NATIONAL BANK OF THE REPUBLIC OF MACEDONIA

Pursuant to Article 64 paragraph 1 item 22 of the Law on the National Bank of the Republic of Macedonia ("Official Gazette of the Republic of Macedonia" No. 3/2002, 51/2003, 85/2003, 40/2004, 61/2005 and 129/2006), and Article 68 of the Banking Law ("Official Gazette of the Republic of Macedonia" No. 67/2007), the National Bank of the Republic of Macedonia Council adopted the following

D E C I S I O N
on the risk management
("Official Gazette of RM" No. 31/2008)

I. GENERAL PROVISIONS

1. This Decision shall prescribe the methodology for managing risks the bank is exposed to during its operations.

2. According to this Decision, risk management shall denote identification, measurement, or assessment, monitoring, control or mitigation of the risks.

II. DEFINITIONS

3. Certain terms used in this Decision shall have the following meaning:

- Risk represents the probability of certain activity or event to have direct adverse influence on the profit and/or on the own funds, or to impede the fulfillment of the bank's objectives;
- Material risks are those risks having significant influence on the bank's operations, i.e. they can considerably influence the bank's profit and own funds;
- Credit risk is a risk of loss for the bank, due to its client inability to service its liabilities toward the bank in the agreed amount and/or within the agreed timeframe;
- Liquidity risk is a risk that the bank cannot provide enough funds for settlement of its short-term liabilities at their maturity, or it provides the necessary funds at very higher costs;
- Currency risk is a risk of loss due to change in the cross-currency exchange rates and/or change in the value of the Denar against other foreign currencies;
- Market risk is a risk of loss arising from the change in the price of financial instruments intended for trading;
- Operational risk is a risk of loss as a result of:

  a. inappropriate or weak internal processes;
  b. inappropriate personnel and improper or weak systems of the bank;

c. external events.

The operational risk shall also include the legal risk.

Legal risk is current or prospective risk to the bank's profit and own funds, caused by violation or non-adherence to the legal framework, agreements, prescribed practices, ethics standards, or as a result of misinterpretation of the regulations, rules, agreements and other legal documents;

- Concentration risk denotes every direct or indirect exposure, or total exposures that can result in a loss that can jeopardize the continuous bank operations;
- Interest rate risk in the banking book is a risk of loss arising from the unfavorable changes in the interest rates, and which influence the banking book items of the bank;
- Country risk is a risk of loss due to the bank exposure to certain country, which may be a result of the economic, social and political environment in the debtor country. A special form of country risk is the transfer risk originating from the possible restrictions in the transfer of funds from one country to another;
- Reputation risk is current, or prospective risk to bank's profit, or own funds, arising from the adverse perception of the customers, creditors, shareholders, investors and regulators of the bank operations;
- Strategic risk is current or perspective risk to the bank's profit, or own funds, arising from the changes in the business environment, adverse business decisions, improper implementation of the decisions or lack of bank responsiveness to the changes in the business environment;
- Stress-tests denote risk management technique used for assessing the potential influence of one or more internal or external risk factors on the financial standing of the bank (solvency, profitability and/or liquidity of the bank);
- Bank's risk profile is documented review of quantitative and/or qualitative estimates of the level of measurable and immeasurable risks the bank takes in its operations. Measurable risks are those, the influence of which on the profit and own funds can be measured, whereas the immeasurable risks are those, the influence of which is determined on the basis of estimate, i.e. appraisal (e.g. strategic and reputation risk).

III. RISK MANAGEMENT SYSTEM

4. The bank shall be required to establish system for managing all material risks it is exposed to, adequate to the nature, size and the complexity of the financial activities the bank performs.

With the system under paragraph 1 of this item, the bank should encompass at least the following types of risks:

- credit risk, including the country risk;
- liquidity risk;
- currency risk;
- market risk;
- interest rate risk in the banking book;
- concentration risk;

- operational risk.

The bank shall be required to include in the risk management system other material risks it is exposed to in its operation, which are not stipulated in paragraph 2 of this item.

The core principles of the individual risks management under paragraphs 2 and 3 of this item are enclosed in the Annex representing an integral part of this Decision.

5. The risk management system shall include:

- establishing risk management rules;
- appropriate organizational structure with clearly defined competencies and responsibilities for risk undertaking and management;
- efficient information system;
- mechanism providing possibility for regular revision of the systems, policies and procedures for risk management;
- adequate system for internal control and adequacy of the internal audit.

III.1. Risk management rules

6. Pursuant to item 5 line 1 of this Decision, the bank shall be required to establish the following:

- strategy for taking and managing risks;
- policies for taking and managing certain risks;
- procedures for identification, measurement or assessment, monitoring, control or mitigation of risks;
- manner of performing stress-tests;
- process of internal capital adequacy assessment process of the bank;
- procedures for introducing new product or system;
- policies and adequate procedures for outsourcing.

Strategy for taking and managing risks

7. The strategy for taking and managing risks shall denote document or set of documents containing: the main objectives and general guidelines in taking and managing risks; general approach to the risk management; general approach to the internal capital adequacy assessment process; general review of the business strategy of the bank, as well as the possible changes in the bank's business strategy; acceptable risk level the bank can be exposed to during its operation.

The strategy for taking and managing risks shall represent an integral part and arises from the business policy and the development plan of the bank (strategy for the bank's operation).

Policies for taking and managing risks

8. Policies for taking and managing risks shall represent a document or a set of documents that contain the following: assessment of the bank capacity to take certain

risks, as well as assessment of its risk profile, organizational structure of the risk management function, basic elements of risk management, acceptable instruments for risks hedging or mitigation, internal control and basic elements of the process of internal capital adequacy assessment process.

Procedures for taking, measurement, or assessment, monitoring, control, or mitigation of risks

9. The procedures under item 6 line 3 of this Decision shall represent a set of documents that should:

- enable timely and comprehensive identification of the risks;
- be based on quantitative and/or qualitative assessments of the measurable and immeasurable risks;
- include rules, manners and steps for risk mitigation, diversification, transfer and avoidance, which are identified, measured and estimated by the bank;
- define the frequency and the methods for risk monitoring.

Method of conducting stress-tests

10. The bank shall be required, once a year at minimum, to conduct stress-tests, in order to estimate whether one or more internal and external risk factors can influence the value of the bank's assets and liabilities, i.e. the level of own funds and the capital adequacy.

The stress tests performed by the bank should be adequate to the size, type and complexity of the bank and the financial activities it performs and should relate to all material risks the bank is exposed to, including the possible correlation between certain risks.

The stress-tests shall be based on the selection of extreme scenarios that can be specific for the bank (internal factors) and those that can arise from the market conditions the bank operates in (external factors).

The stress-tests shall include at least: the effects of deterioration of part or the whole credit portfolio of the bank, the effects of change in the interest rates on the financial markets, the effects of change in the cross-currency exchange rates and the value of the Denar against other currencies, the effects of change in the prices of the other financial instruments.

In addition to the scenario stress-tests, the bank shall conduct tests by combining several scenarios (for ex: change in the banks' credit portfolio currency structure, deterioration of the quality of the credit portfolio, change in the cross-currency exchange rates and the value of the Denar against foreign currencies, as well as change in the interest rates of the financial markets).

11. The bank shall be required to define the manner in which it conducts the stress-tests, as well as the assumptions on the basis of which the tests will be made on, that includes:

- introduction and analysis of different stress scenarios and frequency of their implementation;
- stress-tests in regular (common) working environment and stress-tests in extraordinary working conditions;
- activities that should be undertaken by the Risk Management Committee and/or other bank bodies depending on the test results;
- manner of reporting the test results.

The bank shall be obliged to revise and document the assumptions it uses during the stress-tests, document the obtained results, as well as document the undertaken activities by the respective bodies on the basis of those results.

The bank shall be required to notify the National Bank of the Republic of Macedonia (hereinafter referred to as: the National Bank) on the results of the performed stress-tests, within 30 days after the stress-test was carried out.

Internal capital adequacy assessment process of the bank

12. The bank shall be required to establish an internal capital adequacy assessment process, depending on its risk profile.

Within the process under paragraph 1 of this item, the bank shall be obliged to:

- determine internal targets for the capital adequacy level, in conformity with the risk profile, the size and the complexity of the bank's financial activities;
- make analysis of the current and future needs of own funds, in line with the bank's strategic goals.

Introduction of new product/system in the bank

13. For the risk management purposes, the bank shall be obliged to have appropriate procedure for the introduction of new product, or system.

Before new product or system is introduced, the bank shall be required to make a documented analysis, which will include the following:

- description of the risks, arising from the introduction of a new product, or system;
- analysis of the influence of the new product or system on the bank's risk taking capacity;
- analysis of the influence of the new product, or system on the risk management of the bank.

Before new product or system is introduced in the bank, it is necessary to make the required consultations with other competent organizational units (for ex. organizational unit from the area of legislation, accounting, compliance with the regulations).

The new products that may have considerable influence on the bank's risk profile shall be approved by the Supervisory Board.

Outsourcing

14. If the bank uses outsourcing for performing financial activities and business processes, it shall be obliged, within the policies for risk undertaking and management and appropriate procedures, to include a policy and appropriate procedures for outsourcing. This policy shall include, at least the following elements:

- basic principles and guidelines for risk management arising from the outsourcing;
- performing adequate analysis for selection of potential outsourcing provider;
- verification of the quality of services provided by the outsourcing provider and conditions for efficient monitoring of its operation;
- providing continuity in the operations for the services performed by the outsourcing provider;
- defining strategic measures, in case of expected or unexpected termination of the agreed relationship with outsourcing provider.

At least once a year, the bank's Internal Audit Department shall be required to audit the implementation of the policy and the procedures under paragraph 1 of this item.

The bank shall be obliged to ensure precise definition of the provisions of the agreement concluded with the outsourcing provider, enabling clear segregation of the rights and responsibilities between the bank and the outsourcing provider, as well as:

- clause envisaging possibility for early termination of the agreed obligations, upon the bank request;
- provisions for protection of the secrecy of the bank's data;
- provisions for providing adherence of the outsourcing provider to the respective regulations;
- provisions enabling the bank an access and possibility to inspect the premises and the data of the outsourcing provider.

III.2. Risk management organizational structure

15. The bank shall be obliged to establish organizational structure, with clearly defined rights and responsibilities for taking and managing risks, in conformity with the size, type and the complexity of the bank and the financial activities it performs.

The organization of the risk management system shall be established on the following levels of hierarchy:

- strategic level - the risk management function shall be performed by the members of Supervisory Board and the Board of Directors;
- macro level - the function of the risk management at the level of a business unit, or a business line is performed by other persons with special rights and responsibilities performing management function and/or by the special organizational unit responsible for monitoring the management of all, or certain risks;

- micro level - the activities related to the risk management are carried out by persons taking risks in their everyday operation, in line with the operating procedures and the internal control systems.

16. The bank's Supervisory Board shall perform, at least, the following:

- approve the strategy for taking and managing risks, and monitor its implementation;
- approve the policies for taking and managing risks and monitor their implementation;
- assess the adequacy of the adopted strategy and policies, at least on an annual basis, in accordance with the risk profile, the type and the volume of financial activities of the bank and the external environment;
- review the reports on the bank's risk profile;
- approve the exposure limits for individual types of risks;
- provide conditions and monitor the efficiency of the internal control, as an integral part of the risk management system;
- approve introduction of new products having considerable influence on the bank's risk profile;
- other activities, which pursuant to the Banking Law, the bylaws resulting thereof and the bank's internal acts, is obliged to perform.

17. The Risk Management Committee shall perform at least the following operations:

- establish and implement the strategy for taking and managing risks;
- establish and implement the policies for taking and managing risks, and give proposal for their revision;
- establish procedures and the method of performing stress-test;
- establish policy for outsourcing;
- regularly assesses the risk management system;
- analyze the reports on the bank's exposure to individual risks, as well as the reports on the bank's risk profile;
- determine and regularly revise exposure limits for individual types of risks;
- define possible exceptions regarding the defined limits and entrust the responsibility for deciding upon application of those exceptions;
- other activities, which according to the Banking Law, the bylaws resulting thereof and the internal acts of the bank, is obliged to perform;

18. The Board of Directors shall perform at least the following operations:

- establish and implement the appropriate procedures for identification, measurement or assessment, monitoring, control, or mitigation of risks;
- establish information system, as well as system for reporting to the Supervisory Board and the Risk Management Committee, regarding possible exceeding of the stipulated exposure limits for certain risks;
- provide environment for efficient implementation of the risk management process, including proper and timely information of all bank employees included in the process of managing individual risks;
- establish procedure for introduction of new product, or system in the bank;
- establish procedures for outsourcing;

- other activities, which according to the Law, the bylaws resulting thereof and the internal acts of the bank, is obliged to perform.

19. Depending on the size, type and the complexity of the bank and the financial activities it performs, the bank shall be required to appoint person/persons, i.e. to establish special organizational unit responsible for:

- adequate measurement or assessment, monitoring, control or mitigation of all material risks;
- adequate implementation of the bank's risk management policies and procedures;
- regular monitoring of the exposure limits for individual risks;
- determining and regular monitoring of the bank's risk profile and
- regular reporting to the Risk Management Committee and other bank bodies on the bank's exposure to individual risks and on its risk profile.

The persons responsible for risk management, i.e. the organizational unit for risk management shall be independent from the persons and the organizational units which undertake risks in their operations.

The Internal Audit Department shall audit the operations of the organizational unit under paragraph 1 of this item, according to the annual plan for internal audit.

III. 3 Information system

20. The bank shall be required to establish information system that will enable adequate measurement, or assessment of risks, as well as reporting on the size and the structure of the bank's exposure to risks.

The information system should enable preparation of reports that fulfill at least the following conditions:

- transparency - to contain clear, understandable and accurate data related to risks;
- completeness - to ensure enough data on all material risks and to enable comprehensive analysis and assessment of the bank's exposure to risks;
- usefulness - to contain the most important data related to risks;
- comparableness - the reports should be largely consistent, depending on the data they contain;
- timeliness - to enable timely decision-making regarding taking and managing risks.

III.4. Defining the risk exposure limits

21. The bank shall be required to establish internal exposure limits for individual measurable risks.

The exposure limits for individual risks shall be subjected to revision, depending on the internal and external conditions in which the bank operates.

The bank, can also define, in internal acts, the possible exceptions from the defined limits under paragraph 1 of this item, with appointing persons responsible for deciding upon the implementation of those exemptions.

IV. RISK MANAGEMENT ON CONSOLIDATED BASIS

22. The parent entity of the banking group shall be obliged to establish a risk management system at the level of the entire banking group, pursuant to the provisions of the Banking Law and this Decision.

V. CLOSING PROVISIONS

23. The provisions of this Decision pertaining to banks shall appropriately be applied to the foreign banks' branches and the savings houses, in conformity with the Banking Law and the bylaws resulting thereof.

24. This Decision shall enter into force the eight day from the day it is published in the "Official Gazette of the Republic of Macedonia", and its implementation shall commence on September 01, 2008.

By exception to paragraph 1 of this item:

- the implementation of item 10 shall start on January 01, 2009, with the bank being required to conduct the first stress-test until June 30, 2009;
- the implementation of item 12 shall start on January 01, 2010.

D.No. 02-15/II-2/2008
February 28, 2008
Skopje

Petar Goshev, MSc.
Governor
and President of the National Bank
of the Republic of Macedonia
Council

ANNEX

1. Core principles for managing credit risk and concentration risk

The basic principles and standards for managing credit risk shall be contained in the Decision on credit risk management and shall contain the following:

1. The bank shall be required to provide clear segregation of rights and responsibilities among the organizational units of the bank, which are carriers of the credit activity and take credit risk, and the organizational units responsible for the credit risk management.

2. The bank shall be required to provide clear segregation of rights and responsibilities between the organizational unit responsible for credit approval (front office) and the back-office crediting operations (back-office), within the organizational unit responsible for the credit activity.

In this Decision, the terms credit activity, credit exposure and credit, include all transactions generating credit risk.

3. The bank shall establish appropriate credit process, which will include:

- credit approval process;
- credit monitoring process;
- process of identification, measurement, monitoring, control, or mitigation of credit risk.

4. The bank shall establish clear and transparent credit approval process. Before the credit is approved, the bank shall be required to identify all significant factors that could influence the client's risk, i.e. the bank's exposure to the client.

5. The credit monitoring process shall include the monitoring of the credit, i.e. the agreed conditions, the operations, the financial standing of the client and the value of the credit collateral.

6. The bank shall establish regular process of analyzing the quality of the credit portfolio, which includes an assessment of its future trends.

7. The bank shall establish a process of classification of credit risk exposures on both individual and group basis.

When creating the exposure portfolio for which impairment, i.e. special reserve is determined on a group basis, the bank shall be obliged to define the quantitative and qualitative criteria on the basis of which homogenous exposure portfolios with similar credit risk are created.

8. The determining of the impairment and the special reserve, the classification of the credit exposure and its monitoring shall be made by the organizational unit (personnel) that did not participate in the credit approval.

9. The bank shall define the criteria for "problem credits" identification and the procedure for their monitoring.

10. The bank shall establish information system, providing preparation of, at least, the following data and reports:

- structure of the total credit risk exposure, according to risk category (by sectors, individual credit products, currency structure, type of collateral, the exposure maturity, etc.)
- financial potential of the client;
- exposures with higher risk level;
- due and non-performing claims;
- transition (migration) of the exposures according to the credit risk level (risk category) in certain time-frame;
- prolonged and restructured claims;
- structure of the total credit risk exposure by type of collateral;
- level and the movements of the impairment and the special reserve amount, at the level of credit portfolio and by individual aspects (currency, sectors, maturity, etc.).

2. Core principles for managing the bank concentration risk

1. The bank shall establish methodology for identification, measurement, monitoring and hedging of concentration risk. The Methodology shall contain at least:

- measurement of the concentration risk to certain persons;
- system for identification of connected entities and persons related to the bank;
- measurement of the concentration of both credit portfolio and trading portfolio;
- defining the exposure limits by specific person/entity, geographic location, sectors, activities, currency, etc.:
- possibility for limit adjustments;
- risk transfer to another party.

2. The bank shall establish information system, that will enable preparation of at least the following data and reports on the bank exposure concentration by:

- certain person, group of connected entities and persons related to the bank;
- credit or other type of bank products/service;
- activity;
- geographic location;
- sector;
- currency.

3. Core principles of country risk management

1. The bank shall establish a system for assessment of country risk the bank is exposed to or intends to establish an exposure to.

2. The bank shall establish country risk management policy including:

    - definition of country risk exposure,

    - establishment of exposure limits by country,

    - definition of a list of country the bank is not allowed to be exposed to, if necessary,

    - establishment of exposure limits by entities from other countries (governments, banks, other entities), by type of credit exposure (credits, guarantees, L/Cs, etc), by maturity,

    - method of measuring losses arising from country risk,

    - definition of the exposure monitoring system by country, and the method of reporting to the bank's Risk Management Committee, Board of Directors and Supervisory Board.

3. In conformity with the policy, the bank's Board of Directors shall establish procedures which, inter alia, include: definition of the manner, the form and the pace of internal reporting, identification of the bank's organizational units where the nature of financial activities they perform, are likely to cause this type of risk, appointment of persons /organizational unit in the bank responsible for monitoring this type risk and the exposure to countries.

4. When calculating the loss arising from country risk, the bank may use data from foreign source (such as international credit rating agencies) or domestic source (specialized country risk assessment institutions, the National Bank, etc.), or to establish its own country risk identification and measurement system.

5. The bank shall establish an information system that would generate at least the following data and reports: exposure by country and total exposure of the bank to country risk, sector, currency and maturity structure of the exposure to a certain country and of the bank's total exposure to country risk, the amount of impairment and the special reserve resulting from exposure to a certain country and from the bank's total exposure to country risk.

4. Core principles of liquidity risk management

The core principles and standards for liquidity risk management are included in the Decision on liquidity risk management and cover the following:

1. The bank shall identify, measure, monitor and control the liquidity risk, taking into account the nature, the scope and complexity of its financial activities, in a manner that ensures smooth, continuous and timely settlement of its due liabilities.

2. The bank shall test the liquidity at various scenarios, in order to monitor the liquidity risk and to ensure adequate liquidity position. Based on these liquidity risk management scenarios, the bank shall define methods of ensuring adequate liquidity, taking into account the common (usual) inflows and outflows (basic scenario) and the potential developments in the event of liquidity crisis (stress-test scenarios). The bank shall regularly review the adequacy of assumptions underlying these stress-tests.

3. The bank shall establish contingency plan for liquidity risk management containing, inter alia, obligations for generating reports with data, indicators and other information necessary for undertaking measures in the event of liquidity crises, and for internal reporting within the bank. The bank shall regularly test the adequacy of the contingency plan for liquidity management in extraordinary circumstances (liquidity crisis). The plan shall also include an obligation for reporting to the National Bank on the factors that jeopardize the bank's liquidity and on the bank's planned measures and actions for their elimination.

4. The bank shall establish an information system in place that would generate at least the following data and reports:

    - on residual contractual and expected maturity structure of the bank's assets and liabilities,

    - on the largest depositors and creditors and on the level of concentration of the bank's liabilities,

    - on the projected liquidity needs and sources of funding the liquidity needs in a specific currency and over certain intervals,

    - on the stability of bank's deposits (by maturity, sector, currency),

    - on the bank's cash flows over a certain interval, etc.

5. Core principles for the management of the interest rate risk in the banking book

1. The bank shall establish a system for managing interest rate risk arising from the banking book, taking into account the nature, the volume and complexity of the bank's activities that affect the bank's exposure level to this type of risk.

2. When assessing the interest rate risk exposure, the bank shall take into account all banking book items sensitive to changes in the interest rates, and assess:

    - the risk arising from maturity mismatch of the interest-sensitive assets and liabilities items,

    - the risk arising from the change in the yield curve,

    - the risk arising from options embedded in the interest-sensitive items.

3. The bank shall determine the level of risk arising from changes in the interest rates, observing its effect on the profit and loss and on the interest-sensitive items.

4. The bank shall define interest rate risk exposure limits in the banking book, aimed at reducing the losses, i.e. reducing the adverse effects of the interest rate risk on the amount of bank's profit and own funds, taking into account the results from the stress-tests.

5. Bank facing significant interest rate risk exposure in many currencies shall assess this risk with respect to each currency.

6. The bank shall conduct regular stress-tests of the influence of large changes (shocks) in the interest rates on the bank's profit and own funds. The stress-tests (stress-scenarios) shall be based on the worst scenarios and shall include all material sources of interest rate risk. The Risk Management Committee shall take into account the stress-test results when reviewing the policies and the interest rate risk limits.

7. The bank shall have an information system in place that would generate at least the following reports and data:

    - Report on the amount and structure of interest-sensitive assets and liabilities over certain time intervals or periods,

    - Report on the bank's exposure to interest rate risk by maturity,

    - Level of interest rate risk exposure in various simulations.

6. Core principles for strategic risk management

1. The bank shall establish a system for managing strategic risk it has been or could be exposed to.

2. The bank shall have strategic risk management policy in place, including:

    - definition of strategic risk,
    - sources of strategic risk (external and internal),
    - instruments/factors for mitigating the strategic risk,
    - strategic risk management methods,
    - acceptable level of strategic risk exposure.

    The strategic risk management policy is consistent with the bank's risk management strategy.

    External sources of strategic risk are those which are beyond control of the bank or it has limited control over them, such as: competitiveness, IT developments, amendments to the regulations (prudential, tax, etc.).

    Internal sources of strategic risk are factors controllable by the bank, but though could affect the achievement of its strategic and business objectives, such as bank's organizational structure, work processes and procedures, staff, information, IT, etc.

    Strategic risk mitigation factors shall include: election of adequate members of the Supervisory Board and Board of Directors, establishment of adequate strategic and business objectives, selection of staff members with adequate skills and knowledge and their permanent training, efficient risk management system, adequate access to information.

3. The Supervisory board shall adopt business policy and development plan, i.e. bank's strategy and business objectives, to be approved by the bank's Meeting of Shareholders.

    The bank's strategy and business objectives shall adhere to the size, the type and complexity of the bank and the financial activities it performs and plans to perform, and its business environment.

4. The strategy shall cover a period of three to five years.

    The Strategy shall include at least:

    - Analysis of the macroeconomic environment of the bank,
    - Review of the bank's strategic objectives,
    - Bank's risk management systems,
    - Basic objectives of each organizational unit of the bank,
    - Bank's financial plan and financial statements projections for a period of three to five years.

5. The bank’s business plan shall adhere to the bank’s strategic objectives and shall include all business processes of the bank.

6. The bank shall set clear responsibilities for the person/persons assigned to develop the strategy, should include representatives of different organizational units and should establish coordination between the organizational units involved.

7. For the purpose of strategic risk management, the bank shall have an information system in place that would ensure generation of at least the following data and reports:

    - Report on the effects of the achievement of a certain strategic objective set on assumptions used in the development of the bank’s strategy and its current positions.

    - Report on incurred costs and generated income from activities aimed at implementing the bank’s strategy. This report shall be adequately documented, based on which the Board of Directors shall assess the efficiency of the strategy and the bank’s bodies, as well as of the persons with special rights and responsibilities.

7. Core principles for reputational risk management

1. The bank shall establish a system for monitoring and assessing the exposure to reputational risk it has been or could be exposed to.

2. The bank shall establish and implement stringent procedures for data secrecy protection, in conformity with the Banking Law and other regulation governing the data secrecy.

3. The bank shall establish and implement procedures for protection against breach of duty by staff members, and for anti-money laundering and counter-terrorism financing, violation of prohibitions, or undertaking other activities that imply violation of the regulations and are detrimental to third parties.

4. The bank shall establish procedures for acting upon complaints by the clients and shall ensure their adequate implementation.

5. The bank shall establish and implement procedures for timely and accurate reporting to the regulatory, supervisory and other bodies on all events and grounds specified by the regulations (the National Bank, Revenue Office, etc.).

6. The bank's Supervisory Board and Board of Directors shall:

    - make sure that the work of the bank's staff is aimed at establishing and maintaining the good public image of the bank,

    - ensure adherence to the regulations and responsiveness to the indications and requirements of the regulatory, supervisory and other bodies.

8. Core principles for operational risk management

8.1. Treatment of operational risk

1. The bank shall establish a system for operational risk management it is or could be exposed to, which includes all material aspects of the operational risk.

2. The bank shall establish and implement operational risk management policy and procedures taking into account the nature, size and complexity of bank's financial activities.

   The operational risk management policy shall include at least:

   - definition of all types of operational risk the bank is or could be exposed to,

   - acceptable operational risk exposure level,

   - method of identification, assessment, monitoring and control or mitigation of the operational risk,

   - scope of data and information included in the reports for the purposes of operational risk management,

   - clearly defined operational risk management responsibilities, method of reporting to the Supervisory Board and to other bank's bodies, persons with special rights and responsibilities, persons/organizational unit responsible for risk management in the bank.

3. The bank shall conduct current analysis of the material losses resulting from operational risk. The material losses arising from operational risk shall be defined in the risk management policies.

4. The bank shall establish system for regular reporting to the Board of Directors and the Supervisory Board, and to other persons with special rights and responsibilities on the material losses arising from operational risk exposure. These reports shall include at least description of the type of loss incurred from the exposure to operational risk, the major factors that caused the loss, the amount of loss and list of undertaken measures.

5. The bank's Supervisory Board and Board of Directors shall decide on undertaking additional measures for covering/mitigating the operational risk.

   The bank's Supervisory Board and Board of Directors shall ensure monitoring of the implementation of the additional measures.

8.2. Business continuity and contingency plan

6. The bank shall design a business continuity and contingency plan.

   The business continuity plan shall be a formal document that includes procedures for ensuring business continuity of the most important processes and systems of the bank.

   The contingency plan shall be an integral part of the business continuity plan and shall define the technical and organizational measures and actions for business resumption, i.e. continuity and for minimizing the effects of the business discontinuity, i.e. disturbance of the work environment.

7. The business continuity plan shall ensure availability of ancillary facilities intended for contingencies as soon as possible, and the contingency plan shall ensure, in the event of serious disturbances of the work environment (significant business discontinuities), business continuity and minimization of the effects of the business discontinuity, i.e. disturbance of the work environment.

8. The business continuity plan and contingency plan shall also include:

    - definition of the events considered as contingencies or seriously disturbed work environment,

    - segregation of duties and appointment of persons with special rights and responsibilities and/or employees of the bank responsible for undertaking appropriate actions in the event of contingencies or seriously disturbed work environment,

    - creation of conditions for smooth continuity of the most important systems and processes of the bank,

    - deadlines for ensuring smooth business continuity of the most important systems and processes,

    - procedures for ensuring continuity of the most important systems and processes,

    - method of informing in the case of serious disturbance of the work environment.

9. The bank shall make sure that the persons with tasks related to the contents and relevance of the business continuity plan and the contingency plan, are fully informed.

10. The bank shall ensure testing of the business continuity plan and contingency plan at least once every year and in case of any significant change in the bank's exposure to operational risk. The bank's Supervisory Board and the Board of Directors shall be informed on the results of these tests.

11. The bank shall ensure periodical review of the business continuity plan and the contingency plan for the purposes of complying with the current activities, business processes and strategies.

12. For the purposes of operational risk management, the bank shall have an information system in place that would at least generate the following data and reports:

    - Report on the scope and frequency of errors made, delays and failures to submit reports,

    - Report on new clients and clients that abandoned the bank, including general description of the profile of the bank's new clients, information on clients that abandoned the bank (such as accounts closed by clients, etc.) etc. The purpose of this report is to make the Board of Directors and other bank's bodies understand the potential systemic reasons behind the closing of accounts in the bank, the problems with services to the clients, etc,

    - Report on the total number of transactions and the amount of transaction executed over a certain time period (day, month, year),

- Report on the amount of losses arising from operational risk exposure incurred over a certain time period,

- Report on violations of the administrative and accounting control procedures, number, reasons and nature of violations. This report may also include number of errors in the accounting entries, errors in the credit collateral documentation, unauthorized access to clients' accounts, etc.

9. Core principles for market risk management

1. The bank shall ensure clear operational and organizational segregation between the activities of the front office and the back office, including clear operational and organizational segregation of responsibilities and duties of the persons with special rights and responsibilities performing management function. The bank may segregate the back office from the risk management process and from the accounting records of the trading.

2. The segregation between the front and the back office shall include establishment of adequate work and security procedures, rules for access to computer applications and physical separation of the business premises.

3. The bank shall respectively apply the core market risk management principles, defined in this part of the annex, to the currency risk management.

9.1. Front office

4. The bank shall, prior to the execution of the trade transaction, make sure that all crucial conditions and elements of the transaction are clear and agreed upon.

5. The bank shall not execute transactions which are not in compliance with the common market conditions. As an exception, the bank may carry out such transactions, if:

    - the transaction rests on explicit and well elaborated requirements of the client, whereby the agreed variations from the market conditions is to be clearly stated in the transaction documentation,

    - the bank notifies, in writing, the client on any variation of its requirements from the market conditions, thus clearly elaborating the variations. The bank shall provide written evidence that it has informed the client on such variations.

    The Board of Directors and the persons with special rights and responsibilities in charge of the front office activities shall be informed on the significant (large-value) transactions with variations from the market conditions.

6. The trading outside the premises of the bank shall be allowed only if specified by internal trade rules defining: the dealers, subject and volume of transactions and method of conducting the transactions, introducing an obligation for the dealers to notify the bank in writing on each transaction carried out outside the bank's premises.

7. The bank shall record the conversations of all dealers involved in transactions.

8. Upon carrying out each transaction, the person who carried out the transaction shall prepare a Confirmation including all essential information on the transaction. The Confirmation and other transaction documentation shall as soon as possible be submitted to the back office. Transactions carried out beyond the business hours of the back office shall be included as trade item for that particular date and shall be specially labeled. In such cases, the Confirmation and other transaction documentation shall be submitted, as soon as possible, to the back office.

9. Each person involved in the trade shall enter, in the IT system, data on each transaction it makes under its identification code.

9.2. Back office

10. The bank shall have system/process in place for sending and receiving confirmations on carried out transactions, and for further transaction processing by the back office.

11. The bank shall ensure preparation of a Confirmation for each transaction, proper transaction recording and providing all necessary documentation for the carried out transaction.

12. The bank shall provide accurate, timely and comprehensive confirmations by third parties - transaction counterparties. The confirmations on carried out transactions by third parties shall be directly submitted to the back office. The bank shall immediately inform the third parties if the transaction confirmations are incomplete or missing.

13. The bank shall establish regular monitoring of the transaction carried out by the front office, including verification of:

    - the comprehensiveness of the transaction documentation and its timely submission to the back office,

    - compliance of data on the carried out transaction with the transaction data and confirmation, transaction certificate from the electronic trade system and other sources,

    - observance of the loss limit,

    - adherence of the carried out transactions to the market conditions,

    - deviations from the internal trading rules,

    - compliance of the transaction records between the front office and other organizational units independent from the front office.

14. The bank shall have internal procedures in place for changing the carried out transaction data (e.g. in case of identified errors and deviations, etc.).

9.3. Treatment of market risk

15. Market risk shall be managed by person/organizational part independent from the front office.

16. Market risk measurement shall include evaluation of losses at regular market conditions and losses at extraordinary market conditions. The bank shall assess the effects of the results from measurement of risks arising from trade activities on the amount of bank's own funds and profit.

17. When determining loss limits, the bank shall take into account the amount of its own funds and profit, and the complexity of its financial activities. The bank shall regularly review the limits. The excess of limits shall be approved by empowered person, as specified by the bank's internal procedures prior to its occurrence.

    The bank's Board of Directors shall be immediately informed on each excess of limits.

18. The bank shall ensure day-to-day monitoring of risks arising from trading activities, including at least data on:

    - Executed trading items, the level of limits and breach of limits,

- Results from executed trading.

19. The bank shall monitor the market risk exposure by type of transactions, organizational units, type of financial instrument, and from the aspect of adherence to the set limits. The breach of limits shall be monitored daily, i.e. during and at the end of the trading day.

20. For the purposes of market risk management, the bank shall establish an information system that generates at least the following data and reports:

    - Report on currency structure of trading items by currency,
    - Report on executed trading transactions over a certain period,
    - Report on exemptions from the bank's policies and procedures, particularly focusing on whether such exemptions occurred within the bank's procedures applied in such events,
    - Report on the adherence to the legally set limits and internally set limits.
    - Review of current and cumulative results from trading at least on monthly and annual basis, by areas/types of trading.

21. The bank shall conduct stress-test of the trading book and all transactions which are considered as market risk exposure, have contingency plan in place, and adequate methods for back-testing of the market risk measurement systems. The results from the stress-test and the back-testing shall be an integral part of the overall risk management process and risk management strategy.

22. Data used for evaluation of the trading book items shall be regularly reviewed, by independent internal or external persons not included in the trade process. When the bank uses a model for determining the market value of the trading book items, the model shall be subject to regular independent testing and review.