Baltic International Bank

DISCLOSURE OF INFORMATION ON LIQUIDITY RISK MANAGEMENT (IN ADDITION TO THE 2020 ANNUAL FINANCIAL STATEMENTS)

Content

Definition of Liquidity risk

Liquidity risk is the risk of Baltic International Bank SE (further – Bank) inability to fulfill 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 regulatory and guidance documents:

- Liquidity Risk Management Policy;
- Liquidity Risk Management Procedure;
- Contingency Plan to Survive Potential Liquidity Crisis.

[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.

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).

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: 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).

[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.

The Bank's *Contingency Plan to Survive Potential Liquidity Crisis* encompasses procedures and related work coordination measures that Bank's 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 organization of Liquidity risk management function

The 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:

- regularly, at least once every year, resets and improves (if necessary) the internal liquidity-risk limits adapting them to the changes in the external circumstances having an impact on Bank's business;
- approves stress-testing assumptions and the methodology;
- reviews the results of stress testing, quarterly Liquidity Risk Reports, and, if necessary, makes decisions on risk mitigation measures.

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

Department	Responsibilities
Risk Management Department	Assessment of liquidity risk, limit controls, preparation of quarterly reports
Reporting Division of the Operations and Accounting Department	Preparation of daily and monthly reports, planning of Nostro Account (held with the Bank of Latvia) balance, reporting to FCMC
Financial Institutions Department	Resource reservation, planning of intraday inflows and outflows (customers' outgoing and incoming payments)
Treasury Department	Resource allocation
Securities Division of 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.

The Risk Management Department prepares quarterly Liquidity risk 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.

At least once every half-year, the Risk Management Department carries out stress testing of liquidity risk and submits the results 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.

Reporting Division of the Operations and Accounting Department prepares the daily liquidity-risk report that contains the following information:

- calculation of liquidity ratios used by Bank in liquidity-risk management process;
- a statement of the term structure of assets and liabilities;
- an assessment of limit compliance.

Reporting Division of the Operations and Accounting 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 rules and regulations.

Scope and nature of Liquidity risk measurement system

Bank regularly assesses the term structure 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.

Bank uses liquidity ratios for analyzing and monitoring of liquidity risk. The liquidity ratios characterize the level of Bank's liquidity, the need to hold additional liquidity buffers, and Bank's ability to meet its 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, stability of funding sources and analyses of availability of other funding sources.

The Bank uses the following indicators to assess the level of concentration of funding sources:

- Herfindahl-Hirschman Index for the concentration of funding sources;
- the share of the Bank's 10 (ten) largest customer / interconnected customer group deposits in total deposits;
- the share of deposits in the Bank's liabilities.

[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 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.

As of 31.12.2020, the concentration ratios of financing sources were 2.20%, 36.34% and 92% respectively.

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

In addition to financing and market liquidity risk assessment, the Bank uses the following risk assessment methods:

- Stress testing. As part of the stress testing, the Bank analyzes and evaluates the potential impact of possible stress scenarios on the Bank's liquidity in different periods and at different stress levels. Stress scenarios are based on both internal adverse events characteristic to the Bank and adverse events in the financial markets;
- An early warning indicator system that allows for the timely identification of vulnerabilities in the Bank's liquidity position and the need to attract 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 mitigation 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;
- regularly assesses the level of liquidity risk and analyses factors that have caused changes in the level of liquidity risk;
- regular liquidity risk stress testing;
- develops an effective *Contingency Plan to Survive Potential Liquidity Crisis*;
- provides liquidity planning, which takes the form of forecasting and controlling possible future cash flow imbalances, researching the stability of funding sources and forecasting behavior, specific liquidity requirements and setting annual plans for the liquidity coverage ratio as part of the annual budget.

The Bank implements liquidity risk control as a systematic set of measures.

The Bank assesses the adequacy of liquidity reserves within the intra-day liquidity management process.

The Bank ensures constant control over the observance of liquidity risk limits, compiles and analyzes information on the approved liquidity risk limits, their observance, reasons for non-observance and assesses their impact on the Bank's operations. In order to effectively manage liquidity risk, reduce the impact of possible adverse events and comply with the established liquidity ratio requirement, the Bank sets internal limits on liquidity ratios.

Liquidity risk level and analysis of the reasons for changes in the risk level is performed in accordance with the internal regulatory document *Liquidity risk management procedure*, which describes the liquidity risk assessment procedure and reporting to the management on the Bank's liquidity risk level.

The Bank regularly, but not less than once a year, reviews the effectiveness of *the Contingency Plan to Survive Potential Liquidity Crisis*. The information mentioned in the *Contingency Plan to Survive Potential Liquidity Crisis* is used in developing and updating the Bank's *Recovery Plan*.

Liquidity planning is an integral part of the preparation of the Bank's budget, within which the required amount of liquidity reserves, financing structure, maturities and diversification opportunities are determined.

Declaration on the adequacy of Liquidity risk management arrangements

The Bank has developed an internal liquidity risk management system in accordance with its business model and strategy, which determines liquidity risk assessment methods and control measures, liquidity risk mitigation methods, funding structure management procedures, collateral position management procedures, and internal limit system for liquidity risk, management information procedures and other liquidity risk management measures.

The Bank has developed the *Contingency Plan to Survive Potential Liquidity Crisis* for overcoming a possible liquidity crisis, which sets out the measures that the Bank's management intends to take in the event of an adverse scenario to reduce the impact of adverse events on the Bank's liquidity in a timely and reasonable manner and protect the interests of the Bank's depositors, creditors and shareholders.

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.

At least once every year the Bank revises its internal rules and regulations in order to improve the liquidity risk management process. The Bank prepares the ILAAP Report on a yearly basis to provide Bank's management and supervisory bodies (the Supervisory Board and the Management Board) with complete information the ILAAP performed by the Bank. The purpose of the ILAAP Report is to assist the management in identifying ILAAP deficiencies and in making an informed judgement regarding the appropriate level of liquidity buffer. Based on the results of the liquidity adequacy assessment process, the Bank's management makes decisions to improve the liquidity risk management system and strengthen the Bank's financial stability.

As of 31.12.2020 Bank's special liquidity requirement was 64.61% (the minimal level set by the FCMC for the Bank – 40%) and LCR was 148%[7] (the minimal level set by the EU regulations – 100%). The level of LCR exceeded or reached 100 % in all major currencies when calculated separately (EUR – 114%, USD – 167%, GBP – 100%).

[7] In accordance with Articles 18 and 19 of Regulation (EU) No 575/2013 (CRR), Bank does not prepare calculation of the LCR on a consolidated basis.

Liquidity Coverage Ratio (LCR) in 2020

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

Liquidity Coverage Ratio

No.	Items	Total adjusted value (average per quarter)*			
		Q1	Q2	Q3	Q4
21	Liquidity buffer (thousd. EUR)	120 598	118 914	119 813	111 299
22	Total net cash outflows (thousd. EUR)	71 723	76 006	82 890	76 812
23	LCR, %	168%	156%	145%	145%

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

The disclosure of information on the Liquidity risk management has been reviewed and approved at the Management Board of the Bank.