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Regulations No 38
(protocol No. 10 6. S.)

Regulations on the Internal Capital Adequacy Assessment Process

Issued according to the 6th Paragraph of the Article 50⁸
and 8th Paragraph of the Article 50⁹ of the Credit Institution Law

I. General provisions

1. "Regulations on the Internal Capital Adequacy Assessment Process" (hereinafter – these Regulations) shall be applicable to the banks registered in the Republic of Latvia.

2. The banks shall comply with the requirements of these Regulations on an individual basis or at the consolidated group or consolidated sub-group level according to Articles 50⁸ and 50⁹ of the Credit Institution Law.

3. These Regulations set out guidelines on the implementation of requirements of Article 36² of the Credit Institution Law and requirements of Chapter V of the Financial and Capital Market Commission's (hereinafter – the Commission) Regulations No 63 of May 2, 2007 "Regulations on Establishing an Internal Control System", including:

3.1. general principles of the formation of the internal capital adequacy assessment process;

3.2. guidelines on the contents of the internal capital adequacy assessment process;

3.3. requirements on the preparation and submission to the Commission reports on the internal capital adequacy assessment process.

4. The following terms are used in these Regulations:

4.1. Basel II – Basel Committee on Banking Supervision document "International Convergence of Capital Measurement and Capital Standards"¹;

4.2. Pillar 2 of Basel II – the supervisory review process, underlying principles of which are determined in Part 3 of Basel II: The Second Pillar – Supervisory Review Process²;

4.3. the guidelines on Pillar 2 issued by the Committee of European Banking Supervisors – Guidelines on the Supervisory Review Process included into Section V of the Electronic Guidebook of the Committee of European Banking Supervisors³;

¹ Internet source: <http://www.bis.org/publ/bcbs128.pdf>.

² Internet source: <http://www.bis.org/publ/bcbs128c.pdf>.

³ Internet source: <http://www.c-eps.org/Publications/Compendium-of-guidelines.aspx>.

4.4. concentration risk – any risk exposure or group of risk exposures, which may cause such losses to the bank, that may lead to the bank's insolvency or threaten the ability to conduct further business. Concentration risk arises from high volume risk exposures to the clients or groups of connected clients or risk exposures to clients, whose creditworthiness is dependent on one joint risk factor (for example, one economic sector, geographical region, currency, credit risk mitigation instrument (homogeneous collateral or one guarantee provider etc.));

4.5. money laundering and terrorism financing risk – risk that the bank can be involved into money laundering or terrorism financing;

4.6. funding liquidity risk – risk that the bank will not be able to provide for its current and future cash flows and collateral for its funding borrowing needs in such a way that daily operations or overall financial condition of the bank is not endangered;

4.7. market liquidity risk – risk that the bank will not be able to sell its financial assets for the market price due to the market disruption or insufficient market depth;

4.8. reputation risk – risk that clients, business partners, shareholders, supervisory authorities and other stakeholders of the bank may form a negative opinion about the bank and it may negatively affect the bank's ability to maintain the existing business relations or to establish new business relations with bank's clients and other counterparties, and also negatively affect the bank's accessibility to the financing. As the result of reputation risk other risks that the bank is exposed to may increase (credit risk, liquidity risk, market risk and others) thus causing a negative effect on the bank's profit, capital and liquidity;

4.9. strategic and business risk – risk that changes in business environment and the bank's lack of responsiveness to those changes or inadequate or inappropriately chosen business strategy, or inability of the bank to ensure the necessary resources to implement the strategy may cause negative effect on the bank's profit, capital and liquidity;

4.10. stress testing – different methods (qualitative or quantitative) used to determine the potential effect on the bank's and bank's consolidation group risk levels and on the financial and capital ratios of various extreme, but plausible adverse events or changes in market conditions. In these Regulations the stress testing means sensitivity analysis, as well as scenario analysis and reverse stress testing. The sensitivity analysis is used to identify how adverse changes in one risk factor or simultaneous changes in several risk factors can influence the bank's risk level, financial results and capital ratios (i.e. to evaluate the sensitivity of bank's financial and capital ratios towards changes in one or several risk factors). Scenario analysis is used to assess an impact of adverse scenario that is material for the activities of the bank (i.e. internal or external adverse event or adverse changes in macroeconomic ratios or market conditions) on the overall level of risks inherent in the activities, financial results and capital ratios of the bank. Reverse stress testing is used to identify such negative outcome (e.g., operational losses, decrease in the value of assets, illiquidity of assets, deposit outflow, unavailability of financing sources etc.) that may threaten further operation of the bank, to identify events or combination of events that may result in the above negative outcome, as well as to determine the necessary remedial actions;

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

4.11. capital needed to cover risks – the amount of capital, which according to the bank's assessment is needed to cover losses from risks inherent in the bank's current and planned business activities. Capital needed to cover risks consists of the amount of capital needed to cover individual risks (credit risk, market risk, operational risk and other risks that the bank is or might be exposed to);

4.12. capital buffer – the amount of capital which according to the bank's assessment is needed in addition to the capital needed to cover risks to ensure that the bank's capital is sufficient to cover losses in case of occurrence of plausible adverse scenarios material for the

activities of the bank, and also to ensure that the bank's capital is sufficient throughout the economic cycle;

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

4.13. total capital needs – the capital needed to cover risks and capital buffer together;

4.14. other terms used in these Regulations correspond to the Commission's Regulations No 60 of May 2, 2007 "Regulations for Calculating the Minimum Capital Requirements" (hereinafter – the regulations on minimum capital requirements), Regulations No 63 of May 2, 2007 "Regulations on Establishing an Internal Control System", normative Regulations No 34 of March 7, 2008 "Regulations on the Management of Interest Rate Risk, Preparation of a Report on the Calculation of Economic Value Decline and of a Report on the Term Structure of Interest Rate Risk" (hereinafter – the interest rate risk regulations), recommendations No 125 of July 28, 2006 "Recommendations on Operational Risk Management" and Regulations No 166 of November 30, 2007 "Regulations on the Consolidated Supervision".

II. Overarching principles of the internal capital adequacy assessment process

5. The principles and guidelines on the implementation of Pillar 2 of Basel II are specified in Basel II and in the guidelines on Pillar 2 issued by the Committee of European Banking Supervisors. The bank in the formation of its internal capital adequacy assessment process shall follow the principles and guidelines on Pillar 2 of Basel II and the guidelines on the Pillar 2 issued by the Committee of European Banking Supervisors.

6. Pillar 2 of Basel II consists of two interlinked processes – the internal capital adequacy assessment process conducted by the bank and the supervisory review and evaluation process conducted by the supervisory authority. The internal capital adequacy assessment process conducted by the bank shall consist of both quantitative and qualitative aspects of capital adequacy assessment, including long-term planning and determining the business strategy, identifying material risks, determining the acceptable level of risks, development and improvement of risk management systems, regular identification and control of risks inherent in the activities of the bank (risk profile) and the role of the management in risk and capital management.

7. The internal capital adequacy assessment process shall form an integral part of the bank's management and decision taking culture, risk management systems and business planning. Holding of a certain level of capital does not substitute the risk management, but in the internal capital adequacy assessment process the bank shall define such capital adequacy targets that ensure that capital is sufficient to cover risks that the bank is or might be exposed to due to the current and planned operations of the bank.

8. The bank regularly, but at least once a year, shall assess capital adequacy within the internal capital adequacy assessment process. Within a month after the supervisory board of the bank has approved the results of the internal capital adequacy assessment process, the bank shall submit to the Commission a report on the internal capital adequacy assessment process according to the requirements of Section IV of these Regulations.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

9. The bank shall without delay, but not later than in one month, review the results of the internal capital adequacy assessment process and, if deemed necessary, carry out a new internal capital adequacy assessment if over the period of time between two internal capital adequacy assessment processes material changes have occurred in the bank's business activities or external environment (for instance, changes in bank's business lines and operations, material changes in external environment, implementation of new risk management or measurement models or methods etc.) that may change significantly the results of the internal capital adequacy assessment process (including the results of bank's assessment of amount of capital needed to cover risks, the size of capital buffer, total capital needs and available capital, capital adequacy targets, conclusions drawn from the internal capital adequacy assessment process, action plan for ensuring capital adequacy and other decisions taken as a result of the internal capital adequacy assessment process). The supervisory board of the bank shall review and approve the reviewed results of the internal capital adequacy assessment process. Within a month after the approval by the supervisory board of the bank of the reviewed results of the internal capital adequacy assessment process, the bank shall submit a report on the internal capital adequacy assessment process to the Commission in accordance with requirements of Section IV of these Regulations.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

10. The establishment and effective functioning of the internal capital adequacy assessment process shall be responsibilities of the supervisory board and executive board of the bank. If the internal capital adequacy assessment process is provided by any third party (outsourcing service provider) the supervisory board and executive board of the bank shall be responsible for the results of such outsourcing service provider as if the assessment would be carried out by the bank itself and shall ensure compliance with the provisions of Article 13 of these Regulations.

11. The supervisory board of the bank shall define the conceptual design of internal capital adequacy assessment process, approve the internal capital adequacy assessment process policy, at least once a year approve the results of the internal capital adequacy assessment process and take decisions concerning the capital adequacy.

12. The executive board of the bank shall ensure a regular internal capital adequacy assessment and maintenance of adequate capital level according to the internal capital adequacy assessment policy defined by the supervisory board of the bank. The executive board of the bank shall approve corresponding internal procedures for the realisation of the internal capital adequacy assessment process.

13. The bank shall ensure that the internal capital adequacy assessment process is fully documented, including:

13.1. internal regulations (including policy, procedures, instructions etc.) that determine risk and capital definitions used by the bank, identification of material risks, the methodology used to calculate the amount of capital needed to cover risks and to determine the size of capital buffer, methodology used in the aggregation of internal capital adequacy assessment results (i.e. to determine total capital needs), methodology used to calculate available capital, stress testing framework, the process of capital planning and defining capital targets, the authority, duties and responsibility of the bank's employees and structural units, reporting and information exchange procedures and other organizational and methodological aspects of the internal capital adequacy assessment process are documented and approved at the appropriate management level;

13.2. all material assumptions made during the internal capital adequacy assessment process are documented and the impact of such assumptions on the total results is analysed;

13.3. the results of the internal capital adequacy assessment process, including the assessment of the capital needed to cover risks, capital buffer, the total capital needs and available capital, scenarios examined, assumptions used and the results of stress testing carried out within a capital adequacy assessment process, capital adequacy targets, conclusions drawn from the capital adequacy assessment, action plans for ensuring capital adequacy and other decisions taken as the result of the internal capital adequacy assessment process, are documented and approved at appropriate management level and at least once a year by the supervisory board of the bank.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

14. The bank regularly, but at least once a year, shall review and, if deemed necessary, update the internal capital adequacy assessment process policy and other internal documents taking into account the changes in the bank's operations and external environment.

15. The internal audit shall regularly review and assess the efficiency of the internal capital adequacy assessment process. On the results of this review, the internal audit shall report to the supervisory board of the bank. Within one month after the report is submitted to the supervisory board of the bank, the bank shall provide the Commission with a copy of the internal audit report together with the extract of the respective supervisory board meeting minutes and information on the decisions taken by the supervisory board on the actions planned to implement internal audit recommendations, including those that are planned to eliminate any drawbacks and shortcomings identified as a result of internal audit review.

16. In the internal capital adequacy assessment process the principle of proportionality shall be followed, i.e. a small-sized bank that provides traditional and simple services to its customers can use less sophisticated methods in its internal capital adequacy assessment process, including simplified methods for calculating the capital needed to cover risks as described in these Regulations. However, a large bank or a bank that provides complex financial services, shall design and use advanced and risk sensitive methods for determining the capital needed to cover risks. For the purposes of these Regulations for the application of principle of proportionality all banks are divided into three groups:

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

16.1. the first group – banks whose assets individually or at the level of consolidated group or consolidated sub-group (depending on how the bank complies with the requirements of these Regulations according to Article 2) are less than 1 billion lats and which are not part of the third group according to Article 16.3 of these Regulations;

16.2. the second group – banks whose assets individually or at the level of consolidated group or consolidated sub-group (depending on how the bank complies with the requirements of these Regulations according to Article 2) are equal or exceed 1 billion lats and which are not part of the third group according to Article 16.3 of these Regulations;

16.3. the third group – banks that use internal ratings based approach for calculation of the minimum regulatory capital requirements for credit risk or the advanced risk measurement approach for calculation of the minimum regulatory capital requirements for operational risk or value-at-risk internal model for calculation of the minimum regulatory capital requirements for market risks.

17. Depending on the group to which the bank belongs to according to Article 16 of these Regulations, the bank shall adapt the guidance on the internal capital adequacy assessment process outlined in Section III of these Regulations complying with the following principles:

17.1. to determine the capital needed to cover risks not covered by minimum regulatory capital requirements the bank that belongs to the first group in accordance with Article 16.1 of these Regulations can use simplified methods described in Articles 41, 47–49, 52 and 63 of these Regulations and shall not justify the suitability of these methods to the operations of the bank. The bank can also use internal models or methods developed by the bank. If the bank uses internally developed models or methods, the bank shall ensure that internal models or methods are fully documented in the internal regulatory documents of the bank. Upon the request of the Commission, the bank shall explain the theoretical basis of internal methods or models used and justify the suitability thereof to the operations of the bank;

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

17.2. to determine the capital needed to cover risks not covered by minimum regulatory capital requirements the bank that belongs to the second group in accordance with Article 16.2 of these Regulations can use simplified methods described in Articles 41, 47–49, 52 and 63 of these Regulations and shall additionally assess and justify the suitability of these methods to the operations of the bank. The bank can also use internal models and methods developed by the bank. If the bank uses internally developed models or methods, the bank shall ensure that internal models or methods are fully documented in the internal regulatory documents of the bank. Upon the request of the Commission, the bank shall explain the theoretical basis of internal methods or models used and justify the suitability thereof to the operations of the bank;

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

17.3. to determine capital needed to cover risks the bank that belongs to the third group in accordance with Article 16.3 of these Regulations shall use internal models or methods developed by the bank – advanced and more risk sensitive methods than simplified methods described in Articles 41, 47–49, 52 and 63 of these Regulations. The bank shall ensure that internally developed models or methods are documented in the internal regulatory documents of the bank. Upon the request of the Commission, the bank shall explain the theoretical basis of internal methods or models used and justify the suitability thereof to the operations of the bank.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

III. Contents of the internal capital adequacy assessment process

18. The responsibility for the contents and the scope of the internal capital adequacy assessment lies on the bank. In the internal capital adequacy assessment process the bank shall at least:

- 18.1. determine the available capital;
- 18.2. determine the capital needed to cover risks;
- 18.3. determine the size of capital buffer;
- 18.4. determine the total capital needs;
- 18.5. plan the capital for the time period of at least next three years and determine the desirable capital level (capital adequacy targets).

Assessment of the available capital

19. To assess the amount of the available capital, first of all, the bank shall determine a capital definition, including it shall define capital elements that are included in the calculation of the available capital and define the methodology used to assess the available capital. For the purposes of internal capital adequacy assessment process the bank shall use the same capital definition as it uses in performance measurement, risk management and other decisions concerning the bank's current and planned operations.

20. For the purposes of internal capital adequacy assessment process, the bank may apply any of the following approaches:

20.1. the bank can use the own funds definition and own funds calculation methodology described in the regulations on minimum capital requirements;

20.2. the bank, taking into account the availability of various capital instruments, can use a capital definition and capital calculation methodology other than the own funds definition and own funds calculation methodology described in the regulations on minimum capital requirements. For the purposes of the internal capital adequacy assessment process, the bank, for instance, can define capital as Tier I capital, fair value of net assets etc.

21. For the purposes of the internal capital adequacy assessment process the bank may also use additional capital elements, which are not included in the own funds calculation according to the regulations on minimum capital requirements (e.g. the revaluation reserves not included in own funds calculation, unaudited profit of the current financial year and other elements similar in their nature). When including additional capital elements, the bank shall comply with the following principles:

21.1. the bank shall assess whether such additional capital elements will be available to the bank in crisis situations if there will be a necessity within a very short period of time to use them to cover losses;

21.2. the definition of capital used for the purposes of internal capital adequacy assessment process shall ensure that the capital of the bank, both in terms of elements and the composition, is commensurate to the risks for coverage of which it is intended.

Assessment of the capital needed to cover risks

22. To determine the amount of capital needed to cover risks, the bank shall:

22.1. identify the risks that shall be included in the internal capital adequacy assessment and determine risk definitions used;

22.2. identify material risks inherent in the activities of the bank and determine risks for which bank in its internal capital adequacy assessment process shall determine amount of capital needed to cover them and risks for which capital shall not be calculated, but other risk management and mitigation methods shall be used;

22.3. determine the methodology used to calculate capital needed to cover risks.

23. When determining the amount of capital needed to cover risks the bank shall assess all the risks inherent in the activities of the bank, including:

23.1. risks, for which minimum regulatory capital requirements have been set – credit risk and counterparty credit risk (hereinafter – the credit risk), operational risk and market risks. The guidelines the bank shall follow while assessing risks for which minimum regulatory capital requirements have been set are outlined in Articles 24–38 of these Regulations;

23.2. risks not covered by minimum regulatory capital requirements – interest rate risk in the banking book, concentration risk, money laundering and terrorism financing risk, liquidity risk, reputation risk, strategy and business risk and other risks inherent in the activities of the bank. The guidelines the bank shall follow while assessing risks not covered by minimum regulatory capital requirements are outlined in Articles 39–63 of these Regulations.

Risks for which minimum regulatory capital requirements are set (Pillar I risks)

24. To determine the amount of capital needed to cover risks for which minimum regulatory capital requirements have been set (credit risk, market risks, operational risk), the bank may use:

- 24.1. any approach allowed in the regulations on minimum capital requirements;
- 24.2. an internal model or method developed by the bank that is different from the approaches allowed in the regulations on minimum capital requirements.

Credit risk

25. To determine the amount of capital needed to cover credit risk, the bank may use the standardized approach set out in the regulations on minimum capital requirements, by carrying out at least such additional credit risk assessments and making appropriate adjustments:

25.1. the bank shall evaluate validity of the application of a 35% risk weight to the exposures secured by mortgages on residential property taking into account the projected situation in the real estate market. If the bank identifies decline in clients' creditworthiness, decrease in the value of the collateral, difficulties to realize collateral or other unfavourable tendencies in the real estate market or economy, in assessing the amount of capital needed to cover credit risk inherent in the category of those exposures, the bank shall apply a risk weight that is higher than a 35% risk weight and that may differ from risk weights applied in the standardized approach;

25.2. the bank shall evaluate validity of the application of a 75% risk weight to retail exposures by analysing the statistical data on the changes in quality and granularity of exposures included in the pool of retail exposures. If the bank identifies decrease in quality in the pool of retail exposures, in assessing the amount of capital needed to cover inherent credit risk, the bank shall apply a risk weight that is higher than a 75% risk weight and that may differ from risk weights applied in the standardized approach;

25.3. the bank shall undertake credit risk stress testing on a regular basis. For that purpose the bank shall make forecasts of such events that may affect the size of the credit risk or counterparty risk. Stress testing results shall be taken into account to determine the amount of capital needed to cover credit risk;

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

25.4. to ensure qualitative and reasonable stress testing and reasonable assumptions for credit risk measurement, the bank shall accumulate historical data on credit risk exposures, including currency of the granted loans and borrower's income, overdue payments, provisioning, restructuring of loans, changes in the collateral value, cases of realization of collateral and respective sale prices and other information.

26. To determine the amount of capital needed to cover credit risk the bank that uses internal ratings based approach shall assess whether the minimum capital requirement for credit risk is sufficient to cover possible losses due to credit risk. To ensure assessment of

credit risk the bank shall regularly carry out credit risk stress testing, analyse the results of stress testing and take them into account in determining the amount of capital needed to cover credit risk.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

27. The bank, which in the assessment of capital needed to cover credit risk uses approaches recognized in the regulations on minimum capital requirements, shall assess whether the amount of capital needed to cover credit risk that is determined in accordance with Article 25 or 26 of these Regulations is appropriate to cover all losses due to the credit risk. For this purpose the bank, taking into account the specificities of its activities, shall additionally assess other risks related to credit risk, and, if they are deemed material, shall determine the amount of capital needed to cover these risks, including:

- 27.1. concentration risk (Articles 43–50 of these Regulations);
- 27.2. residual risk;
- 27.3. securitization risks.

28. To assess credit risk inherent in the operations of the bank and the amount of capital needed to cover credit risk the bank may develop an internal model or method different from approaches recognized in the regulations on minimum capital requirements, ensuring that:

- 28.1. the internal model or method covers all relevant sources of credit risk;
- 28.2. in the internal model or method the bank uses one of the generally recognized methods or models paying particular attention to such elements as mutual dependency modelling and counterparty credit risk modelling, that are mentioned in Basel Committee on Banking Supervision document "Range of practices and issues in economic capital frameworks"⁴ and that have a significant impact on the results of credit risk internal models and methods;

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

28.3. bank's internal model or method is documented in the bank's internal documents, including description of the conception of credit risk internal model or method, main parameters and assumptions;

28.4. limitations and assumptions of the model or method used, as well as the impact of those limitations and assumptions on the credibility of the results, are evaluated and documented;

28.5. the stress testing of operation of internal model or method, its elements and parameters is carried out to assess compliance of operation of internal model or method with market tendencies and to assess credibility of the results:

28.6. the results of the stress testing are taken into account in determining the amount of capital needed to cover credit risk.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

Market risks

29. The bank that has a material portfolio of financial instruments is recommended to assess market risks inherent in the whole financial instruments portfolio. For the purposes of Articles 29-33 of these Regulations the term financial instruments portfolio covers all

⁴ Internet source: <http://www.bis.org/publ/bcbs152.htm>.

financial instruments of bank, except those the bank has intended and is capable to hold until maturity, and long-term investments in capital instruments. The bank that has material financial instruments portfolio is recommended to use internal value-at-risk model (hereinafter – VaR) in assessing the amount of capital needed to cover market risks, even if the bank does not use it in the calculation of minimum regulatory capital requirements for market risks.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

30. To determine the amount of capital needed to cover market risks the bank may use the standardized approach described in Articles 174–270 of regulations on minimum capital requirements, by making such additional assessments and making appropriate adjustments:

30.1. to assess capital needed to cover the equity risk the bank may compare the sum of the probability-based risk value of the equities forming overall net positions of equities of the national market (market value of the position of the equity multiplied with the corresponding annual volatility of the equity) with capital requirement against general risk for the equities, which is calculated using the standardized approach. It is recommended to use the largest value of the calculations to assess the capital needed to cover the equities risk. The volatility of equities values (standard deviations) for defined holding period and desirable confidence level shall be calculated based on historical data and future estimates;

30.2. to assess the capital needed to cover the foreign currency risk the bank may compare the total amount of probability-based foreign currency risk values of currencies forming overall net positions (the open net position of the foreign currency multiplied with annual volatility of corresponding foreign currency rate) with the capital requirement for foreign currency risk, which is calculated using the standardized approach. To assess the capital needed to cover the foreign currency risk it is recommended to use the largest value of the calculations. The volatility of foreign currency rates (standard deviations) according to a position holding period and desirable confidence level shall be calculated according to historical data and future estimates;

30.3. the bank on a regular basis shall conduct market risk stress testing. For this purpose the bank shall forecast the events that may affect the size of market risks. The bank shall take market risk stress testing results into account in determining the amount of capital needed to cover market risks.

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31. If the bank to determine the amount of capital needed to cover market risks uses VaR model, which complies with the requirements of regulations on minimum capital requirements, the bank shall analyse the stress testing results, the limitations of the model and underlying assumptions (for instance, correlation assumptions, assumptions on diversification effects, duration assumptions) and their effect on results of the model. The bank shall take market risk stress testing results into account in determining the amount of capital needed to cover market risks.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

32. To assess market risks inherent in the activities of the bank and the capital needed to cover market risks, the bank may develop an internal model or method different from approaches recognized by the regulations on minimum capital requirements, ensuring that:

32.1. the internal model or method includes all relevant market risk sources;

32.2. for the internal model or method, the bank uses any of generally recognised methods (for instance, expected shortfall model or other model mentioned in Basel Committee on Banking Supervision document "Range of practices and issues in economic capital frameworks"⁵);

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

32.3. the bank's internal model or method is documented in the bank's internal documents, including description of conception, main parameters and assumptions of the market risk internal model or method (for example, price changes of the financial instruments, market liquidity, holding period, confidence level and similar):

32.4. the limitations and assumptions of the model used, as well as the impact of such limitations and assumptions on the credibility of results, are assessed and documented;

32.5. the stress testing of operation of internal model or method, its elements and parameters is performed to assess compliance of operation of internal model or method with market tendencies and to assess credibility of the results;

32.6. the results of the stress testing are taken into account in determining the amount of capital needed to cover market risks.

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33. Regardless of what method the bank uses to assess the amount of capital needed to cover market risks, the bank shall evaluate the effect of the financial instruments market liquidity on the level of market risks. Problems with the market liquidity arise if the bank is unable to close the positions of financial instruments in preferable time period or they can be closed only with material discount. In the calculations of the capital needed to cover market risks, the bank shall accordingly either extend the length of holding period or reduce the value of financial instruments which are for sale in illiquid markets based on the experience and estimates.

Operational risk

34. The bank which uses a basic indicator, standardized or alternative standardized approach to calculate the capital needed to cover operational risk, shall additionally assess whether the fulfilment of the minimum regulatory capital requirements ensures that the regulatory capital for operational risk is sufficient to cover operational risk inherent in the activities of the bank. The bank shall determine additional capital to cover operational risk in case the bank considers that the minimum regulatory capital requirement for operational risk is insufficient (for instance, in case of a decrease in the bank's income or assets, introduction of new products, activities, processes or systems).

35. When assessing the adequacy of the calculated minimum regulatory capital requirement for operational risk to the level of operational risk inherent in its activities, the bank shall consider:

35.1. definition of the operational risk used for internal needs. If the operational risk definition used by bank for internal needs is different from the regulatory definition of operational risk used for the minimum capital requirements purposes, the bank shall ensure that the existing differences are included in the calculation of the capital needed to cover operational risk;

⁵ Internet source: <http://www.bis.org/publ/bcbs152.htm>.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

35.2. methods used for the operational risk management, i.e. the bank shall assess the compliance and efficiency of its operational risk policy and procedures with operational risk inherent in the bank's activities, for instance, the efficiency of the control elements used to prevent operational losses, the efficiency of business continuity plan;

35.3. information on the bank's operational losses, operational loss events frequency, reasons and measures taken to prevent their further occurrence. To ensure availability of the mentioned information, the bank shall systematically collect the data on events, amounts and other related material information of its operational losses. Additionally, the bank may analyse external data about operational losses of institutions similar to the bank and assess the possibility of occurrence such losses in the bank. The bank may also compare the amount of bank's minimum regulatory capital requirement for operational risk with other banks', which are similar in size and types of activities, amount of minimum regulatory capital requirement for operational risk.

36. In addition, the bank shall carry out stress testing and shall take the results of stress testing into account in determining the amount of capital needed to cover operational risk. In the stress testing the bank may analyse how the size of its operational risk, income or ability to continue its operations can be affected by, for instance:

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

- 36.1. changes in operational environment;
- 36.2. events with a low probability, but high severity;
- 36.3. outsourcing;
- 36.4. possible disruptions in operations of information technology systems or damages to information technology infrastructure;
- 36.5. termination of cooperation with customer that is important for the bank;
- 36.6. discontinuation of activities in the business line that is material for the bank.

37. The bank, which uses advanced operational risk measurement approach to calculate the capital needed to cover operational risk, may use the results of minimum regulatory capital requirement calculations also for the internal capital adequacy assessment process purposes. To ensure operational risk assessment, the bank shall on a regular basis carry out stress testing and shall take the results of stress testing into account in determining the amount of capital needed to cover operational risk.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

38. The bank, which for the calculation of capital needed to cover operational risk uses an internal model or method, developed by the bank that is different from requirements recognised by the regulations on minimum capital requirements, shall ensure that:

38.1. in the internal model or method bank uses one of generally recognised approaches (for instance, loss distribution approach, scenario based approach or risk drivers and controls approach);

38.2. methodology used in the internal model or method includes all relevant operational risk sources inherent in the various operations of the bank, geographical locations, legal structures or other relevant divisions, which the bank itself has determined;

38.3. the conception, main parameters and assumptions of internal model or method are documented;

38.4. in order to assess security and credibility of the results of the used internal model or method, the inspection of the functioning, elements, parameters and results of the internal model or method is carried out and the results of such inspection are documented;

38.5. the assessment, including stress testing, is carried out to assess whether the capital needed to cover operational risk, calculated in such a manner, is sufficient to cover all possible operational losses. The bank shall take the results of stress testing into account in determining the amount of capital needed to cover operational risk;

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

38.6. the limitations and assumptions (for instance, correlation assumptions), as well as the effect of those limitations and assumptions on the overall results of the developed internal model or method are analysed.

Risks not covered by minimum regulatory capital requirements (Pillar II risks)

39. To assess the amount of capital needed to cover the risks not covered by minimum regulatory capital requirements, the bank shall determine the amount of potential losses that may arise from risks inherent in the activities of the bank, including the risks for which no generally accepted uniform quantitative risk measurement methods have been developed. For that reason the bank, taking into account the specificities of its activities, shall analyse at least following risks:

- 39.1. interest rate risk in the banking book;
- 39.2. concentration risk;
- 39.3. money laundering and terrorism financing risk;
- 39.4. liquidity risk;
- 39.5. other risks inherent in the activities of the bank, including reputation risk, strategy and business risk and other risks.

Interest rate risk in the banking book

40. Considering the provisions of Articles 16 and 17 of these Regulations, the bank shall determine capital needed to cover interest rate risk in the banking book by using one of the following methods:

- 40.1. simplified method (Article 41 of these Regulations);
- 40.2. internal model or method developed by the bank.

41. When applying the simplified method to calculate the amount of capital needed to cover interest rate risk in the banking book:

- 41.1. the bank calculates a decrease in economic value caused by sudden and unexpected interest rate changes according to the interest rate risk regulations;
- 41.2. the bank determines the amount of capital needed to cover interest rate risk in the banking book as 100 percent of the decrease in the bank's economic value (the interest rates risk regulations, Annex 2, summary, position 50 "Weighted position of the whole banking book" – total sum of absolute value).

42. If the bank uses an internal model or method developed by the bank to assess the capital needed to cover interest rate risk in the banking book, the bank shall ensure that:

- 42.1. the internal model or method includes all sources of interest rate risk relevant for the bank that are listed in the Article 3.2 of the interest rate risk regulations (namely, re-pricing risk, yield curve risk, basis risk, optionality risk), and allows to assess the effect of changes in interest rates on the bank's earnings and economic value;

42.2. in the internal model or method the bank uses one of generally recognised methods (for instance, gap analysis, duration method, simulation approaches, which are mentioned in Basel Committee on Banking Supervision document "Range of practices and issues in economic capital frameworks"⁶);

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

42.3. internal model or method includes all interest rate sensitive banking book assets, liabilities and off-balance sheet items in each material currency;

42.4. internal model or method is documented in the bank's internal procedures, including the conception, main parameters (elements) and assumptions (for instance, modelling of interest rate changes, holding period, confidence level, maturity bands and other) of the internal model or method used are described;

42.5. limitations and assumptions of the model or method used, as well as impact of those limitations and assumptions on the credibility of results, are assessed and documented.

Concentration risk

43. In the internal capital adequacy assessment process the bank shall assess the concentration risk and shall determine the amount of the capital needed to cover concentration risk.

44. Considering the provisions of Articles 16 and 17 of these Regulations the bank shall determine the amount of the capital needed to cover concentration risk by using one of the following methods:

44.1. simplified method (Articles 47–49 of these Regulations);

44.2. internal model or method developed by the bank.

45. Taking into account that considerable part of concentration risk arises from loan portfolio, the bank shall evaluate at least concentration of exposures in the loan portfolio, including:

45.1. concentration of exposures to groups of connected clients and individual clients, who do not belong to any group of connected clients (hereinafter – name concentration risk);

45.2. concentration of exposures to clients – representatives of the same economic sector (hereinafter – sector concentration risk);

45.3. concentration of exposures where the currency in which loan is granted is different from the currency of client's income (hereinafter – currency mismatch concentration risk);

45.4. indirect concentrated exposures to one type of collateral or one guarantee provider (hereinafter – collateral concentration risk).

46. For the purposes of Articles 47–49 of these Regulations the bank's loan portfolio shall comprise of loans granted to the bank's clients, except central governments, local governments and banks, and off-balance sheet liabilities to these clients (together hereinafter referred to as – loans). In the calculation described in Articles 47–49 of these Regulations the loans shall be included in the amount that is not reduced by the amount of provisions. Off-balance liabilities to clients shall be included in the calculation described in Articles 47–49 of these Regulations without applying conversion factors.

⁶ Internet source: <http://www.bis.org/publ/bcbs152.htm>.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

47. When applying the simplified method to calculate the amount of capital needed to cover concentration risk in loan portfolio:

47.1. the bank determines the amount of capital needed to cover name concentration risk as follows:

47.1.1. the bank calculates name concentration index (hereinafter – IKI) using the following formula:

$$IKI = \frac{\sum SSKGE^2}{(\sum SSKGE)^2} * \frac{\sum SSKGE}{\sum IKE} * 100,$$

where SSKGE – total exposure to one group of connected clients or client who does not belong to any group. In the calculation only 1 000 largest exposures are included. If the bank has less than 1 000 clients, all clients are included in the calculation,

IKE – the total of bank's loan portfolio exposures,

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

47.1.2. depending on the value of IKI, the amount of capital needed to cover name concentration risk is determined according to table 1 as a percentage from total credit risk capital requirements for loan portfolio calculated according to the regulations on minimum capital requirements:

Table 1. Capital needed to cover name concentration risk

IKI	Capital needed to cover name concentration risk (% of total credit risk capital requirements for loan portfolio calculated according to the regulations on minimum capital requirements)
$0.0 < IKI \leq 0.1$	No capital add-on needed
$0.1 < IKI \leq 0.2$	2
$0.2 < IKI \leq 0.4$	4
$0.4 < IKI \leq 1.0$	6
$1.0 < IKI \leq 5.0$	8
$5.0 < IKI \leq 100$	12

47.2. the bank determines the amount of capital needed to cover sector concentration risk as follows:

47.2.1. the bank calculates sector concentration index (hereinafter – NKI) using the following formula:

$$NKI = \frac{\sum NE^2}{(\sum NE)^2} * 100,$$

where NE – total exposure to clients – resident enterprises and financial institutions that represent one economic sector. All exposures with

non-resident enterprises and financial institutions are included in the calculations as a separate sector.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

47.2.2. for the breakdown of the loan portfolio in economic sectors the nomenclature of NACE 2nd edition is used according to the Bank of Latvia's regulations for the Credit Register,

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

47.2.3. depending on the value of NKI, the amount of capital needed to cover sector concentration risk is determined according to table 2 as a percentage of credit risk capital requirements for the relevant part of loan portfolio calculated according to the regulations on minimum capital requirements:

Table 2. Capital needed to cover sector concentration risk

NKI	Capital needed to cover sector concentration risk (% of credit risk capital requirements for the relevant part of loan portfolio calculated according to the regulations on minimum capital requirements)
$0 < \text{NKI} \leq 12$	No capital add-on needed
$12 < \text{NKI} \leq 15$	2
$15 < \text{NKI} \leq 20$	4
$20 < \text{NKI} \leq 25$	6
$25 < \text{NKI} \leq 50$	8
$50 < \text{NKI} \leq 100$	12

47.3. the bank determines the amount of capital needed to cover the currency mismatch concentration risk for loans granted to households – residents whose income is in different currency than the currency of the loan granted. If the share of such loans exceeds 10 percent out of total loans granted to households – residents, the bank determines the capital needed to cover the currency mismatch concentration risk as 12 percent of credit risk capital requirements for the relevant part of loan portfolio calculated according to the regulations on minimum capital requirements;

47.4. the bank determines the amount of capital needed to cover the collateral concentration risk as follows:

47.4.1. the bank calculates collateral concentration index (hereinafter – NVKI) using the following formula:

$$\text{NVKI} = \frac{\sum \text{NVE}^2}{(\sum \text{NVE})^2} * 100,$$

where NVE – total amount of loans with one type of collateral,

47.4.2. the breakdown of the loan portfolio into types of collateral is determined according to the Bank of Latvia's regulations for the Credit Register,

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

47.4.3. depending on the value of NVKI, the amount of capital needed to cover collateral concentration risk is determined according to table 3 as a percentage of total credit risk capital requirements for loan portfolio calculated according to the regulations on minimum capital requirements.

Table 3. Capital needed to cover collateral concentration risk

NVKI	Capital needed to cover collateral concentration risk (% of total credit risk capital requirements for loan portfolio calculated according to the regulations on minimum capital requirements)
$0 < NVKI \leq 25$	No capital add-on needed
$25 < NVKI \leq 35$	2
$35 < NVKI \leq 45$	3
$45 < NVKI \leq 55$	4
$55 < NVKI \leq 65$	5
$65 < NVKI \leq 100$	6

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

47.5. the total amount of capital needed to cover concentration risk in loan portfolio is determined as a sum of capital needed according to the provisions of Articles 47.1–47.4.

48. If the bank has significant investments in the securities issued by clients that are included in the loan portfolio, the bank shall include such securities into the total exposure to client for the purposes of calculation of the amount of capital needed to cover name concentration risk and sector concentration risk.

49. The bank shall also evaluate concentration risk, including currency mismatch concentration risk, of the exposures included into other balance sheet items (especially claims on credit institutions and securities), and, where appropriate, shall determine the amount of capital needed to cover it. The bank can determine the amount of capital needed to cover concentration risk of exposures included in other balance sheet items by developing approaches similar to those referred to in Articles 47–48 of these Regulations.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

50. The bank shall conduct periodic stress testing of concentration risk, analyse the results of stress testing and take them into account in determining the amount of capital needed to cover concentration risk.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

Money laundering and terrorism financing risk

51. In the internal capital adequacy assessment process the bank shall assess money laundering and terrorism financing risk and determine the amount of capital needed to cover it. Considering the provisions of Articles 16 and 17 of these Regulations, the bank can determine the capital needed to cover the money laundering and terrorism financing risk by using one of the following methods:

- 51.1. simplified method (Article 52 of these Regulations);
- 51.2. internal method or model developed by the bank.

52. When applying the simplified method to calculate the amount of capital needed to cover the money laundering and terrorism financing risk:

52.1. the bank considers the following indicators:

52.1.1. the proportion of non-resident customer deposits in the total deposits,

52.1.2. the proportion of customer with enhanced customer due diligence deposits in the total deposits,

52.1.3. changes in the non-resident customer deposits volume (as a percentage compared to the previous period) during the last calendar year,

52.1.4. the volume of trust operations – trust liabilities as a percentage to total bank's balance sheet amount;

52.2. in addition to the indicators mentioned in Article 52.1 the bank considers the quality of the internal control system in the area of money laundering and terrorism financing prevention;

52.3. the amount of capital needed to cover money laundering and terrorism financing risk is calculated as follows:

52.3.1. the bank assigns numerical score (from 1 – 10) to the indicators specified in Article 52.1 using the following criteria:

52.3.1.1. the proportion of non-resident customer deposits in total deposits (as a percentage) – criteria specified in table 4:

Table 4. Criteria for non-resident customer deposit proportion in total deposits

Proportion (%)	Numerical score
Less than 9.9	1
10 – 19.9	2
20 – 29.9	3
30 – 39.9	4
40 – 49.9	5
50 – 59.9	6
60 – 69.9	7
70 – 79.9	8
80 – 89.9	9
More than 90	10

52.3.1.2. the proportion of customer with enhanced customer due diligence deposits in total deposits (as a percentage) – criteria specified in table 5:

Table 5. Criteria for customer with enhanced customer due diligence deposits proportion in total deposits

Proportion (%)	Numerical score
Less than 9.9	1
10 – 19.9	2
20 – 29.9	3
30 – 39.9	4
40 – 49.9	5
50 – 59.9	6
60 – 69.9	7

70 – 79.9	8
80 – 89.9	9
More than 90	10

52.3.1.3. changes in the non-resident customer deposit volume (as a percentage compared to previous period) during the last calendar year – criteria specified in table 6,

Table 6. Criteria for changes in non-resident customer deposit volume during the last calendar year

Changes (%)	Numerical score
Less than 0	1
0 to +19.9	2
+20 to +39.9	3
+40 to +59.9	4
+60 to +79.9	5
+80 to +99.9	6
+100 to +119.9	7
+120 to +139.9	8
+140 to +159.9	9
More than +160	10

52.3.1.4. trust liabilities as a percentage to total bank's balance sheet amount – criteria specified in table 7;

Table 7. Criteria for trust liabilities as a percentage to total bank's balance sheet amount

Ratio (%)	Numerical score
Less than 9.9	1
10 – 19.9	2
20 – 29.9	3
30 – 39.9	4
40 – 49.9	5
50 – 59.9	6
60 – 69.9	7
70 – 79.9	8
80 – 89.9	9
More than 90	10

52.3.2. the numerical scores assigned on the basis of the criteria specified in Article 52.3.1 are summed up,

52.3.3. if during the last Commission's inspection, where money laundering and terrorism financing prevention in the bank was examined, the Commission has identified material shortcomings in the bank's internal control system in the area of money laundering and terrorism financing prevention, the bank increases the numerical score mentioned in Article 52.3.2 by 10. For the purposes of these Regulations, material shortcomings in the internal control system in the area of money laundering and terrorism financing prevention shall be considered such shortcomings where as a result the bank fails to ensure proper customer identification or verification of the actual beneficiary, or proper knowledge of the customer business, or drawbacks in identification or reporting of unusual and suspicious

transactions, or non-compliance with other material provisions of the Law on the Prevention of Laundering the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing, or insufficient internal audit examinations in the area of money laundering and terrorism financing,

52.3.4. if the specificities of the activities of the bank's customers are such that the transaction volumes of the non-resident customers and/or customers with enhanced customer due diligence are considerable, whereas their account balances are small and therefore the criteria outlined in Articles 52.3.1.1–52.3.1.3 fail to properly reflect the risk inherent in the bank's customer structure, instead of the criteria on the deposit balances or the changes in the balances specified in Articles 52.3.1.1.–52.3.1.3 the bank shall use the criteria characterizing customer transaction volumes (e.g. the proportion of the average monthly (or daily etc.) turnover of the accounts of non-resident customers (or accordingly – customers with enhanced customer due diligence) in the total average turnover of all customers in the respective period),

52.3.5. depending on the total numerical score, determined according to the provisions of Articles 52.3.1–52.3.4, the bank calculates the capital needed to cover money laundering and terrorism financing risk as provided in table 8:

Table 8. Capital needed to cover money laundering and terrorism financing risk:

Total numerical score	Capital needed to cover the risk (% of total of the deposits and trust liabilities)
4–11	No capital add-on needed
12–17	0.25%
18–23	0.50%
24–29	0.75%
30 and more	1.00%

Liquidity risk

53. Maintenance of additional capital for coverage of the liquidity risk does not provide for effective liquidity risk mitigation; however, under stressful conditions the costs of attraction of additional funding can influence the bank's earnings and capital level.

54. In the internal capital adequacy assessment process the bank shall assess the liquidity risk, including:

54.1. shall analyse the quality of the bank's liquidity risk management and control, as well as of stress testing and of contingency funding plans for withstanding liquidity crisis;

54.2. shall analyse the bank's funding structure, including the bank's dependence on external resources, especially inter-bank, money and capital market loans and concentration of funding sources;

54.3. shall assess liquid assets adequacy under stressful conditions, taking into account correlation of funding liquidity risk and market liquidity risk;

54.4. shall assess the potential losses that might incur in the result of the rise in the prices of resources and analyse the necessity to determine additional capital needed for the coverage thereof.

55. To assess the potential losses that may incur in the result of the liquidity risk, the bank shall, by using the analysis of the potential adverse event scenarios (stress testing):

55.1. analyse the possibilities to attract funding, if necessary;

55.2. estimate the costs of attraction of additional funding and the raising costs of the existing funding in case of the liquidity crisis.

56. Liquidity risk stress testing scenarios shall include both internal factors (crisis in the bank, in the branch of the bank, in the parent bank) and external factors (overall market crisis in Latvia or abroad). For stress testing the bank shall analyse the following scenarios:

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

56.1. overall market crisis in Latvia and abroad, including:

56.1.1. simultaneous unavailability of resources in previously highly liquid markets,

56.1.2. loss of liquidity in stock markets,

56.1.3. strict limitations on asset pledge,

56.1.4. interruptions in payment and settlement systems,

56.2. liquidity problems of the bank due to reputation risk events,

56.3. if the bank is a subsidiary of other bank and the liquidity risk of the bank is managed in a centralized manner, the bank shall analyse the possibilities to obtain funding also in cases, when the parent bank is incapable of providing the required resources.

Other risks

57. In the internal capital adequacy assessment process the bank shall also assess other risks inherent in the activities of the bank, including reputation risk, strategic and business risk and other risks that are relevant to the operations of the bank (hereinafter – other risks).

58. Taking into account that reputation risk and strategic and business risk are material risks for any bank, the bank shall ensure proper management of reputation risk and strategic and business risk, and maintenance of a certain level of capital to cover those risks can not substitute other risk management and mitigation methods. Within the framework of reputation risk and strategic and business risk management the bank shall assess the possibility to introduce risk measurement (assessment) systems for these risks.

59. Taking into account the specificities of the bank's activities, the bank shall develop adequate policies and procedures for identification and management of reputation risk. The reputation risk may arise as a result of the bank's activities and also due to external factors independent from the bank. The sources of reputation risk are: taking the heightened levels of risks, insufficient quality of services provided to clients, unethical or illegal activities of the management of the bank or bank's employees, fraud, improper accounting systems, weak corporate governance, non-compliance with the binding laws, regulations and standards, weak operational and financial results, conflicts of interest, sanctions applied by supervisory authorities, low service quality etc. Within the reputation risk management framework the bank shall create and maintain (protect) good reputation both in everyday operations and in crisis situations:

59.1. to maintain a good reputation in everyday operations, the bank shall at least ensure ongoing improvements in its business processes, products and services, develop main principles for cooperation with clients, counterparties and other stakeholders, and develop the public relations (including marketing) conception;

59.2. the bank shall develop procedures and contingency plans for management of crisis situations, including, shall identify the potential events that could cause an increased reputation risk, be aware of reasons and potential consequences of such events, determine

measures to be taken to protect its reputation under stressful conditions and establish the principles for communication with public under stressful conditions.

60. Within the strategic and business risk management framework, the bank shall develop adequate strategic planning system, within which the bank shall at least analyse, assess and document various potential bank's development scenarios depending on various external scenarios, identify such potential events and possible changes in market conditions, that might have an adverse effect on the bank's operations and could impede the achievement of bank's goals, and shall assess the impact of such events and market conditions or changes in market conditions on the operations of the bank. The bank shall take into account its development strategy, including targets, risk strategy and capital adequacy strategy, when the size of capital buffer is assessed.

61. The bank's operations may expose the bank to other risks whose impact on the operations and capital of the bank has not been captured by the minimum regulatory capital requirements, for example:

61.1. if fee income and expenses form significant part of bank's income and expenses and therefore have material effect on the financial results of the bank, the risk of volatility of fee income and expenses is material for the bank and changes in the corresponding business lines or services (wherefrom such income have been gained or expenses incurred) may considerably affect the financial results and the level of capital of the bank;

61.2. if the bank for its employees has set up defined benefit pension plans and the bank itself has taken pension liabilities risk, the pension risk is material for the bank – the risk that the assets of the pension plan will not be sufficient to cover the liabilities of the pension plan and that may materially affect the financial results and the level of capital of the bank;

61.3. if within a consolidation group the bank carries out insurance operations, then insurance risks may be material for the bank and can considerably affect the financial results and the level of capital of the bank.

62. Considering the provisions of Articles 16 and 17 of these Regulations the bank may determine the capital needed to cover other risks by using one of the following approaches:

62.1. simplified method (Article 63 of these Regulations);

62.2. internal models and methods developed by the bank.

63. The simplified method to determine the capital needed to cover other risks means that the amount of capital needed is determined as a certain percentage from the total minimum regulatory capital requirements, but no less than 5 percent.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

Assessment of the capital buffer

64. In addition to capital needed to cover risks, the bank shall also determine the size of capital buffer, in order to ensure that the bank has adequate capital in case of occurrence of plausible adverse scenarios material for the activities of the bank as well as to ensure that the bank has adequate capital throughout the entire economic cycle, i.e. during a period of economic growth the bank shall create a capital buffer to cover losses that might occur in the economic downturn.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

65. To assess the size of capital buffer, the bank shall analyse, assess and document the potential bank's development scenarios for the next two years depending on various macroeconomic development scenarios, events or changes in market conditions, as well as shall assess the impact of such scenarios, events or changes in market conditions on the overall financial position, capital available, capital requirements and capital adequacy of the bank, taking into account the interactions of various risks (especially credit risk, market risk and liquidity risk) to which the bank is exposed to. To determine the size of capital buffer the bank shall consider several macroeconomic development scenarios: base case scenario (scenario used in the planning of bank's operations) and at least one materially adverse (severe) scenario (stress testing scenario). The bank shall analyse, for example, such stress testing (adverse development) scenarios as:

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

65.1. scenarios of overall economic downturn and economic activity decrease (overall recession scenarios);

65.2. scenarios of downturn and decrease in the economic activity of particular economic sectors material for the operations of the bank (scenarios of recession in particular economic sectors);

65.3. scenarios of crisis situations (stressful conditions) in money and financial markets (e.g. decrease in liquidity, high volatility of market prices, severe drop in share prices);

65.4. other possible scenarios (e.g. reputation risk scenarios etc.);

65.5. simultaneous occurrence of several adverse scenarios (e.g. worsening of the overall economic situation and decrease in the economic activity, liquidity crisis and material damage to the bank's reputation).

66. The scenarios used to determine the size of capital buffer shall be institution-wide (covering all material risks inherent in the activities of the bank and all significant business areas), extreme, with sufficiently severe impact, but not impossible. The scenarios shall correspond to such rather rare events that affect the bank, financial and other sectors that are material for the operations of the bank approximately once in 25 years.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

66.¹ Stress testing performed to determine the size of capital buffer shall be forward-looking and shall form an integral part of capital planning. Forward-looking stress testing means that both systemic and institution-specific changes in risk factors for at least next two years are considered.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

67. For the purposes of stress testing the bank, observing sufficient level of prudence, may take into account the likely measures taken by the management of the bank in the event of occurrence of an adverse scenario to reduce the impact of such scenario on the bank (e.g. asset sale, reduction in the volume of operations, attraction of financial investors etc.). At the same time the bank shall ensure that the measures taken by the management are discussed and approved at a relevant management level and stress testing outcomes are documented in the manner that allows identifying an impact of stress test scenarios on the bank both gross and net of management actions.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

68. In the event of occurrence of adverse scenarios the bank may use the capital buffer to cover losses and maintain a smaller capital buffer, by covering the losses incurred from adverse scenarios from the previously accumulated capital buffer. At the same time the bank shall take all the necessary measures to restore within a reasonable time period the capital buffer for other potential adverse scenarios and ensure that the amount of available capital is sufficient over the entire economic cycle.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

69. Deleted in accordance with Regulations No. 11 of the Financial and Capital Market Commission of 28.01.2011 "Amendments to Regulations on the Internal Capital Adequacy Assessment Process" (Article 37).

70. Deleted in accordance with Regulations No. 11 of the Financial and Capital Market Commission of 28.01.2011 "Amendments to Regulations on the Internal Capital Adequacy Assessment Process" (Article 37).

Determination of the total capital needs

71. To determine the total capital needs the bank shall aggregate the results of the calculations of the capital needed to cover separate risks and the amount of capital buffer. In case the bank in the calculations uses different assumptions for different risks (e.g. different confidence levels or holding periods), for the purposes of calculating the total capital needs the bank shall ensure comparability of the obtained results.

72. To aggregate the internal capital adequacy assessment results, the bank may use any of the following approaches:

72.1. the bank may determine the total capital needs by summing up the amounts of capital needed to cover all risks and the amount of capital buffer;

72.2. the bank may determine the total capital needs by using the internal model or method developed by the bank. This approach allows to recognise diversification effects. In case the bank recognizes diversification effects, it shall observe sufficient level of prudence and shall ensure that:

72.2.1. the approach used by the bank (e.g., variance-covariance matrix, copulas, full modelling/simulation approach) is documented in the internal documents of the bank and main parameters and assumptions are described;

72.2.2. the bank has analysed limitations and assumptions of the approach used, including has performed sensitivity analysis of main assumptions, has analysed likely "wrong-way" interactions between risks and other limitations referred to in Basel Committee on Banking Supervision document "Range of practices and issues in economic capital frameworks"⁷,

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

72.2.3. in assessing diversification effects the bank relies not only on the expert judgement, but uses statistically grounded assumptions and parameters, parameters are based on the data on at least a 5-year period;

72.2.4. the bank on a regular basis performs validation of the stability of the method used and data quality.

⁷ Internet source: <http://www.bis.org/publ/bcbs152.htm>.

Capital planning

73. Within a business planning the bank shall plan the capital for a period of at least next three years.

74. Capital planning comprises of the formulation of the capital adequacy maintenance strategy, where the bank shall at least determine the amount of capital needed to cover risks inherent in the planned activities of the bank, the desirable capital level (capital adequacy targets) and the plan for reaching it, sources for capital increase and expected costs of attraction of additional capital, the plan for ensuring the compliance with minimum regulatory capital requirements and the capital adequacy maintenance plan in extraordinary situations (capital contingency plan). In case subordinated capital is included in the bank's own funds the bank within the capital planning shall also plan the subordinated capital and shall identify actions to be taken by the bank to ensure adequate capital to compensate for planned reduction in subordinated capital (for instance, either new subordinated capital will be attracted, or share capital will be increased or other measures will be taken to reduce risks inherent in current and planned activities of the bank).

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

75. Within the capital planning the bank shall project:

75.1. changes in the amount of capital needed to cover risks, taking into account the increase or changes in the volume of operations of the bank according to the bank's strategic and annual plans, including changes in the minimum regulatory capital requirements and changes in the total capital needs according to the internal assessment of the bank;

75.2. changes in the available capital considering the planned profit and distribution of it (including dividend policy), share issues, maturity and attraction plans of subordinated capital, planned investments in the capital of other companies and other likely factors that may affect the size of available capital. The bank in the planning of capital shall determine the internal and external sources for capital increase, if such necessity should arise, e.g. share issues, attraction of subordinated loans etc.

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76. Within the capital planning the bank shall also plan the capital for extraordinary situations, *inter alia*, shall determine actions to be taken to ensure compliance with the minimum regulatory capital requirements in extraordinary situations and develop adequate action plans.

77. The bank shall determine the desirable capital level (capital adequacy targets) considering the risks inherent in the activities of the bank, the economic environment in which the bank operates, the quality of the internal control, governance and risk management systems, the strategic plan, quality of the available capital, the possibilities to attract additional capital – in case such necessity should arise, the requirements on the capital level of the rating agencies for granting certain rating, the requirements on the capital level of bank's creditors and other eventual factors.

78. If the bank's capital decreases below the total capital needs (for example in cases specified in Article 68 of these Regulations), the bank shall immediately notify the Commission of the occurrence of such situation, specifying the reasons of it and the activities planned by the bank to restore the adequate level of capital.

79. Based on the results of the internal capital adequacy assessment process, the bank shall summarize the main conclusions, determine areas that require improvement or other measures and develop an action plan for ensuring capital adequacy. The action plan for ensuring capital adequacy may include the following actions:

- 79.1. increasing the available capital;
- 79.2. changing the risk profile of the bank – reduction in the volume of certain operations, application of new risk mitigation methods etc.;
- 79.3. improvement of the internal control, governance and risk management systems;
- 79.4. changing the capital adequacy targets, and if necessary determining a transition period for achieving the revised capital targets.

IV. Requirements on the preparation and submission to the Commission the report on the internal capital adequacy assessment process

80. The bank shall submit to the Commission the report on the internal capital adequacy assessment process (hereinafter – the report) within a month after the bank's supervisory board has approved the results of internal capital adequacy assessment process.

81. Each year until 1st of December the bank shall notify the Commission of the planned term for submission of the next year's report on the internal capital adequacy assessment process.

82. The report shall contain the following information:

- 82.1. general description of the bank, main business activities, a summary of the current and planned financial position;
- 82.2. summary on strategic planning, including:
 - 82.2.1. description of the business strategy and performance goals,
 - 82.2.2. description of the capital adequacy maintenance strategy,
 - 82.2.3. description of the risk strategy;
 - 82.2.4. quantitative information on the bank's strategy for at least the next three years;

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82.3. description of the risks inherent in the activities of the bank and description of risk management systems, including:

- 82.3.1. the procedure for identification material risks, including qualitative and quantitative criteria that are used for identification of material risks,
- 82.3.2. list of risks identified as material and description of the risk definitions used by the bank,
- 82.3.3. on each of the material risks to which the bank is exposed to – description of the risk management system, description of the methods used in risk measurement (or assessment), description of the risk mitigation methods applied by the bank and other material information characterizing the risk management system in the bank;

82.4. description of the internal capital adequacy assessment process, including:

- 82.4.1. description of the capital definition,
- 82.4.2. list of risks for which the bank in its internal capital adequacy assessment process determines the amount of capital needed to cover them and description of methods used by the bank for determining the capital needed to cover each risk,

82.4.3. list of risks, for which capital in the internal capital adequacy assessment process is not calculated, but other risk management and mitigation methods are used,

82.4.4. description of methods used by the bank to determine the size of capital buffer;

82.4.5. description of method used for aggregating the results of capital adequacy assessment,

82.4.6. description of segregation of duties, authority and responsibility in the internal capital adequacy assessment process,

82.4.7. description of reporting and information exchange procedures in the internal capital adequacy assessment process,

82.4.8. regularity of the internal capital adequacy assessment process;

82.5. summary of the internal capital adequacy assessment process results (including quantitative), including:

82.5.1. bank's assessment of the available capital. If for the purposes of internal capital adequacy assessment process the bank uses the definition of capital and capital calculation methodology that is different from the own funds definition and own funds calculation methodology specified in the regulations on minimum capital requirements, the bank shall include a comparison of the bank's assessment of the available capital and the amount of the own funds, explaining the differences,

82.5.2. bank's assessment of the amount of capital needed to cover each risk for which the bank holds capital. Upon the request of the Commission, the bank shall also submit the corresponding calculations,

82.5.3. bank's assessment of the size of capital buffer. The bank shall indicate a summary of the stress testing results, including description of scenarios analysed and main assumptions used, a summary of the quantitative results of stress testing, conclusions and decisions taken. Upon the request of the Commission, the bank shall also submit the corresponding calculations,

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82.5.4. calculations of the total capital needs,

82.5.5. if for determining the amount of capital needed to cover risks for which minimum regulatory capital requirements have been set the bank uses internal models or methods (including modifications of the approaches allowed in the minimum regulatory capital requirements) – a comparison of the bank's assessment of the amount of capital needed to cover each risk with the minimum regulatory capital requirements and explanation of the differences,

82.5.6. description of the main conclusions drawn and decisions taken in the result of the internal capital adequacy assessment process and description of action plans for ensuring capital adequacy,

82.5.7. information on the main assumptions used in the internal capital adequacy assessment process, reasons for the selection of particular assumptions and results of sensitivity analysis (i.e. their impact on the results of the capital adequacy assessment),

82.5.8. other information characterizing the results of the internal capital adequacy assessment process;

82.5.9. information on the capital planning, including information on the capital adequacy maintenance plan, the plan for ensuring the compliance with minimum regulatory capital requirements (including information about the planning of subordinated capital) and the capital adequacy maintenance plan in extraordinary situations (capital contingency plan).

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82.6. summary of the results of the internal capital adequacy assessment process examinations conducted by internal audit;

82.7. list of the bank's internal procedures governing the strategic planning, identification of material risks, risk management and the internal capital adequacy assessment process;

82.8. other information that is important to understand the bank's strategic planning, risk identification and management systems and internal capital adequacy assessment process.

83. The bank can prepare the report in a free format or use the template form annexed to these Regulations, indicating the advisable layout of report on the internal capital adequacy assessment process. In the annex to the report the bank shall include copies of all internal documents regulating capital adequacy assessment process, copies of documents verifying capital adequacy assessment results, as well as copies of bank's internal regulatory documents that determine the bank's strategy and capital plan for at least the next three years.

(As amended by Regulations No. 11 of the Board of the Financial and Capital Market Commission of 28.01.2011, effective as of 05.02.2011)

84. If on any reporting date the information specified in Article 82 of these Regulations has not changed and corresponds with the information provided to the Commission in the previous report, the bank shall indicate in the respective section of the report that as from the date of the previous report the information has not been subject to any changes.

Chairwoman
Financial and Capital Market Commission

I. Krūmane