

Information on risks in activities of AS „SMP Bank” in 2011, 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 2011 (hereinafter referred to as the Annual Report for the year 2011).

Information on the Bank's management is reflected in the Annual Report for the year 2011 on page 4, and has not changed since its publication. On 8 November 2011 Irina Cibulonoka was appointed to the Board.

Information on the composition of the consolidated group and methods of consolidation is reflected in the Annual Report for Annual Report for the year 2011 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.

The definition of capital for minimum capital adequacy purposes meets definition of capital according to the Section 3 of the CMRC. The definition of capital according to the Section 3 of the CMRC for minimum capital adequacy purposes has been supplemented by the unaudited profit for the current year. Unaudited profit for the current year is available in a crisis situation to cover losses from any kind of risks.

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 2011, 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 5% of its own capital. Exchange rate risk, as calculated in compliance with regulatory minimum capital requirements, in 2011 was sufficient to cover exchange rate risk related losses. In 2011 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 2011 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 one year period is restored to 5%, but during the two years period is restored at the amount of 10% of the total sum of regulatory minimum capital requirements. In 2011 capital reserve was calculated at 5% 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, in 2011, 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 2011 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 2011, according to the Bank's Strategic plan, capital was increased by LVL'000 2232.

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 (6 scenarios), liquidity risk (1 scenario) and interest rate risk (1 scenario). In 2011 the credit risk stress testing methodology has been significantly improved to meet the " Regulations on the Internal Capital Adequacy Assessment Process" No. 38, approved by the Financial and Capital Market Commission decision (from 03/20/2009) requirements, taking into account the Bank's scope of activity and specificity, namely: the Bank analyzes how the macroeconomic indicators effects on credit risk; the Bank of analyzes for changes in the balance sheet, profit and equity in accordance with the Bank's current economic development strategy, within one year and two years; the Bank conducts reverse stress testing.

Test results as at 31.12.2011 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 21-65, 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 7 persons. The salary of the members of the Board is not changeable. In 2011 it amounted to LVL'000 168. The salary of other Bank's risk profile affecting employees is also not changeable. In 2011 it amounted to LVL'000 184.

In 2011 the salary of 74 Bank's risk profile non-affecting employees consists of fixed component and a variable component. The fixed component contained the funds of LVL'000 496, while the variable component contained the funds of LVL'000 12.

In 2011 none of the employees, with whom the Bank terminated the employment relationship, received a severance pay.

Figure 1. Minimum Capital Adequacy Assessment as at 31.12.2011. LVL'000

Item	Bank	Group
Minimum capital adequacy requirements; total	8260	8356
Credit risk capital adequacy requirements; total	7676	7687
incl. claims or contingent claims against central governments or central banks	0	0
incl. claims or contingent claims against institutions	1037	1037
incl. claims or contingent claims against entities	5953	5656
incl. claims or contingent claims with real estate collateral	3	3
incl. past due exposures	609	609
incl. other claims	74	382
Market risk capital adequacy requirements; total	14	89
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	14	89
incl. capital requirements for commodity risk of non-trading book and trading book	0	0
Operational risk capital adequacy requirements	570	580

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 31.12.2011. 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	18292		9174			3014
	after CRM	18292		11568			3014
20%	before CRM		45477				86
	after CRM		45477				86
35%	before CRM				116		
	after CRM				116		
100%	before CRM		3864	80932		2180	909
	after CRM		3864	77476		2180	909
150%	before CRM					4610	
	after CRM					4610	