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Regulations No. 194

Regulations on Credit Risk Management

Issued in accordance with Section 50.⁸, paragraph six; Section 50.⁹, paragraph eight and Section 52 of Credit Institution Law

I. General Provisions

1. Regulations on Credit Risk Management (hereinafter – the Regulations) establish requirements for credit risk management and shall be binding on banks registered in the Republic of Latvia. The banks shall comply with the requirements of these Regulations at an individual level and consolidated group or consolidated sub-group level, providing for credit risk management adequate to requirements for a consolidated group or sub-group, as well as relevant subsidiary.

2. Provisions of the Regulations are recommended to apply also to credit unions, investment firms, as well as investment management companies, insurance and reinsurance undertakings, private pension funds registered in the Republic of Latvia, and regulated market organizers as far as applicable to their activities.

3. The following terms are used in these Regulations:

3.1. credit risk – possible occurrence of loss in case a counterparty fails or refuses to fulfil liabilities to the bank in accordance with contractual terms;

3.2. other terms used in the Regulations correspond to the Commission's Regulations No 60 of 02.05.2007 "Regulations for Calculating the Minimum Capital Requirements" (hereinafter – regulations on minimum capital requirements), the Commission's Regulations No 38 of 20.03.2009 "Regulations on the Development of Capital Adequacy Assessment Process", the Commission's Regulations No 42 of 25.03.2009 "Regulations on Assets Quality Assessment and Provisioning" and the Commission's Regulations No 63 of 02.05.2007 "Regulations on Establishing an Internal Control System".

4. Each bank shall develop a credit risk management system, considering the total amount of credit exposures, types of credits, description of counterparty, number of structural units involved in credit risk management and other factors that have a material effect on the credit risk level at a respective bank. The bank shall ensure credit risk management considering the correlation of the risks to which the bank is exposed.

5. Loans are the most obvious source of credit risk, but also other types of assets can be exposed to credit risk, such as securities, derivatives, as well as credit risk inherent in off-balance-sheet items referred to in Clause 90 of Regulations on Minimum Capital Requirements.

6. Requirements of Regulations shall be applicable to a full scope of the bank activities and services exposed to credit risk either in non-trading book or trading book.

7. Counterparty credit risk in the trading book, country risk and settlement risk are also deemed as credit risks.

8. To ensure efficient credit risk management, the bank shall:

8.1. develop and approve the credit risk strategy and policies, and define responsibility of the senior management and board of directors in the area of credit risk management, ensuring credit risk environment appropriate to the bank's activities;

8.2. ensure reasonable credit granting criteria;

8.3. perform ongoing administration of credits, and measurement, assessment and monitoring of credit risks;

8.4. ensure adequate credit risk monitoring.

9. The bank's board of directors and senior management shall be responsible for efficient credit risk management.

II. Credit risk strategy, policies and procedures

10. Credit risk strategy of bank shall determine credit risk tolerance and other credit risk parameters. Identifying the credit risk tolerance and other credit risk parameters is based on the bank's assessment of its credit risk bearing capacity.

11. The bank shall assess its credit risk bearing capacity, considering any other risks to which the bank is exposed. The bank shall develop, document and apply consistently the methodology for the assessment of the bank's credit risk bearing capacity, which shall define models and methods, as well as parameters, assumptions and calculations used for that purpose. Taking into account that the credit risk bearing capacity depends on the amount of capital available, the amount and quality of credit exposure, as well as income and expenditures related to activities associated with credit risk, following indicators characteristic to the bank's activities and data analysis may be considered as part of the bank's methodology:

11.1. the amount of credit risk capital requirements for previous years and projected credit risk, which is defined in accordance with provisions of "Regulations for Calculating Minimum Capital Requirements";

11.2. the capital required to cover credit risk defined in the previous years by the bank and the projected amounts defined in accordance with the Commission's Regulations No 38 of 20.03.2009 "Regulations on the Development of Capital Adequacy Assessment Process",

11.3. information on income and expenditures related to credit risk provided in previous years and in projected profit and loss statement;

11.4. information on credit exposures provided by the bank in previous years and projected total credit exposures ;

11.6. results of various stress testing scenarios.

12. The credit risk strategy shall be consistent with the bank's total credit exposures, complexity of activities and shall define at least:

12.1. types and amounts of credits the bank intends to grant (for instance, commercial credits, consumer credits, mortgage-backed credits, credits where there is mismatch between the borrower's income currency and credit currency), economic sector, geographical location, acceptable concentration level of various types of credits, currency, maturity and profitability;

12.2. credit risk tolerance and profit the bank intends to generate in assuming relevant risk;

12.3. capital required for credit risk coverage;

12.4. basic principles or access to credit classification by their quality;

12.5. desirable degree of credit portfolio quality and increase or decrease in credit portfolio;

12.6. planned credit risk mitigating methods.

13. In the development of credit risk strategy, the bank shall assess qualification and availability of relevant personnel, as well as capacity of information systems and organisational structures for the implementation of the strategy.

14. The bank's credit risk policies and procedures shall meet the bank's credit risk strategy targets and determine powers, rules and general approach for efficient credit granting, credit administration, for identifying, measuring, assessing, monitoring and controlling credit risk. Policies shall provide for compliance with regulatory requirements, conform to reasonable practice of bank, the size of the bank, nature and complexity of bank's activities and provide for necessary resources.

15. The bank shall develop, document and implement credit risk policies and procedures that define:

15.1. preferable structure of credit portfolio, admissible concentrations, including the concentration level of credits, which are denominated in the currency different from the borrower's income currency;

15.2. credit granting policy that covers:

15.2.1. credit granting criteria and limits,

15.2.2. powers and responsibilities of the senior management, credit committees or similar bodies and relevant employees engaged in credit granting,

15.2.3. terms and limits for granting unsecured credits,

15.2.4. procedure for defining interest rate and repayment of secured and unsecured credits,

15.2.5. criteria for the assessment of the borrower's creditworthiness,

15.2.6. debt service ratios for different types of borrowers, namely, proportion of expenses on borrower's debt servicing to total net income of the borrower (borrower's family members, who have accepted the loan) over the relevant period of time, and above ratios for different categories of borrowers;

15.2.7. types of eligible collateral and procedures for evaluation and revaluation of their eligibility,

15.2.8. limits on the credit amount to collateral value;

15.3. credit administration rules;

15.4. policies and procedures for measuring, assessing and monitoring of credit risk including the monitoring of quality procedures that contain:

15.4.1. early warning indicators of impairment of credit quality and procedure for monitoring mentioned impaired credits,

15.4.2. procedure for identifying, administrating and recovery of credits, whose quality has significantly impaired;

15.5. performing transactions in financial instruments that constitute credit risk to the bank, the bank shall develop and implement the terms of transactions defining:

15.5.1. eligible types of financial instruments and limits on appropriate transactions,

15.5.2. documents underlying the transaction,

15.5.3. a list of proper counterparties and their assessment criteria,

15.5.4. sources of market information required for the assessment of the current replacement cost and potential future exposure of financial instruments, procedures for its storage, models used in the assessment, methods and procedures for considering liquidity level of financial instruments and following adjustment of value,

15.5.5. power and responsibility of relevant employees engaged in carrying out transactions in financial instruments;

15.6. information included in credit risk and stress tests reports, frequency of reporting, providers and recipients of information;

15.7. procedure for reporting on deviations from the approved policies and procedures.

16. The bank shall define following limits for credit concentration:

16.1. limits on exposures to a client or group of connected clients;

16.2. limits on exposures to persons related to the bank;

16.3. limits on intra-group exposures;

16.4. limits on exposures to other banks;

16.5. limits on exposures to clients from a particular economic sector or geographical region;

16.6. limits on exposures secured with a certain type of collateral;

16.7. limits on credits issued in the currency other than the borrower's income currency.

17. A bank shall assess the necessity to set lower limits than provided in the laws and regulations.

18. Exposure limits shall be strictly observed and they must not be adjusted to the needs of the borrower. If the bank's policies provide for a possibility to deviate from the determined low-level limits under stressful conditions, the senior management or powered for this purpose committee shall approve that deviation.

19. The bank, whose strategy provides for granting credits to borrowers, whose financial position and credits repayments are dependent on economic, social and political situation of other member states or third countries, shall develop, approve and implement policies and procedures to identify and manage country risk as well as transfer risk, which is a component of country risk and is related to the borrower's capacity of having available foreign currency in order to meet liabilities to the bank. Restrictions on utilization of income in foreign currencies effective in a relevant country shall be taken into account in terms of those policies and procedures.

20. The bank's policies shall define criteria, including limits and restrictions, for credit granting to counterparties related with the bank. Conditions for granting those credits shall not

be more advantageous than credit conditions for counterparties that are not connected with the bank under similar circumstances.

21. The bank shall ensure identification of all credit risks arising from the bank's new financial services and markets prior to implementation of those services and shall develop and approve policies and procedures for risk management thereof. Prior to implementation of new financial services or before incorporation into the new market the bank shall analyse potential amount of credit risk associated with those services and their effect on the capital required to cover credit risk. The above requirements shall be applicable not only to new financial services but also to the existing financial services whose conditions undergo essential changes.

III. Responsibility of the bank's board of directors and senior management for credit risk management

22. The bank's board of directors shall have responsibility for credit risk management, and it shall:

22.1. approve the credit risk strategy, which defines credit risk tolerance and the goals of activity the bank expects to achieve for incurring various credit risks;

22.2. approve policies for implementation of credit risk strategy;

22.3. supervise and control how the senior management performs management of credit risk inherent in the bank's activities and whether those activities have been performed in accordance with credit risk strategy and policies;

22.4. determine that internal audit regularly reviews and assesses compliance of the bank's activities to its credit risk strategy, policies and procedures and communicates the results of audits to the board of directors;

22.5. determine information exchange procedures between the board of directors and senior management, for instance, the senior management submits quarterly report on credit risk management to the bank's board of directors, summarizing information on attaining objectives set in the credit risk strategy, report to the board results of stress testing and, if necessary submit measures to overcome the critical situations;

22.6. ensure that the bank's remuneration policies neither contradict to its credit strategy nor facilitate short-term profit making from exposures;

22.7. review credit risk strategy and policies regularly, but at least once a year, based on the financial results and action plans and considering changes in laws, regulations, the economic situation, markets and projections, implementation of new products, systems and activities, as well as determine whether amendments to the credit risk strategy and policies are required and whether the bank's own equity is sufficient to cover taken credit risk or expected credit risk.

23. The bank's senior management shall have responsibility for implementing credit risk strategy approved by the board of directors and credit risk management, and it shall:

23.1. ensure development of policies and procedures for credit risk management;

23.2. ensure achieving objectives set in the bank's credit risk strategy and implementation of policies and procedures for credit risk management;

23.3. determine adequate segregation of powers, duties and responsibilities for credit risk management between the structural units and responsible employees;

23.4. approve the procedure for reporting results of credit risk management stress testing, assigning a structural unit or employees responsible for preparing and submitting reports, and control their timeliness;

23.5. ensure informing the employees engaged in the credit granting process about the credit risk strategy, policies and procedures and their responsibilities regarding compliance with the approved policies and procedures;

23.6. ensure recruitment of employees whose qualifications meet their responsibilities in the area of credit risk management;

23.7. ensure high standards of ethical code of conduct and credit granting criteria compliance;

23.8. approve credit concentration limits and ensuring their compliance.

IV. Credit granting

24. The bank shall develop and conform to the credit granting criteria that are appropriate for reasonable decision-making on credit granting. Such criteria shall be adjusted to every credit target market, where the bank issues credits, types of issued credits, credit targets and the borrower's creditworthiness.

25. Prior to granting the credit the bank shall assess the borrower's creditworthiness analysing following information:

25.1. purpose of the credit and sources of repayment;

25.2. the borrower's current risk profile, including the risks the borrower has already taken, aggregate amounts of risks and their sensitivity to economic developments, the value of collateral and its market liquidity, compatibility of credit currency with the borrower's income currency;

25.3. the borrower's financial participation in the financing of credit target;

25.4. sufficiency of the borrower's (natural person) income to cover expenses on credit servicing, setting a prudent debt service ratio for each client or a group of clients. Assessing sufficiency of the natural person's income for servicing the credit, the bank shall consider the stability of income of borrower including position of the borrower's working place, geographical region or economic sector in the market;

25.5. results of economic activities of the borrower, as well as financial statements, expected credit repayment cash flow, as well as the development of the relevant national economic sector or geographical region and the borrower's position in the sector and the borrower's business management competence;

25.6. affiliation of the borrower to a group of connected clients or persons related to the bank. To identify the affiliation, the bank shall develop a procedure for identifying the group of connected clients or persons related to the bank;

25.7. the borrower's credit history with the bank and relevant information available in external sources including the Credit Registry;

25.8. eligibility and sufficiency of existing collateral, i.e. proportion of its market value or the value determined by a certified valuer to the credit principal amount, and alienation of collateral or its enforceability under various scenarios;

25.9. if a third person guarantee is accepted as collateral, the bank shall assess creditworthiness of the third person considering conditions thereof.

26. In decision-making on the credit terms, the bank shall commensurate risks associated with every credit and expected benefits, taking into account resource costs as well as existence of collateral and additional restrictive conditions. The price of credit shall be determined in a manner to cover all credit-related costs and compensate risk-taking.

27. The bank shall have a duty to provide a client with fair and complete information on all contractual conditions and risks as well as additional explanations upon the client's request.

28. If the bank participates in a syndicated credit granting process, before decision-taking the bank shall perform the analysis of credit risk and credit-granting terms independently from the analysis conducted by the chief manager of syndicated credit.

29. In case the bank considers accepting collateral to mitigate credit risk when granting the credit, the bank shall firstly assess the borrower's creditworthiness and consider the offered collateral only as the credit risk-mitigating factor. Collateral cannot serve as a substitute for the assessment of the borrower's creditworthiness and required information.

30. To recognize collateral as eligible for credit mitigation, the bank shall review legal conditions regarding collateral to make certain of its alienation (takeover, sale) possibilities, insurance options and other conditions.

31. In case the credit repayment is based on collateral enforceability, the bank shall perform monitoring of collateral profitability, changes in the market value and liquidity rating to make certain that net realisation of collateral covers credit liabilities.

32. In case the credit is secured with deposits placed with the bank, the bank shall make certain whether there are no impediments for claims and liabilities netting also in case winding-up proceedings are opened against a collateral issuer. If a transaction (total transactions) is significant and subject to a number of jurisdictions, the bank shall ensure a legal opinion on the possibility of claims and liabilities netting.

33. The bank shall determine the procedure for decision-making in regard to credit granting, as well as documents and information required for decision-making, and the persons or a committee (the bank's credit committee), which are authorized to take relevant decisions depending on the type and amount of credit.

34. To verify compliance of decision-making with the approved policies and procedures, the bank shall ensure documenting of the decisions on credit granting, as well as credit granting refusals. The documents shall indicate the persons who have performed credit analysis, as well as persons who have agreed to grant the credit or refused to approve such decision, giving reasons for refusal.

35. In case the persons who analyse the borrower's creditworthiness have reasonable recommendations against granting the credit, but a decision on the granting of credit is taken finally, before credit granting the bank's senior management shall approve such decision.

V. Credit administration

36. The bank shall perform ongoing administration of the granted credits, ensure servicing of granted credits that include credit filing, receipt of regular financial information, drawing up and sending notifications and necessary documents.

37. The bank shall have a system for credit administration in place to provide for:

37.1. efficient monitoring over documentation, contractual terms, restrictive additional conditions and collateral;

37.2. accuracy and timeliness of information provided to the management information system;

37.3. conformity to the duty segregation principle ensuring that storing originals of most important documents, resources transfer and information input into data base are performed by different employees;

37.4. compliance with laws and regulations, as well as the bank's policies and procedures.

38. Credit file shall contain all the information required for the assessment of current financial statements of the borrower for the transparency of decision-making process and credit history (for instance, regular financial reports and their analysis, documents attesting to existence and the amount of the borrower's income, credit assessment documentation, internal reporting to the bank's management body, correspondence with the borrower, reports on visits to the borrower, collateral valuation and the results of collateral value monitoring or reference to the document or other data storage device).

VI. Measuring, assessing and monitoring of credit risk

39. For the credit risk management the bank shall ensure measuring, assessing and monitoring of credit risk.

40. In the measuring and assessing of the credit risk, the bank shall consider provisioning required for the expected losses and the necessity to maintain an adequate amount of capital for taking credit risk, namely, the amount of capital to cover unexpected loss.

41. The bank shall establish and implement a monitoring system for a continued assessment of quality of individual credits or portfolio of credits.

42. Monitoring of credit quality shall ensure that:

42.1. the bank is aware of current financial statements and creditworthiness of the borrower;

42.2. contractual terms are observed;

42.3. assessment of sufficiency of collateral is performed considering the market development tendencies;

42.4. past due payments have been timely identified and deterioration in the credit quality has been identified at an earliest possible stage. The bank shall establish a set of indicators and ratios (for instance, payment more than 15 days past due, deterioration in the company's financial statements, insolvency notification of the company where the client is employed, and similar) used as early warning indicators of client's deterioration in the credit

quality and underlying the inclusion of a client in the close-watch client list. The bank shall ensure timely cooperation with the client and identifying credits with significant deterioration in the credit quality (payments (principal amount or interest) more than 90 days past due and others indicators of significant deterioration in the credit quality);

42.5. if significant deterioration in the credit quality is identified, the bank shall ensure credit risk management of such problem credit in accordance with the procedure approved by the bank's senior management. Considering individual credit circumstances, the bank shall take relevant measures including, for instance, additional analysis of the borrower's problems, enhanced controls over the borrower's current account, revision of credit and collateral documentation, development of a package of remedial measures.

43. The bank's senior management shall assign employees responsible for monitoring the quality of credits and portfolio of credits as well as the quality of collaterals and guarantee providers. In assigning those employees, the bank's senior management shall consider possible conflict of interest, in particular regarding an employee whose performance assessment is dependent on such criteria as the amount of credit, quality of credit portfolio or short-term profitability or valuation of the collateral. Remuneration of any employee must not depend on the above criteria.

44. For efficient monitoring of the quality of individual credit the bank may apply the internal rating system. Within the framework of internal rating system an internal rating is assigned to the borrower reflecting the borrower's creditworthiness and credit quality. Internal ratings shall be used to assess the amount of capital required for credit risk coverage and credit pricing, monitoring of quality of credits or portfolio of credits, expected losses and adequacy of provisions.

45. In order to ensure that the assigned internal rating complies with the credit quality, the bank shall regularly review the assigned internal rating. Responsibility for determining or approval of the internal rating shall rest with the personnel who do not deal with assigning the internal rating.

46. A bank shall monitor credit risk at the level of individual credits, total credit portfolio, total credit exposures (real estate-secured credits, credit lines and derivatives) and total bank's activities.

47. In measuring, assessing and monitoring the credit risk, the bank can apply analytical techniques and internal models appropriate to the nature and complexity of its activities. The essence of applicable methods and models, underlying assumptions and estimates shall be documented and reviewed on a regular basis. The bank must not overly rely on a particular method or model in assessing the credit risk as modelling or other analytical methods are only part of the risk management system and quantitative credit risk measurement shall be at all times supplemented with a qualitative assessment of expert.

48. For the credit that is recognized as a credit with significant deterioration in quality, the bank shall take up the possibility of restructuring a credit or develop credit recovery programme prescribing, for instance, use of pledge rights and guarantee rights or insolvency procedures.

49. If credit-related problems are significant, to ensure efficiency of problem risk management the bank shall establish a particular structural unit of specialists with appropriate qualification and work experience.

50. In monitoring credit risk the bank shall develop a set of ratios or indicators including:

- 50.1. total past due credits to total amount of credit exposures;
- 50.2. total provisions for past due credits to total past due credits;
- 50.3. maximum amount of provisions to be covered by the calculated excess of regulatory capital over minimum capital requirements;
- 50.4. maximum amount of provisions to be covered by the current year profit without deduction of capital;
- 50.5. total amount of credits in every internal ratings;
- 50.6. migration matrices for internal ratings.

VII. Management information system

51. The bank shall have a management information system in place to ensure qualitative, detailed and timely reporting on the structure of portfolios under management, on the clients, including information on existing connections among the clients, as well as provide for information required to identify persons related to the bank, assessment of various concentrations and compliance with limits.

52. Management information system shall ensure the provision of information to enable the board of directors and senior management to monitor the credit risk management system in a sound manner, including maintenance of capital required to cover credit risk and analyse results of stress testing. Management information system shall provide for assessment of both the total amount of the bank's credit risk and credit risk inherent in various portfolios or activities in a timely and credible manner as well as make judgements on conformity of credit risk amount to the credit risk strategy targets.

53. The bank shall ensure that its internal procedures and information systems are compatible and reliable, all the sources of credit risk are identified and the amount of credit risk is measured and assessed, monitoring of such risk is conducted at a portfolio, structural unit and subsidiary level as well as at a consolidated group or consolidated sub-group level.

54. Management information system shall ensure timely provision of information for the management of appropriate level in case the total credit risk amount of the borrower is approaching or reaches the set credit limits.

55. The bank shall have a formal and transparent communications mechanism in place to ensure the possibility to obtain and exchange the information regarding management, analysis and monitoring of risks for the bank's board of directors, senior management, structural units and employees.

VIII. Assessment and a package of measures for preventing and avoiding excessive credit risk under stressful conditions

56. In assessing individual credits, the bank shall analyse national economic projections and assess potential critical situations (stressful conditions), namely, such adverse internal and external circumstances that may cause material loss to the bank. The amount of credit risk shall be significantly affected by the changes and tendencies in the determined macroeconomic ratios. For that reason the bank shall analyse an impact of such macroeconomic ratios on credit exposures and portfolios, their profitability, the capital required to cover potential loss or availability and prices of other resources to withstand critical situations. Such an assessment shall be part of decisions on the credit risk management.

57. To assess the amount of capital required to cover credit risk and identify potential critical situations (for instance, the national economic downturn or decline in particular sectors credited by the bank, an increase in the borrowers' default rate exceeding the projected rate, adverse circumstances that may cause substantial correlation of various risks, and in particular, credit risk and market risk correlation), the bank shall perform credit risk stress testing at least once a half year.

58. The bank shall develop stress testing methodology, scenarios and parameters and, after their approval by the senior management, perform credit risk stress testing, analyse the result of stress testing and use them in credit risk management, draw up and submit reports of the results of credit risk stress testing to the board of director and senior management.

59. To ensure qualitative stress testing of credit risk, the bank shall develop such stress scenarios that encompass changes in indicators affecting the credit risk quantitatively and qualitatively for various periods of time and degrees of stress. The amount of credit risk is mostly affected by changes in national macroeconomic indicators, adverse trends in the development of particular sectors or extraordinary events that have an impact on the implementation of the financed projects.

60. Stress testing scenarios shall be used as extraordinary measures that have a considerably material impact. The number of scenarios and their granularity shall depend on the variety and level of complexity of credit exposures and the size of the bank.

61. In the credit risk stress testing the bank shall provide for at least two phases of stress events, i.e. short-term (for instance, changes expected within one year) and a protracted phase (for instance, changes expected within two years).

62. The bank shall develop at least two scenarios to perform credit risk stress testing: a basic scenario based on the economic projections that provide for rather insignificant changes in macroeconomic ratios (projected Gross Domestic Product, unemployment and inflation rate), and a pessimistic scenario based on the material adverse economic development indicators.

63. In case the results of credit risk stress testing reveal potential loss that may be covered by the excess of capital available for the coverage of the bank's total risks, the senior management shall consider possible measures for improving credit risk management to ensure that coverage also in the future. If potential loss cannot be covered by the capital available, the bank shall develop a contingency plan to prevent occurrence of such situation, for

instance, provide for changes in credit risk management policies, procedures and appropriate limits, additional issue of capital instruments or attracting of subordinated capital, or selling or closing any structural unit, or taking any measures to prevent or withstand the adverse results of stress testing.

64. The bank shall consistently perform the assessment of probable occurrence of stressful situations, assess its capability of withstanding the identified stressful situation and analyse possible implementation of the contingency plan based on the change of assumptions underlying one or several variables.

65. The bank shall ensure stress testing according to the Commission's scenario if requested.

IX. Controls over credit risk

66. The bank shall ensure controls over credit risk according to the Commission's Regulations No. 63 of 02.05.2007, "Regulations for Establishing an Internal Control System".

X. Closing provisions

67. Upon these Regulations taking effect the Commission's recommendations No. 17/6 Recommendations for Credit Risk Management of 02.11.2001 shall become null and void.

68. The Regulations shall take effect no later than 01.07.2010.

Chairwoman
Financial and Capital Market Commission

I. Krūmane