Baltic International Bank

DISCLOSURE OF LIQUIDITY RISK MANAGEMENT BY BALTIC INTERNATIONAL BANK (IN ADDITION TO THE 2018 ANNUAL FINANCIAL STATEMENTS)

DEFINITION OF LIQUIDITY RISK

Liquidity risk is the risk of Bank's inability to honour its financial obligations (owed to the clients and partner banks) in a timely manner, fully and without incurring substantial losses.

LIQUIDITY RISK MANAGEMENT STRATEGY AND PROCESSES

The purpose of Bank's Liquidity Risk Management Strategy is to articulate Bank's liquidity risk tolerance[1] and liquidity risk appetite[2] and to ensure that Bank maintains the risk within the levels required for Bank's current and planned activities.

Based on the Liquidity Risk Management Strategy approved by Bank's Supervisory Board, Bank formulates the following internal legal instruments:

- Liquidity Risk Management Policy;
- Liquidity Risk Management Procedure;
- Action plan to head off a possible liquidity crisis.

To implement its Liquidity Risk Management Strategy, Bank takes the following actions:

- when drafting its annual budget, Bank ensures that the planned asset allocation pattern is consistent with the liquidity risk tolerance and liquidity risk appetite as articulated in the Strategy;
- when allocating the raised capital (borrowed resources) across asset classes, Bank is aware of the possibilities to sell the respective asset (i.e. degree of liquidity) and of the impact of investments (that have already been made and that are yet to be made) on Bank's liquidity profile;
- Bank diversifies its own resource base and reinforces it through expanding Bank's customer portfolio and reducing the amount of deposits held by major depositors as a percentage of total deposits. To this end, Bank focuses on term deposits of non-bank financial institutions (NBFIs) and bonds issued.

The purpose of the Liquidity Risk Management Policy is to provide guidance on how to avert the adverse impact of liquidity risk on Bank's financial condition. The Policy provides guidance for early identification, measurement, analysis and management of liquidity risk over an appropriate set of time horizons, including intraday, to ensure that Bank maintains adequate liquidity buffers, taking into consideration both the Funding Liquidity Risk[3] and Market Liquidity Risk[4].

The Policy addresses the following aspects:

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[1] Risk Tolerance means Bank's readiness to bear the risk after risk treatments in order to achieve its objectives.

[2] Risk Appetite means the aggregate level of risk that Bank is willing to assume within the level of its risk tolerance, in line with its business model, to achieve its strategic objectives.

[3] Funding Liquidity Risk is the risk that Bank will not be able to meet efficiently both expected and unexpected current and future cash flow and collateral needs without affecting either daily operations or the overall financial condition of Bank.

[4] Market Liquidity Risk describes the danger of being unable to sell financial assets at the desired time without incurring material losses because of market disruption or inadequate market depth.

sources of liquidity risk, liquidity risk management process and techniques, liquidity risk assessment techniques, procedure for managing the financial architecture (funding structure), procedure for managing collateral (security) items, analysis of stressful situations (stress test), liquidity risk mitigation tools, framework of internal limits imposed on liquidity risk, liquidity risk monitoring measures, and lines of authority and responsibility for liquidity risk management.

In addition, the Liquidity Risk Management Procedure addresses:

- a detailed manner of assessing liquidity risk (please refer also to the paragraph *Scope and Nature of the Liquidity Risk Measurement System* outlined herein);
- Bank's assessment of the sufficiency of liquidity buffers;
- the manner of preparing reports, including the ILAAP reports subsequently submitted to the Financial and Capital Market Commission (FCMC);
- methodology for calculating internal limits; limit control and corrective action taken over reported internal-limit breaches;
- early warning indicators and action to be taken when the early warning indicators reach their critical values;
- a detailed analysis of critical situations;
- a detailed evaluation of collateral positions;
- Funding Transfer Price (FTP) and methodology for calculating liquidity-related costs;
- intraday liquidity management;
- presentation of relevant information to the senior management (please refer also to the paragraph *Scope and Nature of the Liquidity Risk Reporting System* outlined herein).

Bank's *Contingency Plan to Survive Potential Liquidity Crisis* encompasses procedures and related work coordination measures that Bank's senior management intends to implement when a crisis (distressful situation) occurs, in order to reduce the impact of adverse events on Bank in a timely manner and at reasonable costs.

At least once every year, Bank revises its policies and procedures regulating risk management processes to (i) reflect therein changes in market conditions, legislative and regulatory updates, and changes in Bank's products and services; (ii) follow industry best practices.

STRUCTURE AND ORGANISATION OF LIQUIDITY RISK MANAGEMENT FUNCTION

Bank's Supervisory Board formulates and approves the Liquidity Risk Management Strategy, considers the ILAAP results, makes liquidity adequacy-related decisions and supervises to what extent the Management Board is involved in the liquidity risk management process and whether the liquidity risk is actively managed at the Bank-wide level in accordance with the Strategy approved by the Supervisory Board.

The Management Board is responsible for implementing the Liquidity Risk Management Strategy approved by the Supervisory Board, arranging ILAAPs on a regular basis and ensuring liquidity risk management and monitoring in accordance with the Liquidity Risk Management Strategy Policy approved by the Supervisory Board. To ensure that Bank maintains a tolerable level of liquidity risk, the Management Board:

- approves the internal liquidity-risk limits, monitors compliance with the limits and determines what action should be taken in response to a breach of the internal limits;

- approves stress-testing assumptions and the frequency of stress testing exercises;
- regularly, at least once every year, resets and improves (if necessary) the internal liquidity-risk limits and stress-testing assumptions, thus adapting them to the changes in Bank's business and in the external circumstances having an impact on Bank's business.

The Chief Risk Officer is responsible for supervising and ensuring improvement of the liquidity-risk management framework, for evaluating the Liquidity Risk Management Strategy and the Liquidity Risk Management Policy on a regular basis and for reporting the non-compliance (breaches) to the Supervisory Board and to the Management Board.

The Risk Management Department monitors liquidity risk, analyses the maturity structure of assets and liabilities, liquidity ratios and the concentration level of the funding sources while taking into consideration the prescribed thresholds and limits.

The Risk Management Department ensures that Bank's liquidity-risk management framework meets the requirements of the laws, regulations and standards, makes improvements to the liquidity-risk management framework, devises internal liquidity ratios and draft limits on the concentration in funding sources, and supervises whether Bank's stays within the approved limits.

Table 1 shows Bank's departments and divisions engaged in an intraday management of liquidity risk.

Table 1

Departments and divisions engaged in an intraday liquidity-risk management process and their key responsibilities

Departments and Divisions	Responsibilities
Risk Management Department	Assessment of liquidity risk, limit controls, preparation of reports
Statements Division subordinate to the Operations and Accounting Department	Preparation of reports, planning of Nostro Account (held with the Bank of Latvia) balance
Financial Institutions Department	Setting aside financial resources (buffers), planning of intraday inflows and outflows (customers' outgoing and incoming payments)
Treasury Department	Resource allocation
Securities Division subordinate to the Treasury Department	Borrowings (through repo transactions); marketability analysis (the possibility to sell securities)

SCOPE AND NATURE OF LIQUIDITY RISK REPORTING SYSTEM

At least once every year, the Risk Management Department submits the liquidity-risk management report to the Supervisory Board. The report contains information about the overall assessment of the level of liquidity risk, i.e. the risk appetite and the tendencies/developments.

In addition to the liquidity-risk management report, the Risk Management Department submits (once every year) the ILAAP Report to the Supervisory Board. The ILAAP Report enables the Supervisory Board to make an informed judgement regarding the efficiency and effectiveness of Bank's liquidity-risk management framework.

At least once every quarter, the Risk Management Department prepares the liquidity-risk management report that is intended for the Management Board and contains information about assessment of the level of liquidity risk, i.e. the risk appetite and the tendencies/developments, and information about limit compliance. The report also discloses potential liquidity-risk management problems and describes the recommended measures designed to address and eliminate the problems.

At least once every half-year, the Risk Management Department carries out stress testing of liquidity risk and submits a summary of the results (together with the liquidity-risk management report) to the Management Board.

As part of each stress testing, Bank evaluates the impact of potential adverse events on:

- special liquidity requirement [5] and liquidity coverage ratio[6];
- the level of liquidity buffers;
- maintenance of internal limits;
- possible (contingent) expenses associated with raising additional financial resources;
- possible (contingent) loss stemming from the sale of liquid assets.

Once every month, the Risk Management Department submits a monthly liquidity-risk management report to the Chief Risk Officer. The report contains information about the overall assessment of the level of liquidity risk, i.e. the risk appetite and the tendencies/developments.

The Risk Management Department also prepares a daily liquidity-risk management report that contains the following information:

- calculation of liquidity ratios used by Bank in the liquidity risk management process;
- overview of the maturity pattern of assets and liabilities;
- maintenance of the limits.

The Risk Management Department distributes the daily liquidity-risk management report among all members of the Management Board and submits it to the Chief Risk Officer and the Treasury Department.

The Risk Management Department prepares and submits relevant liquidity-risk management reports in accordance with the requirements of the Bank of Latvia, the FCMC, and Bank's internal legal instruments.

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[5] As of 1 January 2018, the statutory current liquidity ratio (in effect until 31 December 2017) was replaced with a fully-fledged liquidity coverage ratio in accordance with the FCMC's Regulations.

Furthermore, the FCMC's set forth a special liquidity requirement (in effect as of 1 January 2018) for those banks whose business models are oriented towards servicing foreign clients (non-residents of the Republic of Latvia). The special liquidity requirement represents a ratio of *liquid assets to liabilities repayable on demand and liabilities with a residual maturity of up to 30 days*. Calculation of the requirement is based on the data contained in the "Overview of the Maturity Pattern of Assets and Liabilities" prepared in accordance with the FCMC's Regulation No 195 "Liquidity Regulation (*Compliance with Liquidity Requirements and Liquidity Risk Management*)".

[6] Implemented in accordance with Regulation (EU) No 575/2013 of the European Parliament and of the Council, liquidity coverage ratio (LCR) is calculated in accordance with the Commission Delegated Regulation (EU) 2015/61.

SCOPE AND NATURE OF LIQUIDITY RISK MEASUREMENT SYSTEM

Bank regularly assesses *the maturity pattern of assets, liabilities and off-balance sheet items*. For this purpose, the assets are grouped by residual maturity to repayment or sale, while liabilities and off-balance sheet commitments are grouped by remaining term to settlement.

Banka uses liquidity ratios for analysing and monitoring of liquidity risk. The liquidity ratios characterise the level of Bank's liquidity, the need to hold additional liquidity buffers, and Bank's ability to meet its financial obligations.

When Bank assesses its funding structure, the assessment covers all of the material elements, i.e. types of funding sources, the level of concentration in funding sources, and stability of funding sources. Bank also analyses availability of other funding sources.

To identify market liquidity risk, Bank assesses the ratios of the liquid asset structure and the level of liquidity of the assets in accordance with the Commission Delegated Regulation (EU) 2015/61 (LCR delegated act).

In addition to assessment of funding liquidity risk and market liquidity risk, Bank uses the following risk methodologies:

- analysis of critical situations (*stress testing*). As part of stress testing, Bank analyses and considers possible development scenarios for different timeframes and different stress levels. Stress scenarios capture unfavourable events that adversely affect Bank's liquidity;
- Bank develops the system of early warning indicators that enables Bank to timely gauge vulnerabilities of Bank's liquidity position and identify the need to obtain additional funding.

LIQUIDITY RISK HEDGING AND MITIGATION POLICY

Bank manages liquidity risk in accordance with the Liquidity Risk Management Policy. Bank revises the Policy at least once every year, in the light of the changes in Bank's business and in the external circumstances affecting Bank's operations.

Bank uses the following liquidity-risk reduction measures:

- maintains adequate levels of liquidity buffers that ensure Bank's ability to tide over different distressful situations;
- develops and maintains an effective internal-limit allocation framework;
- has controls in place to verify whether Bank stays within the regulatory thresholds (complies with the regulatory ratios) and within Bank's internal limits on a regular basis;
- regularly assesses the level of liquidity risk and analyses factors that have caused changes in the level of liquidity risk; Bank also exercises regular liquidity-risk stress testing;
- develops an effective *Contingency Plan to Survive Potential Liquidity Crisis* based on stress test results;
- ensures liquidity planning in the framework of which Bank forecasts and keeps in check a possible mismatch in the future cash flow, assesses the stability of funding sources and predicts their behaviour in the foreseeable future, and is planning (within the framework of Bank's annual budget) the specific liquidity requirement[7] and liquidity coverage ratio.

[7] See Note 5

Liquidity risk controls represent a package of systematic measures implemented by Bank.

Bank assesses sufficiency of its liquidity buffers as part of intraday liquidity management.

Bank continuously monitors adherence to liquidity-risk limits, summarises and analyses information about the approved liquidity-risk limits, maintenance of the limits, and the events that have triggered limit breaches. Bank evaluates the impact of the events on Bank's business. To manage liquidity risk effectively, reduce the impact of potential adverse events and meet the regulatory requirements (comply with the statutory liquidity ratios), Bank sets internal limits on its liquidity ratios at the Bank-wide level. Immediate supervisors of the departments and divisions engaged in managing liquidity are responsible for ensuring adherence to Bank-approved liquidity risk thresholds and limits.

Bank analyses the level of liquidity risk and the factors that caused the changes therein in accordance with the Liquidity Risk Management Procedure. The Procedure describes the manner in which Bank measures liquidity risk and informs the senior management about the level of Bank's liquidity risk (please refer also to the paragraphs *Scope and Nature of the Liquidity Risk Reporting System* and *Scope and Nature of the Liquidity Risk Measurement System* outlined herein).

Bank regularly, at least once every year, tests the *Contingency Plan to Survive Potential Liquidity Crisis* to determine the plan's effectiveness. When devising and updating the Group's Recovery Plan, Bank uses the information about Bank's potential activities (as described in the *Contingency Plan*) to tackle liquidity crunch.

Liquidity planning is an integral part of Bank's budget drafting in the context of which Bank determines the required amount of liquidity buffers, funding structure, maturity dates, and diversification possibilities.

DECLARATION APPROVED BY THE MANAGEMENT BODY ON THE ADEQUACY OF LIQUIDITY RISK MANAGEMENT ARRANGEMENTS

Bank has in place the internal liquidity-risk management framework that encompasses liquidity-risk assessment techniques and controls, liquidity-risk mitigation strategies/techniques, management of the funding structure, collateral management, liquidity risk-related internal limits system, framework for informing senior management, and other liquidity-risk management measures.

Bank has in place the *Contingency Plan to Survive Potential Liquidity Crisis*. Bank intends to activate the plan when adverse events occur, in order to reduce the impact thereof on Bank.

Bank's *Contingency Plan to Survive Potential Liquidity Crisis* encompasses procedures and related work coordination measures that Bank's senior management intends to implement when a crisis (distressful situation) occurs, in order to reduce the impact of adverse events on Bank in a timely manner and at reasonable costs.

In accordance with the internal and external reports prepared by Bank in the context of ILAAP, Bank maintains sufficient liquidity buffer that is consistent with Bank's business model and therefore there is no need to hold an extra cushion of liquid assets.

At least once every year Bank revises its internal legal instruments in order to improve the liquidity risk management process. Bank prepares the ILAAP Report on a yearly basis as Bank is committed to provide Bank's senior-level bodies (the Supervisory Board and the Management Board) with information, which is as complete as possible, on the ILAAP performed by Bank. The purpose of the ILAAP Report is to assist the senior management in identifying ILAAP deficiencies and in making an informed judgement regarding the appropriate level of liquidity buffers. Based on the ILAAP results, Bank's senior management makes the decisions on how to improve the liquidity-risk management framework and to reinforce Bank's financial stability.

Bank's special liquidity requirement was 76.35% as of 31 December 2018. Bank's LCR was 210% as of 31 December 2018. The Group's LCR was 211% as of 31 December 2018.

In 2018, Bank maintained its special liquidity requirement and LCR above Bank-specific threshold set by the FCMC. Bank's special liquidity requirement set forth by the FCMC was 50%. Bank maintained a minimum LCR of 100 percent, thus ensuring 100- percent compliance with the LCR requirement.

LIQUIDITY COVERAGE RATIO (LCR) IN 2018

Table 2 shows Bank's LCR calculated in accordance with the EBA's Guidelines on LCR disclosure to complement the disclosure of liquidity risk management under Article 435 of Regulation (EU) No 575/2013.

Table 2

The Group-level LCR

No	Items	Total adjusted value (average per quarter)*			
		1Q	2Q	3Q	4Q
21	Liquidity buffers (EUR ths.)	127 250	124 883	123 836	127 731
22	Total net cash outflows (EUR ths.)	46 683	56 361	61 771	61 220
23	LCR, %	273%	222%	200%	209%

* Liquidity buffers and the net cash outflows are specified as the values after haircuts on liquid assets and the outflow rates are applied.