Information on risks in activities of AS „SMP Bank" in 2010, objectives, methods and policies of risk management, as well as on requirements to equity and internal capital adequacy.

The information has been prepared in compliance with Regulations No. 61 on disclosure of information, approved by the decision of the Council of the Financial and Capital Market Commission of 02.05.2007 and partially reflected in the AS "SMP Bank" (hereinafter referred to as the Bank) Bank and Consolidated Financial Statements for the year ended 31 December 2010 (hereinafter referred to as the Annual Report for the year 2010)**.**

Information on the Bank's management is reflected in the Annual Report for the year 2010 on page 4, and has not changed since its publication.

Information on the composition of the consolidated group and methods of consolidation is reflected in the Annual Report for Annual Report for the year 2010 on pages 13-14, and has not changed since its publication.

The aim of capital adequacy assessment is to ensure that the capital of the Bank in respect of amount, capital units and their proportion would be sufficient to cover existing and probable risks of current and planned activities of the Bank.

The Bank has worked out the Policy and Process of Capital Adequacy Assessment. For the purposes of the process of capital adequacy assessment the Bank is using and is going to use in the future the definition of capital given in Section 3 of the FCMC Regulations No. 60 on calculation of minimum requirements to capital dated 02.05.2007 (hereinafter referred to as the CMRC). The same definition of capital Bank is using for the purposes of the own results assessment, risk management and for other decisions on current and future activity.

For identifying of significant risks an expert method was applied, as well as the results of researches on significant risks in banking sphere worldwide and in separate regions. Significant risks, in the opinion of the Bank's management, were Credit risk, Liquidity risk, Currency risk, Interest rate risk, Operational risk (including legal risk), Risk of non-compliance with Anti Money Laundering regulation, Country risk, Reputation risk and Strategic risk.

During the year 2010, the Bank assessed the capital adequacy by applying „Basel's First Pillar +" approach. The capital amount required to cover the risks (hereinafter referred to as requirements of the Internal Capital) is calculated as the sum of

- minimum capital requirements;
- capital requirements for risks for which no minimum regulatory capital requirements are established. The capital amount required to cover the risks is formed from the capital amount required to cover individual risks

and the rest of the existing and potential risks inherent in the Bank's dealing operations;

- Capital reserve - the amount of capital that is needed to ensure that the Bank's capital is sufficient in case of occurrence of possible adverse events, as well as to ensure that banks have sufficient capital over the economic cycle, i.e., during the period of economic upturn the Bank holds capital reserves to cover losses, that may arise during the period of economic downturn.

Methods used for calculation of minimum capital requirements.

The Bank applied standardized approach to calculation of capital requirements for credit risk, according to the CMRC. The Bank has nominated an external credit rating institution – *Standard & Poor's Ratings Services* – for determining of credit quality level for all categories of risk transactions.

The bank shall assess whether the 35% risk rate, to be applied to the loans secured by residential real estate, is consistent with the projected developments in real estate market. Where there is established customer solvency deterioration, collateral values decrease, the enforcement problems or other negative trends in the real estate market or the economy, when calculating the capital amount required to cover the credit risk concerning this exposure category, the bank will apply a risk weight, which is higher than 35 percent risk weight and which may differ from the risk weights in the standardised approach.

The Bank is allowed not to calculate the capital requirements for risk of positions of debt securities and capital securities of trading book, instead applying the approaches to calculation of capital requirements, mentioned in Chapter II Section 2 and Section 3 Clause 3 of the CMRC. The conditions of application of the above approaches are determined in the Bank's Trading Book Policy and are strictly controlled.

The capital requirements for settlement risk of trading book were calculated according to the provisions of Chapter II Section 3 Clause 2 of the CMRC.

The capital requirements for credit risk of the trading book transaction partner were calculated according to the provisions of Chapter II Section 3 Clause 3 of the CMRC. For determining of the value of risk transactions the Bank applied the original cost method according to the provisions of Clause 3 of Annex 1 to the CMRC.

The capital requirements for foreign currency risk of non-trading book and trading book were calculated according to the provisions of Chapter II Section 3 Clause 4 of the CMRC.

The capital requirements for commodity risk of non-trading book and trading book were calculated according to the provisions of Chapter II Section 3 Clause 5 of the CMRC.

For calculation of capital requirements for operational risk the Bank applied the basic index approach, according to the CMRC.

For currency and transaction risk the Bank assessed whether the level of risk, calculated according to minimum capital requirements, is sufficient to cover damages related to such risk. An open foreign exchange position in recent years did not exceed 3% of its own capital. Exchange rate risk, as calculated in compliance with regulatory minimum capital requirements, in 2010 was sufficient to cover exchange rate risk related losses. In 2010 the operational risk internal capital requirement was added to the operational risk capital requirement.

The Bank calculates the individual internal capital requirements for the following risks for which no minimum capital requirements have been determined:

- interest rate risk in the nontrading book;
- the effect of concentration risk on the credit risk;
- money laundering and terrorism financing risks;

The Bank uses a simplified method for calculating the capital amount required to cover the interest rate risk.

The Bank uses a simplified method for calculating the capital amount required to cover the concentration risk. In addition, the Bank limits the potential exposure levels – requirements for one client, requirements for a group of mutually connected clients, the requirements for customers whose activities are related to one sphere and economic sector. In 2010 the Bank strictly observed the concentration risk limits. Risk limit reviews are regularly examined by the Board.

The Bank uses a simplified method for calculating the capital amount required to cover the money laundering and terrorist financing risks.

Other included risks are the following: liquidity risk, country risk, reputation risk, strategic risk, as well as non-essential risks.

The Bank uses a simplified method for calculating the capital amount required to cover other risks. The capital amount required to cover the risks is 5% of the total sum of regulatory minimum capital requirements.

The Bank provides capital reserve to ensure that the Bank's capital is sufficient in case of occurrence of possible adverse events, as well as to ensure that banks have sufficient capital over the economic cycle, i.e., during the period of economic upturn the Bank holds capital reserves to cover losses, that may arise during the period of economic downturn.

The Bank uses a simplified method for calculating the capital reserve, i.e. capital reserve is 10% of the total sum of regulatory minimum capital requirements.

The Bank in case of occurrence of possible adverse events can use the capital reserve to cover losses and to keep smaller capital reserves when covering losses related to occurrence of adverse events using the previously established capital reserve. At the same time the Bank shall take all necessary steps to restore in appropriate time the capital reserve used for other potential adverse events, as well as to ensure that the available amount of capital is sufficient over the economic cycle. When the economy is in a downturn, the capital reserve is up 2% of the total sum of regulatory minimum capital requirements. In the period of economic upturn the capital reserve during the six months period is restored to 5%, but during the 1 year period is restored at the amount of 10% of the total sum of regulatory minimum capital requirements.

The Bank calculates the total capital amount required as the sum of the required amount of capital and capital reserve to cover all the risks for which the Bank provides capital in the process of capital adequacy assessment.

The legislation of the Republic of Latvia provides for the banks minimum capital adequacy index of 8%. In accordance with the requirements of the Bank’s Policy of Capital Adequacy Assessment, the Bank’s regulative capital adequacy ratio should be equal to 10% or higher. The internal capital adequacy ratio (minimum capital requirements plus special internal capital requirements and capital reserve) should be 8% or higher. The above limits are adequate to the scope and complexity of the Bank’s activities and are sufficient to cover the risks inherent to the Bank’s activities. In 2010 the Bank observed these requirements.

The Policy of Capital Adequacy Assessment stipulates that the Bank’s capital must be sufficient for current activities and future development of the Bank. The Bank plans capital adequacy for at least a three-year period.

For planning of capital adequacy the Bank takes into account:

- forecast for the Bank’s activities (risk level forecast, profit forecast, forecast of amount and structure of assets and liabilities, customer needs and maximally allowable amounts of risk transactions of the Bank, results of stress tests);
- intentions of the Bank’s shareholders (dividends policy, possibility of new issues);
- economic conditions and forecast for market trends.

Increase of the Bank’s equity can be achieved by:

- increase of the Bank’s net profit;
- additional contributions to capital (additional stock issue);
- attraction of subordinated capital.

In a crisis situation, when the regulatory or internal limits of capital adequacy are not observed or most likely will be exceeded, the Bank, first of all, provides for attraction of subordinated capital with the help of its shareholders.
During 2010, according to the Bank's Strategic plan, capital was increased by LVL’000 2000.

The bank uses stress tests for assessment of future risks. Stress tests help identify such probable events or probable market changes, which may have negative affect on the amount of the Bank’s capital. Stress tests simulate situations corresponding to strategic approaches to the Bank’s economic activities and possible changes of market situation. The Bank carried out stress tests in credit risk (5 scenarios), liquidity risk (6 scenario) and interest rate risk (1 scenario). Test results as at 31.12.2010 confirm that the Bank’s capability to absorb negative consequences of realization of different scenarios is acceptable.

Additional information about significant risks management methods used by the Bank is reflected in the Annual Report for the year 2010 on pages 22-67, and has not changed since its publication.

Remuneration policies and practices of the Bank.

Employees' salaries are determined based on the list of salary rates, defining salary interval boundaries applied for each post, which is approved by the Board of the Bank.

For making decisions on the employee's salary increase within the definite salary interval boundaries the Bank can use:

- the results of regular certification of employees,
- recommendation by Head of Department,
- other objective information about the employee`s results compiled by the Bank staff inspector.

By developing and applying models of remuneration, the Bank ensures that the remuneration model, either directly or indirectly, does not motivate the employee to treat carelessly concerning his or her official duties, or to use his or her power contrary to the Bank's interests, including complying with the risk limits, as well as other quasi-boundary conditions, defined by the Bank's policies, procedures, or the legislation, regulations and laws of the Republic of Latvia.

The Board consists of 6 persons. The salary of the members of the Board is not changeable. In 2010 it amounted to LVL’000 148. The salary of other Bank's risk profile affecting employees is also not changeable. In 2010 it amounted to LVL’000 115.

In 2010 the salary of 37 Bank's risk profile non-affecting employees consists of fixed component and a variable component. The fixed component contained the funds of LVL’000 279, while the variable component contained the funds of LVL’000 3.
In 2010 3 employees with whom the Bank terminated the employment relationship, received a total severance pay at the amount of LVL’000 3. The largest amount of severance pay per person was equal to LVL’000 2.

Figure 1. Minimum Capital Adequacy Assessment as at 31.12.2010. LVL’000

Item	Bank	Group
Minimum capital adequacy requirements; total	6916	6899
Credit risk capital adequacy requirements; total	6351	6360
incl. claims or contingent claims against central governments or central banks	0	0
incl. claims or contingent claims against institutions	833	833
incl. claims or contingent claims against entities	5194	5078
incl. claims or contingent claims with real estate collateral	9	9
incl. past due exposures	231	231
incl. other claims	84	209
Market risk capital adequacy requirements; total	43	21
incl. capital requirements for settlement risk of trading book	0	0
incl. capital requirements for credit risk of the trading book transaction partner.	0	0
incl. capital requirements for foreign currency risk of non-trading book and trading book	43	21
incl. capital requirements for commodity risk of non-trading book and trading book	0	0
Operational risk capital adequacy requirements	522	518

The Bank use deposits as collateral for purposes of Credit Risk Mitigation.

Figure 2. Bank's exposure before and after Credit Risk Mitigation (CRM) as at 31.12.2010. LVL'000

Conversion factor	Exposure Classes	central governments or central banks	Institutions	Entities	with real estate collateral	past due exposures	other claims
0%	before CRM	12627	71	7037			1936
	after CRM	12627	71	8053			1936
20%	before CRM		52037				231
	after CRM		52037				231
35%	before CRM				238		
	after CRM				238		
100%	before CRM			66952	26	495	1008
	after CRM			65936	26	495	1008
150%	before CRM					1592	

Conversion factor	Exposure Classes	central governments or central banks	Institutions	Entities	with real estate collateral	past due exposures	o ther claims
	after CRM					1592	