysis and Financial Risk Management Department in accordance with its Insurance Company Credit Capacity Evaluation Methodology;

2.3.7. Credit risk related to the Bank's Financial Markets Department transactions – interbank investments, claims related to currency sale and purchase transactions, loans against securities, purchase of bonds from various issuers and other transactions, as well as holding of funds on correspondent accounts with other banks – is mitigated and controlled at the Bank using limits defined by the IC in accordance with the regulation on its operations;

2.3.8. Limits are specified for the maximum extent of the Bank's claims on each counterparty or issuer of bonds involved in transactions. The Investment Committee determines the ratio of a loan to the market value of securities for Repo credit against securities depending on the estimated credit capacity of the issuers and (for Repo credit against debt securities, which constitutes most of the Bank's Repo loan portfolio) the amount of loans under standard Repo terms and conditions represents 70-50% of the market value of collateral securities. The limit system is outlined in the Description of the Bank's Limit System, a document approved by the IC;

2.3.9. Upon determining limits, the IC should ensure that information at its disposal regarding the credit capacity of a (potential) counterparty or issuer of bonds is sufficient for making its decision. The credit capacity of potential counterparties that are banks is evaluated in accordance with the Methodology for Assessing Borrower Credit Capacity and Potential Losses for the Bank, using available information. The credit capacity of corporations that issue bonds is evaluated based on the Loan Credit Risk Evaluation Methodology. Once limits are assigned to counterparties and bond issuers, the Financial Analysis and Financial Risk Management Department regularly monitors their credit capacity;

2.3.10. Monitoring of limits intended for controlling credit risk is performed in accordance with the Procedure for Routine Monitoring of Observance of Limits, which covers, among other concerns, the actions to be taken by Bank employees if limits are exceeded or if a counterparty fails to perform its obligations to the Bank in due time;

2.3.11. In addition, the Bank manages assumed credit risk on the portfolio level, implementing the following activities:

2.3.11.1. determines limits for the total of loans granted to clients (except loans backed by securities), portfolios of securities placements (with loans backed by securities) in a range of risk profiles, Internet Bank deposits with various maturities, investments in debt securities (and loans backed by debt securities) across a number parameters , along with "country risk" limits in accordance with the Bank's Country Risk Management Policy;

2.3.11.2. evaluation of assumed credit risk within the framework of the internal capital adequacy assessment process;

2.3.11.3. planning of the Bank's balance.

2.4. Debt security market/price risk:

2.4.1. Debt securities price risk refers to potential losses that might arise for the Bank as a result of falling market prices on securities in its trading portfolio owing to shifts in market factors;

2.4.2. The Bank manages the debt securities price risk by specifying a limit on the overall volume of its trading portfolio and by purchasing mostly securities with relatively short terms to maturity, which are less affected by price risk. The Bank is aware that the debt security market/price risk is limited because, despite potential changes in debt security prices and value as a result of market factors, which may be significant, the Bank will recover the principal amount of its investment as well as receive interest if the issuer fulfils its obligations on time and redeems the financial instrument.

2.5. Operational risk:

2.5.1. Operational risk is the potential for direct or indirect losses occurring as a result of uncontrollable events arising from flaws in business organisation, inadequate control, incorrect decision-making, system errors due to human factors, issues with technology, assets, internal systems, the impact of various internal and external circumstances, legal regulations, and specific risky projects;

2.5.2. The Bank's Non-financial Risk Management Committee regularly evaluates the extent of operational risk identified for all of its major products, lines of business, processes and systems, the likelihood of their occurrence and impact on its operations based on internal regulation developed by the Operational Risk Management Department and approved by the Board. The self-assessment method is used for evaluating operational risk;

2.5.3. To ensure the Bank's ability to operate without disruptions as well as minimise losses resulting from external circumstances, the Bank develops an operational continuity plan, identifying processes and resources essential for its operation that must be restored if there are disturbances in their operation, and defines technical and labour organisation measures and means for restoring processes and renewable energy sources essential for the Bank's operation.

2.6. Strategy, business, AML and reputational risks:

2.6.1. The Bank has defined its strategy by formulating a mission statement, core lines of business/products, target markets and clients, and has developed a system of planning which it uses to analyse various potential development scenarios depending on certain scenarios of potential external circumstances, as well as its plan execution control system. The Bank also verifies compliance of the business or personal activity of its clients, observing the client policy developed by the Bank, and evaluates the impact of such business or personal activity on the Bank's reputational risk, identifies and evaluates the risk of compliance of current or potential activity in terms of money laundering and terrorist financing prevention;

2.6.2. However, considering that most of the deposits attracted by the Bank are non-resident deposits, and most of the income of the Bank is fees from servicing non-residents (i.e. their payments), the Bank is subject to the relevant strategy/business risk, AML risk and reputational risk. These risks are largely interrelated and could manifest simultaneously;

2.6.3. The worst-case scenario that might manifest for the Bank if the aforementioned risks occur includes: (1) a significant decrease in client deposits and (2) a significant decrease in fee income. This scenario might manifest, for instance, as a result of economic sanctions against Russia, policy implemented by the Russian government/ Central Bank with regard to cash flow changes, or if the Bank's largest counterparties (correspondent banks) significantly limit their cooperation with the Bank; reputational risk may also manifest independently of AML risk, due to occurrence of other unfavourable events;

2.6.4. Potential reduction in client deposits which might arise as a result of strategy, business, AML or reputational risk is evaluated as part of liquidity risk stress testing;

2.6.5. matters related to AML risk are managed by the Bank's Client Activity Compliance Control Committee.

2.7. Liquidity risk:

2.7.1. Liquidity risk denotes potential losses (or reduced profits) of the Bank from sale of assets or attraction of resources at a price (rate) that is not advantageous for the Bank in order to allow the Bank to fulfil its liabilities to creditors. The Bank carries liquidity risk due to imbalances in the structuring of the Bank's claims and liabilities over time;

2.7.2. Because the Bank's operations involve servicing of non-resident clients, the Financial and Capital Market Commission (FCMC) has determined and individual liability indicator requirement for the Bank, at 60%

2.7.3. The procedure of managing the Bank's liquidity risk is specified in its Liquidity Management Policy, and consists of several elements: a system of liquidity risk indicators, balance sheet planning, stress testing, and limits on investment in illiquid assets;

2.7.4. The purpose of liquidity risk indicators is to reflect objectively the degree of the Bank's liquidity risk and to quickly identify any increase in liquidity risk. The Bank's Liquidity Risk Management Policy includes certain activities in order to improve the Bank's liquidity situation, if liquidity risk indicators reach certain levels;

2.7.5. Liquidity risk stress testing:

2.7.5.1. liquidity stress testing calculates the excess (or deficit) of liquid assets of the Bank, involving both less detrimental but more likely scenarios and detrimental/particularly detrimental but sufficiently unlikely ones. The less detrimental, more likely scenarios are tested in order to verify that the amount of the Bank's liquid assets in the relevant stress scenarios would be sufficient in order to maintain the Bank's liquidity ratio at no less than 60%. The detrimental/particularly detrimental but sufficiently unlikely scenarios are tested in order to verify that the amount of the Bank's liquid assets in the relevant stress scenarios would be sufficient in order to maintain the Bank's business activities, i.e. execution of client payments. The Bank assumes that the amount of liquid assets required for maintaining its business activities, i.e. executing client payments, equals at least 30% of short-term liabilities (30% liquidity ratio);

2.7.5.2. The result of liquidity risk stress testing is determined primarily by assumptions made regarding potential loss of client deposits. It is assumed that the Bank might suffer a major decrease in client deposits compared to previous events in its relatively short business history.

2.7.5.3. If the results of stress testing indicate that the Bank may face a deficit of liquid assets and require attraction of additional (external) financing to sustain its activities and meet regulatory liquidity benchmarks in a liquidity stress scenario, then the options of attracting the necessary amount in additional external financing – and the expenses related to attracting such emergency funding (also known as liquidity risk losses) – are evaluated in the Action Plan for Liability Crisis Situations;

2.7.5.4. liquidity risk testing results as of 31.12.2014 showed that the Bank would be able to maintain operations and adhere to regulatory liquidity indicators even in highly detrimental liquidity stress scenarios without attracting external financing; therefore, potential losses for the Bank due to liquidity risk were estimated at zero;

2.7.5.5. the results of stress testing serve as the general limit on investments in illiquid assets – limits on investments in assets with low liquidity are specified in such a way that allocation thereof despite manifestation of liquidity stress scenarios would enable the Bank to maintain its operations and comply with regulatory liquidity indicators.

3. Capital adequacy assessment process

3.1. The purpose of the capital adequacy assessment procedure is to evaluate all risks borne by the Bank and evaluating and ensuring adequate coverage of these risks with capital.

3.2. The procedure of internal evaluation of the Bank's capital adequacy is specified in the Bank's Capital Adequacy Management Policy.

3.3. Internal evaluation of capital adequacy is performed on a quarterly basis, within one month following the end of a calendar quarter.

3.4. The Bank's capital is evaluated as either "adequate" or "inadequate" by the Bank's Investment Committee (IC). All calculations are performed by the Financial Analysis and Financial Risk Management Department, in accordance with the procedure specified in the Bank's Capital Adequacy Management Policy and annexes thereto, using assumptions specified by the IC where applicable.

3.5. On the basis of FCMC Regulations on the Internal Capital Adequacy Assessment Process, the Bank defines:

3.5.1. the amount of capital necessary to cover risks (capital requirements);

3.5.2. the capital reserve;

3.5.3. total capital necessary (the total of capital to cover risks and the capital reserve);

3.5.4. amount of capital at the Bank's disposal.

3.6. The Bank employs the simplified methods specified in the FCMC Regulations on the Internal Capital Adequacy Assessment Process for evaluating credit risk, concentration risk, debt securities price risk, currency risk and operational risk capital requirements. The Bank employs in-house approaches and methodologies to determine capital requirements for liquidity risk, interest rate risk in the non-trading portfolio, money laundering/terrorist financing risk, reputational risk, strategy and business risk, and "other" risks:

3.6.1. Capital requirements for credit risk (applies to the Bank's claims on credit institutions and other counterparties, loans to clients, investments in debt securities, and investments in other assets) include all capital requirements which, in accordance with EU Regulation 575/2013, apply to credit risk, as well as concentration risk (additional credit risk related to loans to clients and investments in bonds) calculated using the FCMC Regulations on the Internal Capital Adequacy Assessment Process. In addition to capital requirements determined using the aforementioned simplified methods, the Bank also conducts stress testing of credit risk related to client loans (including loans taken over), stress testing of credit risk related to investments in debt securities, and assessment of credit risk related to claims on other credit institutions and counterparties, and if potential losses determined using stress testing or assessment exceed capital requirements determined using simplified methods, the difference between potential losses determined using stress testing or assessment and capital requirements determined using simplified methods is included in the capital reserve amount:

3.6.1.1. Major assumptions for stress testing of credit risk related to loans issued to clients (excluding securities-backed loans) are specified by the IC

3.6.1.2. Stress testing of credit risk related to the Bank's investments in debt securities and loans against debt securities is performed using the Securities Credit Risk Stress Testing Methodology;

3.6.1.3. The calculation of potential losses is based on the assumption that the probability of default in the obligations of issuers is characterised by, and may be predicted based on, historical data about default (non-performance) by issuers maintained by the Moody's ratings agency, available as a list of defaulting issuers grouped by credit capacity rating. Potential (1 year) losses are calculated with the assumption that the amount of investments in securities and loans against securities, as well as the distribution of this volume among issuers with specific credit capacity ratings will remain unchanged

during the subsequent 12-month period (i.e. other securities with the same rating as redeemed securities will be purchased). Thus, potential losses are calculated regardless of the remaining maturity terms of such securities, factoring in only the credit capacity of the issuers;

3.6.1.4. during calculation of potential losses, the likelihood of (partial) recovery of investments in the event of default by an issuer (also known as the Recovery Rate) is considered;

3.6.1.5. to calculate potential losses, 1000 tests/simulations are performed, and in each of the tests each issuer may potentially default or not default based on the relevant default probability. Losses from investments in the securities of each issuer in the event of default are calculated by multiplying the total of the Bank's investments and loans by (1 minus recovery rate); the total of losses from all defaults by all issuers thus constitutes the Bank's total potential losses for the relevant test/simulation. Potential losses of the Bank are calculated as total losses in the 40th worst (by total losses) test/simulation out of the 1000;

3.6.1.6. default probabilities for the subsequent 12-month period in the negative stress testing scenario use the ratio of total defaulting issuers (by rating) to the total number of issuers (by rating) observed in 2009, the year following a financial crisis when the ratio of issuers in default was one of the highest observed in 31 years (from 1983 to 2013);

3.6.1.7. assessment of credit risk related to claims on other credit institutions and counterparties is performed by the Bank's IC, considering concentration of the Bank's claims among various counterparties and countries;

3.6.2. The capital requirements for debt securities price risk and currency risk are consistent with capital requirements specified in EU Regulation 575/2013. In addition to the capital requirements specified using the aforementioned simplified methods, the Bank also performs stress testing of these risks; if potential losses determined using stress testing or assessment exceed capital requirements determined using simplified methods, the difference between potential losses determined using stress testing or assessment and capital requirements determined using simplified methods is included in the capital reserve amount:

3.6.2.1. stress testing of market risk for bonds is performed in accordance with the Debt Securities Market Risk Stress Testing Methodology. Stress testing determines potential losses that the Bank might sustain in the event of a major market crisis and ensuing decrease in the value of securities in its trading portfolio (1 month scenario), as well as if the Bank should be forced to liquidate the entirety of its securities portfolios (including the investment portfolio) 1 year following the date of the stress testing with the assumption that the prices of such securities would be at historically low levels at that point (1 year scenario);

3.6.2.2. to calculate potential losses for the Bank due to potential decrease in debt securities prices, maximum expected bond revenue levels are specified (depending on credit capacity ratings)given a stress situation. It is assumed that the likely level of bond income under market stress would be characterised by the highest income on various Russian and CIS country issuers' bonds observed during the period of time from October 2014 till February 2015;

3.6.2.3. the results of internal capital adequacy assessment include "1 year" scenario results. For bonds with a term to maturity that exceeds 1 year as at the date of stress testing, the stress scenario price is calculated using the Excel PRICE formula at the date 1 year following the stress testing date, given stress scenario income for the relevant credit rating, and for bonds with a term to maturity of no more than 1 year following the stress testing date, the Bank's potential losses are calculated as the difference between the value of a bond at market price and at price = 100; Potential losses are calculated as the difference between the current balance sheet value of a security and its stress testing value (divided by 100) and multiplied by the balance sheet value of the relevant security. The "1 year" scenario includes the Bank's expected income from securities coupons;

3.6.2.4. currency risk stress testing calculates potential losses to the Bank from potential changes in exchange rates (within 1 day). The period of holding a position for 1 day has been selected because the periodicity of holding positions is actually short (the Bank does not maintain a position in any currency long-term), and the Bank is capable of closing any position within a short span of time. To calculate potential losses, the (absolute) value on the position stress testing date (for positions worth > EUR 70 thous.) is multiplied by the largest change in the value of the relevant currency (against EUR) within 1 day during the period since the beginning of 2008;

3.6.3. interest rate risk in the Bank's non-trading portfolio is evaluated in accordance with the procedure specified in the Interest Rate Risk Management Policy. If the IC has identified/assessed interest rate risk as significant, the Financial Analysis and Financial Risk Management Department conducts stress testing of interest rate risk quarterly within the framework of its internal assessment of capital adequacy, calculating the potential impact of changes in base interest rates (in the currencies significant for the Bank) on the Bank's net interest income (non-trading portfolio) and, if stress testing calculations show that the Bank's net interest income as a result of changes in interest rates might be negative, the potential losses are considered the capital requirement for this risk;

3.6.4. considering that the base interest rates in USD and EUR were near zero as of 31.12.2014 (0-0.25% and -0.20%), which essentially excluded the likelihood of a decrease, and the fact that any increase in these rates would have a positive impact on net interest income of the bank, during its 31.12.2014 risk identification the Bank's IC identified and assessed the interest rate risk in the Bank's non-trading portfolio as insignificant (equal to zero);

3.6.5. The liquidity risk capital requirement is determined based on liquidity risk stress testing results. If stress testing indicates that liquidity risk stress scenarios could produce a deficit of liquid assets for the Bank, potentially requiring attraction of additional (external) financing for the Bank to maintain its operations and meet regulatory liquidity criteria, then expenses that might be related to attracting such emergency assets are evaluated, and these expenses are considered the liquidity risk capital requirement. The procedure of stress testing liquidity risk is described in section 2.7.5 of this report;

3.6.6. The operational risk capital requirement is defined as the larger of two values: the operational risk capital requirement determined using the basic indicator approach specified in EU Regulation 575/2013 575/2013, and the value of potential operational risk losses determined/estimated by the Bank's Non-financial Risk Management Committee (over a 1-year period);

3.6.7. Strategy, business, AML, reputational risks:

3.6.7.1. as mentioned in section 2.6 of this report, the Bank assumes the risks of strategy, business, AML and reputational risks, and believes that the worst-case scenario that might occur if the aforementioned risks manifest themselves, is (1) major decrease in client deposits and (2) major decrease in income from fees. The potential decrease in client deposits is included in liquidity risk stress testing, while the risk of decreased income from fees is calculated in the manner outlined below;

3.6.7.2. the fee income risk is calculated as the difference between the total of the Bank's administrative expenses (annualised based on the preceding quarter) and 50% of the Bank's net fee income and currency trading income during the preceding 12 months: if the amount of administrative expenses of the Bank exceeds 50% of its net fee and foreign exchange income total, then the relevant positive difference is considered the Bank's fee income risk; otherwise, fee income risk is assumed to be zero;

3.6.8. The capital requirement for covering other risks is calculated as 5% of the total of minimal regulatory capital requirements.

3.7. Capital reserve:

3.7.1. The Bank defines the capital reserve as the total of (1) additional capital necessary for covering risks (to ensure that the Bank's capital is sufficient for the occurrence of unfavourable scenarios significant for the Bank, as well as to ensure the Bank's capital adequacy throughout the economic cycle) and (2) minimum capital necessary for the Bank in the aforementioned negative scenarios to maintain operations, i.e. observe the capital adequacy requirement;

3.7.2. To determine the additional capital necessary to cover risks (for which the capital requirement is determined using simplified methods), stress testing or evaluation is performed, and the amounts of potential losses obtained using stress testing/evaluation are compared to capital requirements specified using simplified methods. If the amount of potential losses obtained using stress testing/evaluation exceeds capital requirements specified using simplified methods, the positive difference is assumed to represent additional capital necessary for risk coverage; otherwise, no additional capital is assumed necessary for covering the relevant risk;

3.7.3. The minimum capital that might be necessary for the Bank to continue operation, i.e. maintain the capital adequacy indicator in significant negative scenarios, is calculated by multiplying the expected total value of risk-weighted assets following all significant losses from all significant risks and the increased individual minimum capital adequacy indicator specified for the Bank.

3.8. Capital at the Bank's disposal:

3.8.1. For the purpose of evaluating capital at the Bank's disposal, the Bank defines such capital as its net worth, calculated on the basis of EU Regulation 575/2013 by adding 50% of the unaudited, undistributed profit for the reporting year (and prior years), considering the dividend payment policy/plans and the fact that undistributed profits are fully available for coverage of sudden losses should such losses arise;

3.8.2. The decision to include unaudited undistributed profit in capital at the Bank's disposal is made by the IC (each time that internal assessment of capital adequacy is performed), evaluating whether the undistributed profit would be available for coverage of potential losses.

3.9. Following assessment of total necessary capital (capital necessary for coverage of risks plus capital reserve) and of capital at the Bank's disposal, the capital excess/deficit is calculated in the interpretation of FCMC Regulations on the Internal Capital Adequacy Assessment Process as the difference between capital at the Bank's disposal and the total capital requirement.

3.10. In evaluating its capital as "adequate" or "inadequate", the Bank also considers available measures to mitigate risk/ increase capital, which the Bank could relatively easily and without significant additional expenses implement in order to increase its capital adequacy indicator.

3.11. If calculations show that, following potential losses in all significant risks, available measures would produce a higher than minimal individual capital adequacy indicator for the Bank, then the Bank's capital may be assessed as "adequate". If calculations show that, following potential losses on analysis significant risks and available measures would produce a lower than minimal individual capital adequacy indicator for the Bank, the Bank's Capital Adequacy Management Policy specifies appropriate measures to inform the Board and Council of the Bank and the FCMC, as well as actions to ensure that the calculated potential capital adequacy is no less than the specified individual minimum value.

3.12. In order to evaluate the adequacy of additional capital, the Bank's Capital Adequacy Management Policy also specifies capital/capital adequacy planning measures performed within the framework of planning the Bank's budget.

4. Overview of the results of the capital adequacy assessment process

4.1. Results of Bank's internal capital adequacy assessment are largely dependent on the capital adequacy calculation performed in accordance with EU Regulation 575/2013:

4.1.1. Calculation of the Bank's capital adequacy as of 31.12.2014, (EUR thous., excluding undivided profits for 2014:

Tier-one capital	42,246
Statutory capital	*39,493*
Reserve capital	*24*
Undivided profits from previous years	*6,502*
Other reserves	*-2,400*
Intangible assets	*-737*
Other deductions	*-636*
Tier-one capital	11,322
Subordinated capitalSubordinētais kapitāls	*11,322*
Tier one and two capital adjustment	-1,142
Total equity	**52,426**

	Expressed in risk-weighted assets (RWA)	*Expressed in capital (RWA * 8%)*
Credit risk (standardised approach)	243,771	19,502
Institutions	*80,354*	*6,482*
Commercial companies	*120,238*	*9,619*
Risky transactions with defaults on obligations	*67*	*5*
Capital securities risk transactions	*19,505*	*1,506*
Other assets	*23,607*	*1,889*
Market risks	20,274	1,622
Debt securities (trading portfolio): general risk (price risk)	*5,638*	*451*
Debt securities (trading portfolio): specific risk (credit risk)	*14,302*	*1,144*
Currency risk	*334*	*27*
Operational risk (basic indicator approach)	45,478	3,683
Risks total	**309,524**	**24,762**
Capital adequacy ratio	**16.94%**	

4.1.2. as of 31.12.2014, the ratio of the Bank's equity to non-risk-weighted assets was 9%, significantly exceeding the 3% minimum specified in Basel III guidelines;

4.1.3. credit risk accounts for the largest fraction of the Bank's risk-weighted assets. The following table groups the Bank's assets by type of risky transaction (institutions, commercial companies etc.) and credit quality level (risk weighting) in thousands of EUR as of 31.12.2014:

	Expressed in non-risk-weighted assets	*Expressed in risk-weighted assets (RSA) following analysis adjustments*
Central banks and governments	12,296	0
0% (risk weighting)	*12,296*	*0*
Institutions	301,919	80,354
20%	*259,015*	*51,803*
50%	*28,706*	*14,353*
100%	*14,198*	*14,198*
Commercial companies	134,090	120,238
100%	*116,536*	*94,154*
150%	*17,555*	*26,083*
Risky transactions with defaults on obligations	90	67
100%	*81*	*53*
150%	*9*	*14*
Capital securities risk transactions	21,005	19,505
100%	*21,005*	*19,505*
Other assets	24,614	23,607
0%	*710*	*0*
20%	*533*	*107*
100%	*16,696*	*15,939*
150%	*6,675*	*7,561*

4.1.4. to determine risk weighting in the transaction categories "central banks and governments" and "institutions", credit ratings assigned by external credit ratings institutions are used in accordance with EU Regulation 575/2013 (hereinafter referred to as the Regulation) requirements, and the bank uses the "average" of the ratings assigned by ratings companies Standard & Poor's, Moody's, and Fitch Ratings to determine the risk-weighted value of each transaction. In the "commercial companies" and other categories (not including "central banks and governments" and "institutions") the base/standard risk-weighting is 100%; higher or lower risk-weightings may be applied depending on the requirements of the Regulation based on the type of the Bank's terms and conditions, observance of the terms and conditions, transaction collateral, and the rating assigned to the counterparty's country of domicile. In accordance with the provisions of the Regulation, the "institutions" transaction category applies solely to institutions (credit institutions and investment companies) registered in the European Union and institutions on the list of countries approved by the European Banking Authority; credit institutions and investment companies not registered in the European Union or on the aforementioned list are included in the "commercial companies" transaction category;

4.1.5. to mitigate credit risk for loans granted to clients (included in the "commercial companies" category), the Bank obtains collateral (as mentioned in clauses 2.3.6 and 2.3.8 of this report). However, collateral is not considered while calculating the Bank's capital adequacy indicator (excluding an insignificant amount in monetary collateral and guarantees).

4.2. The results of the previous internal capital adequacy assessment as of 31.12.2014 (prior to available measures to improve the capital adequacy ratio) are as follows:

EUR thous.	**Internal assessment of capital adequacy**	**Minimal capital requirement calculation**
Credit risk	20,646	
Standardised approach (SA)	19,502	19,502
Credit portfolio (commercial companies, excluding investment portfolio and repo securities)	*5,360*	*5,359*

Commercial companies (investment portfolio)	*1,625*	*1,625*
Repo loans against securities	*588*	*588*
Loans (formerly banks)	*2,052*	*2,052*
Correspondent accounts and interbank loans	*5,677*	*5,677*
Debt securities	*751*	*751*
Other items	2,905	2,905
Loans taken over	544	544
Debt securities position risk capital requirement, specific risk; risk capital requirement, specific risk	1,144	1,144
Concentration risk	1,967	
Loans	981	
Individual concentration risk	643	
Institutional concentration risk	322	
Collateral concentration risk	0	
Currency imbalance concentration risk for resident households	16	
Debt securities (including banks)	986	
Individual concentration risk	493	
Industry concentration risk	493	
Market risks	478	
Debt and capital securities position capital requirement, general risk	451	451
Currency risk capital requirement	27	27
Interest rate risk in the non-trading portfolio	0	
Operational risk	3,638	3,638
Strategy/business, ML/TF and reputational risks	0	
Liquidity risk	0	
Other risks	1,238	
Capital reserve	45,751	
Capital reserve (related to additional risk)	7,964	
Capital reserve/capital (to ensure capital adequacy despite all risks)	37,787	
Total capital necessary for covering risks	**73,718**	**24,762**

Tier 1 and Tier 2 capital	53,568	
Additional capital elements: undistributed profit for current year	3,900	
Additional capital elements: equity capital adjustment	-1,142	
Total capital at the Bank's disposal	**56,326**	
Capital surplus or deficit according to the Bank's assessment (prior to measures to improve capital adequacy)	**-17,392**	

Results of internal capital adequacy assessment as of 31.12.2014 (with available capital adequacy improvement measures):

EUR mio.	**Actual, 31.12.2014**	**Prior to improvement measures: considering total capital necessary for covering risks***	**With securities sale/discharge and repo termination measure: P1****	**With placement of funds on Bank of Latvia correspondent account, in sovereign bonds: P2 in addition to P1**	**With attraction of EUR 5 mio. in subordinated capital: P3 in addition to P1 and P2**
Correspondent accounts and interbank (20%)	51.1	48.5	64.7	41.3	42.3
Interbank (50-100%)	52.0	52.0	52.0	-	-
Bonds (50-150%)	48.8	42.3	5.5	5.5	5.5

Repo and bsb (100%)	7.4	7.4	0.4	0.4	0.4
Loans etc. (100%)	56.3	46.0	46.0	46.0	46.0
Fixed assets etc. long-term and other (100%)	47.3	41.2	41.2	41.2	41.2
Off balance sheet: non-drawn credit lines etc.	5.4	5.4	5.4	5.4	5.4
Risk-weighted assets	**268.3**	**242.8**	**215.2**	**139.8**	**140.8**
Capital requirement for general risk of debt and capital securities	0.3	0.3	0.0	0.0	0.0
Capital requirement for currency risk	0.1	0.1	0.1	0.1	0.1
Capital requirement for operational risk	3.6	3.6	3.6	3.6	3.6
TOTAL, expressed as risk-weighted assets	318.4	292.9	261.7	186.3	187.3
Stock capital	**52.4**	**20.4**	**20.4**	**20.4**	**25.4**
Simplified CA indicator	**16.47%**	**6.96%**	**7.79%**	**10.94%**	**13.56%**
EXCESS CAPITAL GIVEN AVAILABLE MEASURES					**EUR 1.2**

** - considering reduction in the value of risky assets at the expense of potential losses*

*** - except bonds with discharge terms of over 2 years, which may become illiquid if a major market crisis arises*

4.3. On 31.12.2013, capital at the Bank's disposal was assessed at EUR 56.3 mio., capital necessary for risk coverage (including capital for maintaining business if stress scenarios occur) – EUR 73.7 mio., capital deficit in the interpretation of FCMC Regulations on the Internal Capital Adequacy Assessment Process - EUR 17.4 mio.

4.4. Considering that, if negative scenarios occur, the Bank would be able to quickly and without significant additional losses implement the following measures to improve its capital adequacy situation –

4.4.1. Reducing/liquidating investments in bonds, including at the expense of discharging obligations at (maturity) – except investments in longer-term bonds that may become illiquid – as well as to reduce/liquidate the portfolio of loans backed by securities (repo);

4.4.2. Investing up to EUR 170 mio. in 0%-risk assets on a correspondent account with the Bank of Latvia and in 0%-risk sovereign bonds;

4.4.3. Attracting EUR 5 mio. in subordinated capital, allowing to secure excess capital of EUR 1.2 mio. an a capital adequacy ratio of 13.56%; the Bank's Investment Committee assessed the Bank's capital as of 31.12.2014 as adequate and decided that no additional measures were necessary for improving the Bank's capital adequacy situation.