# BALTIC INTERNATIONAL BANK CAPITAL ADEQUACY ASSESSMENT

**The purpose of the Bank's internal capital adequacy assessment process (ICAAP)** is to ensure that

- the Bank maintains, on an ongoing basis, an amount of internal capital sufficient to cover material risks inherent in the Bank's activities
- the Bank's capital is sufficient to absorb losses during periods of possible economic downturn.

The Bank's definition of the term capital corresponds to the definition given in Regulation (EU) No.575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms, amending Regulation (EU) No. 648/2012 (hereinafter referred to as the Regulation).

**In determining the required capital charges for various risk profiles, the Bank identifies and evaluates the following material risks to which the Bank is exposed:**

- risks referred to in Section 92 of the Regulation (hereinafter referred to as risks of Pillar 1);
- other risks (hereinafter referred to as risks of Pillar 2);
- impact of possible adverse events on Bank's capital.

To determine the size of capital necessary for addressing risks under Pillar 1, the Bank assesses whether the adherence to the minimum regulatory capital requirements ensures that the Bank's capital is adequate for covering all contingent losses associated with these risks. To this end, the Bank measures the following risks:

- credit risk;
- market risk;
- credit value adjustment risk (hereinafter referred to as CVA risk);
- operational risk.

When calculating the required capital level based on the minimum regulatory capital requirements, the Bank applies the following methods:

- capital requirements for credit risk– standardised approach;
- capital requirements for market risk – standardised approach;
- capital requirements for credit value adjustment risk (CVA) – standardised approach.
- capital requirements for operational risk – the basic indicators approach.

To determine the amount of risk, Bank relies on credit ratings assigned by *Moody's Investors Service*.

Bank uses two techniques of credit risk mitigation: funded credit protection and unfunded credit protection.
In the case of *funded credit* protection, Bank uses:

- the on-balance sheet netting of mutual claims between Bank and its counterparty, where eligibility is limited to reciprocal cash balances between Bank and the counterparty (i.e. loans and deposits);
- the Financial Collateral Simple Method.

To determine the size of capital necessary for addressing risks under Pillar 2, the Bank measures the probability of loss to be incurred as a result of inherent material risks. The Bank, therefore, analyses:

- concentration risk;
- interest rate risk in the non-trading (banking) book (the Bank measures the risk each half-year);
- liquidity risk;
- ML/TF risk;
- other material risks inherent in Bank's business.

To assess the impact of possible adverse events on Bank's capital, the Bank applies scenario analysis, including stress testing. The Bank determines the size of recommended **capital buffer** in order to ensure that the Bank's capital is sufficient to support its activities upon the occurrence of any adverse circumstances, and to ensure that the Bank's capital is sufficient throughout the economic cycle.

The size of overall required capital, determined by the Bank as part of its capital adequacy assessment process, represents the sum of the capital charges for all risks plus the capital buffer. Within the scope of its business planning, the Bank conducts internal capital planning on a forward-looking basis, i.e., for at least the next three years.

**Capital Adequacy Ratio as of 31 December 2017 (EUR)**

| **Items** | **Group** | **Bank** |
|---|---|---|
| Tier 1 capital elements | | |
| Paid-in share capital | 31 496 395 | 31 496 395 |
| Reserve capital and other reserves | 835 152 | 835 152 |
| Retained earnings | -383 562 | -166 586 |
| Profit/loss for the current year | -7 700 104 | -8 093 849 |
| Intangible assets | -4 184 319 | -4 184 319 |
| Available for sale instruments revaluation reserve | 156 133 | 156 133 |
| Less revaluation of investment property | -40 228 | -27 079 |
| Specific decline in Tier 1 capital | -2 073 852 | -2 073 852 |
| **Tier 1 Core Capital** | **18 105 615** | **17 941 995** |
| **Tier 2 capital elements** | | |
| Subordinated liabilities | 8 982 260 | 8 982 260 |
| Specific decline in Tier 2 capital | -2 073 852 | -2 073 852 |
| **Tier 2 Supplementary Capital** | **6 908 408** | **6 908 408** |
| **Total capital** | **25 014 023** | **24 850 403** |
| Capital charge for credit risk inherent in the Bank's book, including the breakdown of exposures by categories: | 12 170 643 | 12 214 103 |
| *Central governments or central banks* | 264 950 | 264 950 |
| Multilateral development banks | | |
| *Institutions* | 446 240 | 446 240 |
| *Corporates* | 4 169 828 | 4 169 828 |
| *Default exposures* | 1 508 397 | 1 485 224 |
| *High-risk exposures* | 3 242 675 | 3 384 381 |
| Equity exposures | 260 161 | 403 352 |
| *Other items* | 2 278 390 | 2 060 128 |
| The total capital charge for market risks | 1 391 | 1 391 |
| Capital charge for CVA risk | 63 321 | 86 494 |
| Capital charge for operational risk | 2 989 929 | 2 986 979 |
| **Total capital charge** | **15 225 284** | **15 288 967** |
| **CET1 capital ratio** | **9.51%** | **9.39%** |
| **Capital adequacy ratio** | **13.14%** | **13.00%** |

In accordance with the capital adequacy requirements set by the Financial and Capital Market Commission, banks with a business model focusing on non-resident customer service, are required to maintain their individual capital adequacy ratios. As of 31 December 2017, the Bank's individual capital adequacy ratio was set at 12,9%. In addition, banks have to hold a capital conservation buffer of 2,5% of their total exposure value. This means that the Bank, as of 31 December 2017, had to maintain the capital adequacy ratio of 15,4%.

As part of the capital adequacy assessment process, the Bank, on an annual basis, assesses the capital that is necessary for covering of risks. The results of the assessment are presented in the table below:

**A Summary of the Results of the Capital Adequacy Assessment**

| Items | Item code | **Group** | **Bank** |
|---|---|---|---|
| **Pillar 1 risks** [1.1.+1.2.+1.3.+1.4.] | **1.** | **15 539 835** | **15 609 312** |
| Credit risk | 1.1. | 12 281 802 | 12 325 262 |
| Credit value adjustment risk (CVA risk) | 1.2. | 1 775 | 1 775 |
| Market risks | 1.3. | 266 329 | 295 296 |
| Operational risk | 1.4. | 2 989 929 | 2 986 979 |
| **Pillar 2 risks** [2.1.+2.2.+2.3.+2.4.+2.5+2.6.] | **2.** | **9 010 935** | **9 044 147** |
| Interest rate risk in the non-trading (banking) book | 2.1. | 2 785 317 | 2 814 528 |
| Credit portfolio concentration risk | 2.2. | 929 016 | 950 115 |
| NILL/TF risk | 2.3. | 2 010 926 | 2 011 972 |
| Liquidity risk | 2.4. | 600 158 | 600 158 |
| Other risks | 2.5. | 1 065 770 | 1 070 228 |
| Additional capital requirement, related to the individually set capital adequacy ratio | 2.6. | 1 619 749 | 1 597 146 |
| **Diversification effects** | **3.** | - | - |
| **Total capital reserve requirement** | **4.** | **4 757 901** | **4 777 802** |
| **Recommended capital reserve** | **5.** | 0 | 0 |
| **Total capital required for covering risks** | **6.** | **29 308 671** | **29 431 261** |
| **The amount of capital held by the Group (Bank)** | **7.** | **25 014 023** | **24 850 403** |
| **Capital surplus** | **8.** | **-4 294 648** | **-4 580 858** |

To strengthen capital, the shareholders' meeting held on 26 January 2018 made the decision to increase its share capital by EUR 6 million through issuing 845 071 dematerialised ordinary registered shares.

## Leverage Ratio

The risk of excessive leverage is defined as the risk resulting from Bank's vulnerability due to leverage or contingent leverage in its funding structure that may require unintended corrective measures to its business plans, including distressed selling of assets which might result in losses or in valuation adjustments to its remaining assets. The leverage ratio is the ratio representing the percentage of Tier 1 capital to the total amount of non-risk weighted exposures (including off-balance sheet business). As at the end of 2017, banks were required to maintain the leverage ratio at a certain level. It is expected that the minimum requirement for a leverage ratio will be determined on the basis of data obtained during the observation period and will take effect on 01 January 2019.

| Items | **Group** | **Bank** |
|---|---|---|
| Off-balance sheet items | 6 503 007 | 6 588 165 |
| Assets | 294 150 952 | 294 061 181 |
| Regulatory adjustments – tier 1 capital – after a fully implemented definition | -6 258 171 | -6 258 171 |
| Total exposure measure | 294 395 788 | 294 391 175 |
| Tier 1 capital | 18 145 843 | 17 969 074 |
| **Leverage ratio** | **6.16%** | **6.10%** |

## Encumbered and unencumbered assets as at 31 December 2017

### Assets

| | | Carrying amount of encumbered assets | Fair value of encumbered assets | Carrying amount of unencumbered assets | Fair value of unencumbered assets |
|---|---|---|---|---|---|
| | | 10 | 40 | 60 | 90 |
| 10 | Total assets | 31 930 392 | X | 276 159 553 | X |
| 30 | including equity instruments | 0 | | 4 718 400 | |
| 40 | including debt securities | 19 202 143 | | 79 145 733 | |
| 120 | including other assets | 0 | X | 50 301 284 | X |

### Collateral received

| | | Fair value of encumbered collateral received or own debt securities issued | Fair value of collateral received or own debt securities issued available for encumbrance |
|---|---|---|---|
| | | 10 | 40 |
| 130 | Total collateral received | 2 310 335 | 12 548 977 |
| 150 | including equity instruments | | 363 982 |
| 160 | including debt securities | | 12 184 996 |
| 230 | including other collateral received | | |
| 240 | Own debt securities issued other than own covered bonds or ABSs | | 234 323 |

## Encumbered assets and collateral received that serve for securing of bank's liabilities

| | | Liabilities, contingent liabilities or securities lent | Assets, collateral received and own debt securities issued other than covered bonds and ABSs encumbered |
|---|---|---|---|
| | | 10 | 30 |
| 10 | Carrying amount of financial liabilities | 6 190 533 | 34 240 727 |