# Joint Stock Company *Parex banka*

# Unaudited Public Financial Report for the year ended 31 December 2010

MAXIMUM RECOVERY OF STATE AID

PAREX BANKA

*Information disclosed in the report is prepared in accordance with the Financial and Capital Market Commission's regulations No. 145 "Regulations on Preparation of Public Quarterly Reports of Credit Institutions".*

**TABLE OF CONTENTS**

## MANAGEMENT REPORT

### Dear Shareholders and Cooperation Partners,

2010 was a year of substantial changes in Parex banka's activity – restructuring of one of biggest banks in Latvia which was facing financial difficulties – Parex banka – was successfully completed in 1 August with support from the State. As a result, two separate companies were formed: Citadele Bank which the largest part of assets of former Parex banka were transferred to, and Parex banka where problematic assets were left. Since 1 August 2010 Parex banka has become a unique financial institution in Latvia with an ambitious goal: to maximise the recovery of State Aid. At the same time, Parex banka has discontinued to provide such traditional banking services as taking deposits and executing money payments, issuing new loans, attracting new clients and others.

### *Events prior to 1 August 2010*

At the beginning of the reporting period, major shareholder of Parex banka – the Republic of Latvia – provided the bank with an aid and additional capital needed. On 23 February 2010, the Cabinet of Ministers approved the increase of the bank's share capital by 31.5 million Lats and on 26 February 2010 the capital was increased by capitalizing the respective share of State Treasury deposits placed in the bank.

On 23 March 2010, the Cabinet of Ministers of the Republic of Latvia approved the restructuring plan for Parex banka developed by Nomura International plc, international financial consultant, and on 31 March the plan was submitted for approval to the European Commission.

Evaluating the volume of attracted deposits by Parex banka, stability in Lats' money market as well as liquidity ratios of the bank, on 5 May 2010, Parex banka made an agreement with the Bank of Latvia on early repayment of the borrowed funds in the amount of 117.6 million Lats.

### *Events after 1 August 2010*

On 1 August 2010, Parex banka commenced to work as a resolution bank with a particular goal – to maximise the recovery of State Aid. In order to achieve this goal, the bank's activities are focused on efficient restructuring of loans, recovery of debts and management of repossessed real estates for selling them in more favourable market conditions. According to Parex banka's restructuring plan, the allocated for its implementation is by 2017.

On 15 September 2010, the European Commission approved Parex banka's restructuring plan. In the international banking sector, such approval is recognised as a significant achievement within the process of Parex banka's restructuring considering that several European banks had to wait for similar approvals for a much longer period of time.

In December 2010, Parex banka paid 9.7 million Lats of interest payments for use of the State Aid.

In accordance with restructuring plan of joint stock company Parex banka and decision passed by the Cabinet of Ministers on 28 December 2010, the bank's share capital was increased by 9.7 million Lats. The reason for the transaction was to ensure Parex banka's compliance with the capital adequacy ratio. The issued shares were acquired by state joint stock company Privatization Agency, thus increasing the State's share in the bank's share capital. Accordingly, as of 31 December 2010, the Parex banka shareholders structure was as follows: state joint stock company Privatization Agency owned 81.83 percent of shares, European Bank for Reconstruction and Development – 14.62 percent, and minority shareholders - 3.56 percent of Parex banka's shares.

On 31 December 2010, the loan portfolio of Parex banka and Parex Banka group was 566.3 and 541.6 million Lats accordingly, total assets – 789.3 and 792.1 million Lats. The equity at the end of 2010 was 48.5 and 48.1 million Lats.

In accordance with the requirements of the International Financial Reporting Standards, Parex banka has made provisions for non-performing loans in amount of 115.7 million Lats during the reporting period. This adjustment affected the bank's financial results therefore Parex banka ended 2010 with losses in amount of 152.7 million Lats as planned. Since all cash resources recovered by Parex banka are accumulated for the repayment of syndicated loan and State Aid, no profit from the bank's activities is envisaged according to restructuring plan. Simultaneously, the bank is taking all possible actions to limit losses and caries out deliberative and prudent operational and financial activities, scrutinises all expense items in order to achieve this goal.

Since 1 August 2010 to end of the reporting period, namely, during only five months, Parex banka through targeted and hard work has been able to recover 58 million. This amount largely consisted of monies recovered through restructuring of non-performing loans and sales of securities portfolio as considering still inactive real estate market the purchase price offered by potential buyers for real estate assets repossessed by the bank were significantly lower than its potential market price in majority of cases.

### *Other significant events*

On 30 July 2010 Parex banka filed the claim against its former Members of the Board – Valērijs Kargins and Viktors Krasovickis – asking to compensate damages caused to the bank in the amount of more than 62 million Lats. On 16 August 2010, Riga district Court resolved to secure the claim, simultaneously ordering Parex banka to secure loss compensation which might occur from the enforcement of the decision. On 15 November 2010, Parex banka filed a request with Riga District Court to reduce mentioned security deposit, pointing out, inter alia, that actually the bank who wants to protect its infringed legal interests in fair trial, is put in a considerably more unfavourable position than the defendants.

On 17 September 2010 Parex banka's Council Meeting the claim from minority shareholders Firebird Republics SPV, Amber Trust and DCF Fund received on 7 September 2010 demanding to file the claim in the court against previous Board members for sales of Parex leasing in Belarus was reviewed. After thorough revaluation of the claim and enclosed documentation submitted by minority shareholders, Parex banka's Council concluded that there are no legal grounds for filing a claim and that the requests of minority shareholders are based on incomplete information.

During the reporting period, Parex banka also initiated several proceedings against particular companies of Kolonna group and I. Plaude-Relinger for permanent non-performance of liabilities toward the bank and malicious concealment of assets. Parex banka's management as a thorough and diligent proprietor has indicated several times that to protect tax payers' interests it will use all legitimate means to turn against any dishonest clients' activities or any activities punishable by law.

### *Main events after the end of the reporting period*

In the first half of 2011 Parex banka's priority is repayment of syndicated loan without State assistance which is a significant challenge for the bank's management and employees. In accordance with the agreement made with syndicated loan lenders in March 2009, Parex banka has already repaid 70 percent of the total loan outstanding. The remaining 30 percent or 163 million Lats are due in May 2011 therefore maximum attention is paid to the accumulation of necessary funds.

By the end of February 2011, Parex banka had accumulated 80 million Lats for repayment of the syndication loan. As previously, also in 2011 the funds needed for the repayment of syndicated loan will be recovered through restructuring of non-performing loans and sales of securities portfolio without executing unprofitable forced assets sales transactions

.

Considering the total assets managed by Parex banka, thorough attention is paid to attract properly qualified professionals. Comparing with global generally accepted standards, Parex banka with its human resources of slightly over 100 employees is evaluated as an extremely efficient organization. The basis for such a successful modern company model is continuous evaluation of administrative resources and deliberative use of outsource service providers.

After the end of accounting period, Parex banka continues to work with loan restructuring, asset recovery and real estate management thus ensuring the safeguarding and growth of assets value. Looking into Parex banka's long-term perspectives in line with the economic processes in Latvia and across the world, it is expected that along with recovery of real estate market, Parex banka will be able to carry out successfully the task set in the restructuring plan, i.e. to maximise the recovery of State Aid.

AS Parex banka
Chairman of the Board
Christopher Gwilliam

*Riga, 31 March 2011*

*Information disclosed in the report is prepared in accordance with the Financial and Capital Market Commission's regulations No. 145 "Regulations on Preparation of Public Quarterly Reports of Credit Institutions".*

**BALANCE SHEETS AS AT 31 DECEMBER 2010 AND 2009**

*LVL 000's*

| | **Reporting period** *Unaudited* | **Preceding reporting year** *Audited** | **Reporting period** *Unaudited* | **Preceding reporting year** *Audited** |
|---|---|---|---|---|
| | **Group** | **Group** | **Bank** | **Bank** |
| Cash and deposits with central banks | 26 944 | 157 502 | 26 944 | 142 259 |
| Balances due from credit institutions | 67 687 | 220 836 | 65 837 | 325 869 |
| Financial assets held for trading | 1 248 | 4 765 | 1 248 | 4 774 |
| Financial assets designated at fair value through profit and loss | - | 2 770 | - | - |
| Available-for-sale financial assets | 59 410 | 114 349 | 59 410 | 95 199 |
| *Loans and receivables to customers:* | | | | |
| Loans to companies and private individuals | 541 550 | 1 660 368 | 566 280 | 1 445 406 |
| Held-to-maturity investments | 24 208 | 299 371 | 41 365 | 318 649 |
| Prepayments and accrued income | 3 857 | 4 620 | 3 855 | 3 529 |
| Fixed assets | 1 756 | 52 495 | 1 754 | 12 545 |
| Intangible assets | 152 | 3 294 | 152 | 585 |
| Investments in subsidiaries | - | - | 258 | 72 725 |
| Investment property | 19 810 | 12 607 | 13 627 | 11 729 |
| Income tax assets | - | 39 469 | - | 35 991 |
| Other assets | 45 464 | 24 451 | 8 551 | 1 890 |
| **Total assets** | **792 086** | **2 596 897** | **789 281** | **2 471 150** |

| | | | | |
|---|---|---|---|---|
| Due to central banks | - | 167 966 | - | 167 966 |
| Demand liabilities to credit institutions | 3 962 | 615 | 3 962 | 7 144 |
| Financial liabilities held for trading | 2 002 | 937 | 2 002 | 962 |
| Financial liabilities designated at fair value through profit and loss | - | 709 | - | - |
| *Financial liabilities measured at amortised cost:* | | | | |
| Loans from credit institutions | 174 653 | 383 885 | 174 653 | 397 672 |
| Deposits from customers | 495 875 | 1 687 849 | 495 875 | 1 540 669 |
| Issued debt securities | - | 90 551 | - | 90 742 |
| Subordinated liabilities | 53 030 | 103 949 | 53 030 | 103 956 |
| Other financial liabilities | - | 5 430 | - | - |
| Accrued expenses and deferred income | 1 821 | 5 928 | 1 794 | 5 025 |
| Income tax liabilities | - | 1 282 | - | - |
| Other liabilities | 12 638 | 8 846 | 9 474 | 4 345 |
| **Total liabilities** | **743 981** | **2 457 947** | **740 790** | **2 318 481** |
| Shareholders' equity | 48 105 | 138 950 | 48 491 | 152 669 |
| **Total liabilities and shareholders' equity** | **792 086** | **2 596 897** | **789 281** | **2 471 150** |

| | | | | |
|---|---|---|---|---|
| **Memorandum items** | | | | |
| Contingent liabilities | 885 | 6 826 | 2 618 | 11 464 |
| Financial commitments | 198 | 126 088 | 19 863 | 166 323 |

* Auditors: SIA „PricewaterhouseCoopers”

**STATEMENTS OF INCOME**
**FOR THE YEARS ENDED 31 DECEMBER 2010 AND 2009**

*LVL 000’s*

| | **Reporting period** *Unaudited* | **Respective period of the preceding reporting year** *Audited** | **Reporting period** *Unaudited* | **Respective period of the preceding reporting year** *Audited** |
|---|---|---|---|---|
| | **Group** | **Group** | **Bank** | **Bank** |
| Interest income | 75 291 | 172 310 | 64 248 | 153 562 |
| Interest expense | (87 171) | (145 883) | (80 297) | (141 315) |
| Commission and fee income | 16 002 | 28 160 | 11 569 | 21 588 |
| Commission and fee expense | (4 958) | (8 588) | (3 602) | (6 944) |
| Net gain/ (loss) on available for sale financial assets and financial liabilities | (141) | (11) | (1 119) | 15 |
| Net gain/ (loss) on financial assets measured at amortised cost | - | (327) | - | - |
| Net gain/ (loss) on financial assets or financial liabilities designated at fair value though profit and loss | 65 | 1 557 | - | 1 491 |
| Net gain/ (loss) on held for trading financial assets and financial liabilities | 717 | 1 792 | 809 | 1 778 |
| Gain/ (loss) from foreign exchange trading and revaluation of open positions | - | 2 644 | - | 2 256 |
| Net gain/ (loss) on disposal of non-current assets held for sale | (956) | (3 652) | - | - |
| Other income | 11 311 | 15 020 | 6 317 | 10 291 |
| Other expense | (2 182) | (4 476) | (749) | (4 115) |
| Administrative expense | ( 43 335) | (71 524) | (30 427) | (50 352) |
| Amortisation and depreciation charge | (5 882) | (11 348) | (2 740) | (7 752) |
| Impairment charge and reversals, net | (108 826) | (119 699) | (115 731) | (109 693) |
| Restructuring result | 12 270 | - | - | - |
| Corporate income tax | (1 883) | 17 015 | (950) | 18 080 |
| **(Loss)/ profit for the reporting period** | **(139 678)** | **(127 010)** | **(152 672)** | **(111 110)** |
| | | | | |

Statements of Comprehensive Income:

*LVL 000’s*

| | **2010 year** *Unaudited* | **2009 year** *Audited** | **2010 year** *Unaudited* | **2009 year** *Audited** |
|---|---|---|---|---|
| | **Group** | **Group** | **Bank** | **Bank** |
| Net change in fair value revaluation reserve of securities | 7 633 | 21 889 | 7 293 | 21 291 |
| **Other comprehensive income / (loss) for the period** | **7 633** | **21 889** | **7 293** | **21 291** |

| | | | | |
|---|---|---|---|---|
| **Total comprehensive income / (loss) for the period** | **(132 045)** | **(105 121)** | **(145 379)** | **(89 819)** |

*Information disclosed in the report is prepared in accordance with the Financial and Capital Market Commission’s regulations No. 145 ”Regulations on Preparation of Public Quarterly Reports of Credit Institutions”.*

**CONSOLIDATION GROUP**

| No. | Name of company | Registration number | Registration address | Country of domicile | Company type* | % of total paid-in share capital | % of total voting rights | Basis for inclusion in the group** |
|---|---|---|---|---|---|---|---|---|
| 1 | AS “Parex banka" | LV-40003074590 | Latvia, Riga LV-1010, Republikas laukums 2A | LV | BNK | 100 | 100 | MAS |
| 2 | Regalite Holdings Limited | CY-HE93438 | Cyprus, Nicosia 1075, 58 Arch. Makarios 3 Avenue, Iris Tower, 6th floor, office 602 | CY | PLS | 100 | 100 | MS |
| 3 | OOO "Parex Leasing and Factoring" | AZ-1105-T10-3749 | Azerbaijan, Baku AZ1065, Dz.Dzabbarli 44, "Caspian Plaza" | AZ | LIZ | 100 | 100 | MS |
| 4 | OOO "Ekspress Lizing" | RU-1037867006726 | Russia, St. Petersburg 192019, Sedova 11, liter A | RU | LIZ | 100 | 100 | MS |
| 5 | LLC "Laska Lizing" | UA-33104543 | Ukraine, Kiev 03150, Dimitrova 5 | UA | LIZ | 100 | 100 | MS |
| 6 | LLC "Parex Leasing" | RU-1047796715603 | Russia, Moscow 111116, Energeticheskaja 3 | RU | LIZ | 100 | 100 | MS |
| 7 | OOO "Extroleasing" | RU-1027739537220 | Russia, Moscow 111116, Energeticheskaja 3 | RU | LIZ | 100 | 100 | MS |
| 8 | SIA "Parex Private Banking" | LV-40003103438 | Latvia, Riga LV-1050, Smilšu 7 | LV | PLS | 100 | 100 | MS |
| 9 | OOO "Extrocredit" | RU-1067746758518 | Russia, Moscow 111116, Energeticheskaja 3 | RU | CFI | 99 | 99 | MMS |
| 10 | LLC "Parex Leasing and Factoring" | GE-205224461 | Georgia, Tbilisi, Kazbegi avenue 44 | GE | LIZ | 100 | 100 | MS |
| 11 | SIA "NIF" | LV-40103250571 | Latvia, Riga LV-1010, Republikas laukums 2A | LV | PLS | 100 | 100 | MS |
| 12 | SIA “NIF Dzīvojamie īpašumi” | LV-40103253915 | Latvia, Riga LV-1010, Republikas laukums 2A | LV | PLS | 100 | 100 | MMS |
| 13 | SIA “NIF Komercīpašumi” | LV-40103254003 | Latvia, Riga LV-1010, Republikas laukums 2A | LV | PLS | 100 | 100 | MMS |
| 14 | SIA “NIF Zemes īpašumi” | LV-40103255348 | Latvia, Riga LV-1010, Republikas laukums 2A | LV | PLS | 100 | 100 | MMS |
| 15 | UAB “Nekilnojamojo turto valdymo fondas” | LT-302462108 | Lithuania, Vilnius LT03107, K.Kalinausko 13 | LT | PLS | 100 | 100 | MMS |
| 16 | OÜ “Restruktureeritud Kinnisvarafond” | EE-11788043 | Estonia, Tallinn 10119, Roosikrantsi 2 | EE | PLS | 100 | 100 | MMS |
| 17 | SIA “NIF Projekts 1” | LV-50103300111 | Latvia, Riga LV-1010, Republikas laukums 2A | LV | PLS | 100 | 100 | MMS |
| 18 | SIA “NIF Projekts 2” | LV-40103353475 | Latvia, Riga LV-1010, Republikas laukums 2A | LV | PLS | 100 | 100 | MMS |
| 19 | SIA “NIF Projekts 3” | LV-40103353511 | Latvia, Riga LV-1010, Republikas laukums 2A | LV | PLS | 100 | 100 | MMS |

*BNK – bank, CFI – other financial institution, LIZ – leasing company, PLS – company providing various support services.
** MS – subsidiary company, MMS – subsidiary of the subsidiary company, MAS – parent company.

## INFORMATION ABOUT PAREX BANKA'S BRANCHES

As at 31 December 2010 the Bank was operating a total of 2 branches, including 2 foreign branches, and 4 representative offices.

## ISSUED SHARE CAPITAL AS AT 31 DECEMBER 2010

| Shareholders | Nominal value (LVL) | Number of shares | Paid-in share capital (LVL) | Voting rights | Paid-in share capital (%) |
|---|---|---|---|---|---|
| SJSC "Privatizācijas Aģentūra" | 1 | 221 933 292 | 221 933 292 | 156 283 292 | 81.83% |
| EBRD | 1 | 39 631 824 | 39 631 824 | 39 631 824 | 14.61% |
| Other | 1 | 9 662 179 | 9 662 179 | 5 468 323 | 3.56% |
| **Total** | | **271 227 295** | **271 227 295** | **201 383 439** | **100%** |

## MANAGEMENT OF THE BANK AS AT 31 DECEMBER 2010

### *Council of the Bank*

| Name | Position |
|---|---|
| Michael Joseph Bourke | Chairman of the Council |
| Sarmīte Jumīte | Deputy chairman of the Council |
| Vladimirs Loginovs | Member of the Council |
| Mary Ellen Collins | Member of the Council |

### *Management of the Bank*

| Name | Position |
|---|---|
| Christopher John Gwilliam | Chairman of the Management Board, p.p. |
| Solvita Deglava | Member of the Management Board, p.p. |
| Jurijs Adamovičs | Member of the Management Board |

Roberts Stuģis was dismissed from duties as a member of the Management Board according to 15 March 2010 Council's decision.

New Council of Parex banka was elected during extraordinary meeting of shareholders on April 6, 2010. Following Council members were elected – Juris Jākobsons, Michael J. Bourke, Laurence Phillip Adams, Juris Vaskāns and Klāvs Vasks. Two new representatives were elected to the Council – Juris Jākobsons and Klāvs Vasks. Representatives of Ministry of Finance Andžs Ūbelis and Kaspars Āboliņš have resigned from Parex banka's Council effective 31 March 2010.

On July 30, 2010 the new members were elected to the Management Board: Solvita Deglava and Christopher John Gwilliam, who took up their duties on August 1, 2010, and Jurijs Adamovičs, who took up his duties on August 16, 2010.

On August 1, 2010 the following board members have finished their work at the Bank's Management Board: Vladimirs Ivanovs, Valters Abele and Guntis Beļavskis. 16th August 2010 was the last working day for Nils Melngailis at the Bank's Management Board (till July 31 – as the Chairman of the Board, from August 1 till August 16 – as the member of the Board).

The Extraordinary Board meeting took place on July 30, 2010, where the new Council of the Bank was elected - Michael J. Bourke, Sarmīte Jumīte, Mary E. Collins and Vladimirs Loginovs. 31st July 2010 was the last working day at the Council of the Bank for Juris Jākobsons , Juris Vaskāns, Klāvs Vasks, Laurence Philip Adams.

## INFORMATION ON CERTAIN PARTIES THAT WERE RELATED TO THE BANK AT THE MOMENT IT RECEIVED STATE AID

Pursuant to FCMC regulations on preparation of quarterly public reports of banks (Article 14[1]) the following table represents summary of material transactions with certain parties that were related to the Bank at the moment it received the State Aid:

*LVL 000's*

| | 2010 year | | | 2009 year | | |
|---|---|---|---|---|---|---|
| | **Period-end balance** | **Average interest rate *** | **Interest income/ (expense)** | **Period-end balance** | **Average interest rate *** | **Interest income/ (expense)** |
| Loans issued by the Bank | 1 893 | 0.00% | 534 | 29 038 | 2.10% | 1 016 |
| Deposits placed with the Bank | - | - | (1 109) | 28 006 | 7.90% | (3 024) |
| Subordinated financing provided to the bank | 36 005 | 6.00% | (3 084) | 36 008 | 11.20% | (4 768) |

* according to period-end rates

Subordinated financing contracts were entered into force in 2008 and have maturities ranging 2015 through 2018. Subordinated financing is LVL and EUR denominated. Prior repayment can be unilaterally requested only upon liquidation of the Bank.

The following table represents the details of Group's subordinated capital:

| Counterparty | Residence country | Currency | Issue size, 000's | Interest rate | Original agreement date | Original maturity date | Amortised cost (LVL 000's) 31/12/2009 | Amortised cost (LVL 000's) 31/12/2008 |
|---|---|---|---|---|---|---|---|---|
| Private person | Latvia | LVL | 7,500 | 6M Rigibid + 3% | 28/09/2007 | 26/09/2017 | 7,502 | 7,502 |
| Private person | Latvia | LVL | 7,500 | 6M Rigibid + 3% | 28/09/2007 | 26/09/2017 | 7,502 | 7,502 |
| Private person | Latvia | EUR | 15,000 | 12% | 20/06/2008 | 14/05/2015 | 10,601 | 10,602 |
| Private person | Latvia | LVL | 1,500 | 6M Rigibid + 3% | 30/10/2008 | 30/10/2018 | 1,500 | 1,500 |
| Private person | Latvia | LVL | 1,500 | 6M Rigibid + 3% | 30/10/2008 | 30/10/2018 | 1,500 | 1,500 |
| Private person | Latvia | LVL | 2,284 | 6M Rigibid + 3% | 04/12/2008 | 18/09/2015 | 2,284 | 2,285 |
| Private person | Latvia | LVL | 2,284 | 6M Rigibid + 3% | 04/12/2008 | 18/09/2015 | 2,284 | 2,285 |
| Private person | Latvia | LVL | 1,416 | 6M Rigibid + 3% | 04/12/2008 | 29/09/2015 | 1,416 | 1,416 |
| Private person | Latvia | LVL | 1,416 | 6M Rigibid + 3% | 04/12/2008 | 29/09/2015 | 1,416 | 1,416 |
| **Total** | | | | | | | **36,005** | **36,008** |

## RISK MANAGEMENT

The Group's risk is managed according to principles set out in Group's Risk and Capital Management Policy. The Group adheres to the following key risk management principles:

- Undertaking an acceptable risk level is one of the Group's main functions in all areas of operation. Risks are always assessed in relation to the expected return. Risk exposures that are not acceptable for the Group are avoided, limited or hedged;
- The Group does not assume high or uncontrollable risks irrespective of the return they provide. Risks should be diversified and those risks that are quantifiable should be limited or hedged;
- The Group pursues prudent risk management policy, that is aligned with the Group' business and ensures effective total risk mitigation;
- Risk management is based on awareness of each and every Group's employee about the nature of transactions he/she carries out and related risks;
- Risk limit system and strict controls are essential elements of risk management. Control of risk level and compliance with limits is ensured by structured risk limit systems for all material risks;
- The Group aims to ensure low risk exposure, diversified asset portfolio, limited risks in financial markets and low level of operational risk.

Risk management is an essential element of the Group's management process. Risk management within the Group is controlled by an independent unit unrelated to customer servicing - Risk Management Division.

The Group is exposed to the following main risks: credit risk, market risk, interest rate risk, liquidity risk, currency risk and operational risk. The Group has approved risk management policies for each of these risks, which are briefly summarised below.

**Credit risk**

Credit risk is the risk that the Group will incur losses from debtor's non-performance or default. The group is exposed to credit risk in to its lending, investing and trading activities, as well as in respect to the guarantees issued to third parties and other off-balance sheet commitments to third parties.

Credit risk management is based on adequate risk assessment and decision-making. For material risks, risk analysis is conducted by independent Risk Management Division. The analysis of credit risk comprises evaluation of customer's creditworthiness and collateral and its liquidity. The analysis of

creditworthiness of a legal entity includes analysis of the industry, the company, and its current and forecasted financial position. The analysis of creditworthiness of an individual includes the analysis of the customer's credit history, income and debt-to-income ratio analysis, as well as the analysis of social and demographic factors. In the event of material risks, lending decision is made by the Credit Committee, and further reviewed by the Bank's Management Board.

The Group reviews its loan portfolio on a regular basis to assess its quality and concentrations, as well as to evaluate the portfolio trends.

Credit risk identification, monitoring and reporting is the responsibility of Risk Management Division.

**Market risk**

Market risk is the risk that the Group will incur a loss as a result of the mark-to-market revaluation of balance sheet and off-balance sheet items caused by changes in market values of financial instruments due to changes in foreign exchange rates, interest rates and other factors.

Due to the specific nature and limited scale of the Bank's operations since the split of the bank on August 1, the Group does not take up new market risks. Market risk assessment, evaluation of undertaken positions, as well as risk monitoring and reporting is carried out by Finance Planning and Control Division and Risk Management Division.

**Interest rate risk**

Interest rate risk is related to the negative impact of interest rate changes on the Group's interest income and economic value.

Interest rate risk measurement, management and reporting in the Group is coordinated by Finance Planning and Control Division and Risk Management Division. Bank's interest rate risk assessment and relevant decision making is carried out by the Bank's Management Board.

**Liquidity risk**

Liquidity risk is the risk that the Group will be unable to meet its legal payment obligations. The purpose of liquidity risk management is to ensure the availability of liquid assets sufficient to meet potential obligations.

Under ordinary circumstances the Group manages its liquidity risk in accordance with the Group's Liquidity Risk Management Policy. Liquidity risk is assessed and related decisions are made by the Bank's Management Board. Daily liquidity management, as well as liquidity risk measurement, monitoring and reporting, is ensured by the Risk Management Division and Finance Planning and Control Division. Liquidity risk management in the Group is coordinated by the Risk Management Division and Finance Planning and Control Division. However the main source of liquidity is the funding provided by the State Treasury. In 2010 the Bank is in compliance with liquidity ratio requirements and meets mandatory reserve requirements in the Bank of Latvia.

**Currency risk**

Currency risk is related to mismatch in foreign currency asset and liability positions that impact the Group's cash flow and financial results via fluctuations in currency exchange rates.

Currency risk management in the Group is carried out in accordance with the Group's Currency Risk Management Policy. Day-to-day currency risk monitoring, management and reporting is the responsibility Risk Management Division and Finance Planning and Control Division. The Group has set

a limit for open currency positions in each currency at 10% of its equity, and the limit for the total open currency position at 20% of its equity. The limits are in compliance with the requirements of Latvian legislation. To assess currency risk, the Group also uses scenario analysis.

**Operational risk**

Operational risk is the risk of suffering losses resulting from processes that are deficient or non-compliant with requirements of external and internal regulations, losses resulting from actions of employees and system malfunctioning, as well as losses resulting from actions of third parties or from other external conditions, including legal risk (risk of penalty fees, sanctions applied by external institutions, losses resulting from litigation and other similar events), but excluding strategic risk and reputation risk. The Group further divides operational risk into the following categories: personnel risk, process risk, IT and systems risk, external risk.

The Group does not undertake / accept operational risks with potential impact exceeding 10% of the Group's net annual revenues, or risks with unquantifiable impact that are concurrently unmanageable (it is impossible to prevent such risks or provide for their consequences – e.g. non-compliance with legal regulations etc.) , irrespective of the financial gains this could bring (i.e., the Group does not perform business activities incurring such operational risks).

The Group applies following approaches for operational risk management:

- Defining operational risk indicators – use of statistical, financial and other indicators that reflect the level of various operational risk types and its changes within the Group;
- Operational risk measurement by recording and analysing operational risk events, the extent of the respective damage incurred, causes and other related information (data base of operational risk losses and incidents);
- "Four-eye-principle" and segregation of duties;
- Business continuity planning;
- Insurance;
- Investments in appropriate data processing and information protection technologies.