Information on risks in activities of AS „SMP Bank" in 2012, objectives, methods and policies of risk management, as well as on requirements to equity and internal capital adequacy.

The information has been prepared in compliance with Regulations No. 61 on disclosure of information, approved by the decision of the Council of the Financial and Capital Market Commission of 02.05.2007 and partially reflected in the AS "SMP Bank" (hereinafter referred to as the Bank) Bank and Consolidated Financial Statements for the year ended 31 December 2012 (hereinafter referred to as the Annual Report for the year 2012.
http://www.smpbank.lv/static/uploaded_files/documents/latvija/reports/2012/as_smp_bank_year_report_2012_eng.pdf) **.**

Information on the Bank's management is reflected in the Annual Report for the year 2012 on page 4, and has not changed since its publication.

Information on the composition of the consolidated group and methods of consolidation is reflected in the Annual Report for Annual Report for the year 2012 on page 13, and has not changed since its publication.

Process of assessment of capital adequacy

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

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

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

During the year 2012, the Bank assessed the capital adequacy by applying „Basel's First Pillar +" approach. The capital amount required to cover the risks (hereinafter referred to as requirements of the Internal Capital) is calculated as the sum of the following characteristics:

- minimum capital requirements;
- capital requirements for risks for which no minimum regulatory capital requirements are established. The capital amount required to cover the risks is formed from the capital amount required to cover individual risks and the rest of the existing and potential risks inherent in the Bank's dealing operations;
- Capital reserve - the amount of capital that is needed to ensure that the Bank's capital is sufficient in case of occurrence of possible adverse events, as well as to ensure that banks have sufficient capital over the economic cycle, i.e., during the period of economic upturn the Bank holds capital reserves to cover losses, that may arise during the period of economic downturn.

Methods, described below, has been used for calculation of minimum capital requirements.

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

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

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

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

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

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

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

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

For currency and operational risk the Bank has assessed whether the level of risk, calculated according to minimum capital requirements, is sufficient to cover losses related to such risk. An open foreign exchange position in recent years did not exceed 5% of its own capital. Exchange rate risk, as calculated in compliance with regulatory minimum capital requirements, in 2012 was sufficient to cover exchange rate risk related losses. In 2012 the operational risk internal capital requirement was added to the operational risk capital requirement.

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

- interest rate risk in the Non- trading Portfolio;
- the imfluence of concentration risk on the credit risk;
- money laundering and terrorism financing risk;

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

The Bank uses a simplified method for calculating the capital amount required to cover the concentration risk. In addition, the Bank limits the potential exposure levels – requirements for one client, requirements for a group of mutually connected clients, the requirements for customers whose activities are related to one sphere and economic sector. In 2012 the Bank strictly observed the concentration risk limits. Risk limit reviews are regularly examined by the Board.

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

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

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

The Bank provides capital reserve to ensure that the Bank's capital is sufficient to cover possible losses in case of occurrence of scenarios, unfavourable for the business of the Bank, as well as to ensure, that the scope of capital, at the disposal of the Bank, is sufficient over the whole economic cycle, it means, that during the period of economic growth, the Bank creates capital reserve for coverage of losses, that might occur during the period of economic downfall.
In case of adverse events, the Bank can use capital reserve to cover losses and maintain lower capital reserve, applying the capital reserve, created before for coverage of losses, caused by unfavourable circumstances. Simultaneously, the Bank takes all the necessary action to renew within the acceptable period of time its capital rezerve for other possible adverse events, as well as to provide, that the capital, at the disposal of the Bank, is sufficient over the whole economic cycle.

Due to lending risk, representing the most essential type of the risks, capital reserve is calculated solely based on the results of the stress testing of the lending risk.

Based on the results of the stress testing of the lending risk and the assessment of the current econimic situation, the calculation of the capital reserve is as follows:

	During stable and successful economical development	During economical downfall	During post – crises economical growth
All results of the stress testing scenarios for the lending risk prove compliance with the requirements of minimum capital adequacy characteristics (minimum capital reserve)	3% of the amount of the minumum scope of the regulated capital requirements	1% of the amount of the minumum scope of the regulated capital requirements	Capital reserve is renewed till the level of 2% of the amount of the minumum scope of the regulated capital requirements
At least one of the results of the stress testing for the lending risk indicates non-compliance with the characteristics, set for capital adequacy.	100 % of the scope of possible capital deficit, according to the most unfavourable scenario, but not less than minimumj capital reserve.	30% of the scope of possible capital deficit, according to the most unfavourable scenario, but not less than minimum capital reserve.	Capital reserve is renewed till the level of 60% of the scope of possible capital deficit, according to the

			most unfavourable scenario, but not less than minimum capital reserve.

The current economical situation for the purpose of assessment of capital adequacy, the Bank evaluates in the business development strategy of the Bank.

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

The legislation of the Republic of Latvia provides for the banks minimum capital adequacy index of 8%. In accordance with the requirements of the Finance and Capital Market Commission, since 30.09.2012, the Bank's regulative capital adequacy ratio should be equal to 10.4% or higher. The internal capital adequacy ratio (minimum capital requirements plus special internal capital requirements and capital reserve) should be 8% or higher. The above limits are adequate to the scope and profile of the Bank's activities and are sufficient to cover the risks inherent to the Bank's activities. In 2012 the Bank has strictly observed these requirements.

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

For planning of capital adequacy the Bank takes into account:

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

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

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

In a crisis situation, when the regulatory or internal limits of capital adequacy are not observed or most likely will be exceeded, the Bank, first of all, considers the attraction of the subordinated capital with the assistance of its shareholders.
In accordance with the Bank's Strategic plan, capital has been increased to LVL'000 13635 during 2012.

The Bank uses stress tests for assessment of future risks. Stress tests help to identify such probable events or probable market changes, which may have a negative influence on the amount of the Bank’s capital. Stress tests simulate situations corresponding to strategic approaches to the Bank’s economic activities and possible changes of market situation. Stress testing methodology is adequate to the scope and specific of the Bank’s activities. The Bank has carried out stress tests in credit risk (5 scenarios), liquidity risk (7 scenario) and interest rate risk (1 scenario). When performing the credit risk stress testing, Bank analyzes how the macroeconomic indicators effects on credit risk, analyzes for changes in the balance sheet, profit and equity in accordance with the Bank's current economic development strategy, within one year and two years period, as well the Bank conducts reverse stress testing.

Test results as of 31.12.2012 have confirmed the Bank’s capability to absorb negative consequences of realization of different scenarios to be acceptable.

Additional information about significant risks management methods used by the Bank is reflected in the Annual Report for the year 2012 on pages 22-63, and has not changed since its publication.

Remuneration policies and practices of the Bank.

The remuneration of the employees are determined based on the list of salary rates, approved by the Board of the Bank, which defines salary interval boundaries applied for each position.

For decisions in regard of the increase of the employee's salary within the pre - defined salary interval boundaries, the Bank can uses:

- the results of regular certification of employees,
- recommendation by Head of Department,
- other objective information about the employee’s results compiled by the Bank human resources officer.

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

For remuneration of the separate categories of employees, in the year 2012, the Bank has used constant as well as variable remuneration models, both parts of remuneration being paid to the employee simultaneously.

Table no. 1. Information on the renumeration structure of the Bank’s risk profile affecting employees by the staff positions:

	Council	**Board**	**Unit managers, wich provides**	**Other Bank’ s staff affecting**

			internal control function, with the exeception of the Board members	on the risk profile, with the exeception of the Board members
Number of employees,	5	7	2	7
including the variable part of remuneration	0	0	0	3
Total amount of salary (in thousands of lats)	0	197	35	127
including the variable part of remuneration (in thousands of lats)	0	0	0	4

Table no. 2. The structure of the variable part of remuneration of the Bank's risk profile affecting employees by the staff positions and by types of activity:

Types of activity	Number of other Bank's staff affecting on the risk profile, with the with the exeception of the Board members
Investment services	1
Service of the individuals or small and medium-sized commercials	3

The total amount of salary, granted during the reporting year, for all employees of the Bank, including members of the Bank's Council and the Board, is 1740 thousand lats, while the variable part of remuneration is 75 thousand lats.

Table no. 3. The structure of the variable part of remuneration for all Bank's employees by types of activity:

Types of activity	Number of employees	Amount (in thousands of lats)
Investment services	2	2
Service of the individuals or small and medium-sized commercials	81	73

Dismissal alowance in 2012 has been paid to one employee of teh Bank, with whom the Bank has cancelled employment.

Results of minimum capital adequacy assessment

Table no. 4. Calculated results of the minimum capital requirements on the 31.12.2012. are (in thousands of lats):

Type of the minimum capital requirements	Bank	Concern

Type of the minimum capital requirements	Bank	Concern
The regulatory minimum capital requirements (total):	8741	8771
Capital requirements for credit risk (total):	7876	7893
including Central governments or central banks	0	0
including Institutions	873	873
including Commercial companies	6642	6151
including Secured by real estate	3	3
including Past due exposures on risk deals	256	256
including Other items	102	610
Market risk capital requirement (total):	59	60
including capital requirement for Trading portfolio setllement risk is calculated in accordance with the requirements of MCRR 2nd section 3rd chapter 2nd part.	0	0
Including capital requirement for Trading portfolio partner risk is calculated in accordance with the requirements of MCRR 2nd section 3rd chapter 3rd part.	0	0
including capital requirement for Non–trading portfolio and Trading portfolio foreign exchange risk, as determined in accordance with the requirements of MCRR 2nd section 3rd chapter 4th part.	59	60
Including capital requirement for Non–trading portfolio and Trading portfolio commodities risk, as determined in accordance with the requirements of MCRR 2nd section 3rd chapter 5th part.	0	0
Operational risk capital requirement	806	818

For creditrisk mitigation the Bank has used financial security

Table no. 5. The value of the Bank's risk deal exposure as of 31.12.2012. before and after the application of credit risk mitigation (henceforth – CRM) (in thousands of lats):