NOVA BANKA A.D. BANJA LUKA

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

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INDEPENDENT AUDITOR'S REPORT

TO SHAREHOLDERS OF NOVA BANKA A.D. BANJA LUKA

We have audited the accompanying financial statements of Nova banka a.d., Banja Luka (hereinafter referred as to "the Bank"), which comprise the balance sheet as at 31 December 2012, income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Law on Accounting and Auditing of the Republic of Srpska, and regulations of the Banking Agency of the Republic of Srpska, governing financial reporting of banks, and for such internal controls as management determines are necessary to enable the preparation of financial statements that are free from misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International standards on auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of the Bank as of 31 December 2012, and of its financial performance and cash flows for the year then ended, in accordance with the Law on Accounting and Auditing of the Republic of Srpska and regulations of the Banking Agency of the Republic of Srpska governing financial reporting of banks.

Sarajevo, 8 April 2013

DRUŠTVO ZA REVIZIJU ERNST & YOUNG SARAJEVO, d.o.o.

Stephen Fish
Ernst & Young d.o.o. Sarajevo

Maja Hafizović
Authorized auditor

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2012

	Note	2012	2011
		KM thousand	*KM thousand*
Interest and similar income	3	66.866	52.996
Interest and similar expenses	3	(28.112)	(22.213)
NET INTEREST AND SIMILAR INCOME		38.754	30.783
OPERATING INCOME	4	26.309	23.330
Operating and direct expenses	5	(11.745)	(8.267)
Operating and other expenses	6	(41.637)	(35.571)
NON-INTEREST EXPENSES		(53.382)	(43.838)
PROFIT BEFORE TAX		11.681	10.275
Taxes	7	(1.628)	(1.417)
NET PROFIT		10.053	8.858

Banja Luka, 8 April 2013

On behalf of Nova banka a.d. Banja Luka

Mr Milan Radović
General Manager

BALANCE SHEET AS AT 31 DECEMBER 2012

	Note	31 December 2012	31 December 2011
		KM thousand	*KM thousand*
ASSETS			
Cash and cash deposits with deposit institutions	8	220.242	169.193
Securities held for trading	9	33.757	29.109
Due from banks	10	2.046	1.001
Loans and advances to customers	11	875.822	708.497
Securities held to maturity	12	198	226
Business premises and other fixed assets	13	31.650	26.568
Investments in non-consolidated related parties	14	1.765	1.906
Other assets	15	45.381	36.362
TOTAL ASSETS		1.210.861	972.862
LIABILITIES			
Deposits	16	847.246	650.620
Debt issued and other borrowed funds	17	211.950	196.820
Subordinated debts and bonds	18	18.740	10.869
Provisions for off-balance sheet items	19	2.615	2.262
Other liabilities	20	24.784	16.818
Total liabilities		1.105.335	877.389
EQUITY	21		
Share capital - ordinary shares		70.863	70.863
Share premium		8.070	8.070
Retained earnings		17.934	8.859
Capital reserves		3.338	2.923
Regulatory loan loss reserves		5.321	4.758
Total equity		105.526	95.473
TOTAL LIABILITIES AND EQUITY		1.210.861	972.862
OFF-BALANCE SHEET ITEMS	22	222.494	159.807

Banja Luka, 8 April 2013

On behalf of Nova banka a.d. Banja Luka

Mr Milan Radovic
General Manager

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2012

KM thousand	Share capital – ordinary shares	Share premium	Legal reserves	Retained earnings	Regulatory loan loss reserves	Total
Balance as at 1 January 2011	63.146	8.070	2.517	8.608	4.274	86.615
Issue of shares (the 16th share issue) from retained earnings	7.717	-	-	(7.717)	-	-
Transfer to provisions from retained earnings	-	-	-	(484)	484	-
Transfer to legal reserves from retained earnings	-	-	406	(406)	-	-
Profit for the year	-	-	-	8.858	-	8.858
Balance as at 31 December 2011	70.863	8.070	2.923	8.859	4.758	95.473
Balance as at 1 January 2012	70.863	8.070	2.923	8.859	4.758	95.473
Transfer to provisions from retained earnings	-	-	-	(563)	563	-
Transfer to legal reserves from retained earnings	-	-	415	(415)	-	-
Profit for the year	-	-	-	10.053	-	10.053
Balance as at 31 December 2012	70.863	8.070	3.338	17.934	5.321	105.526

Banja Luka, 8 April 2013

On behalf of Nova banka a.d. Banja Luka

Mr Milan Radović
General Manager

CASH FLOW STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2012

	2012	2011
	KM thousand	*KM thousand*
Cash flows from operating activities		
Interest, fees and commissions receipts	83.757	67.292
Interest paid	(28.745)	(23.909)
Collection of loans previously written-off (principal and interest)	1.374	534
Cash payments to employees and suppliers	(38.789)	(33.466)
Payments on off-balance sheet contracts	-	(401)
Cash borrowings, loans to clients and related collection	(175.275)	(179.483)
Deposits from customers	196.626	95.015
Income tax paid	(1.409)	(1.281)
Net cash flows from operating activities	37.539	(75.699)
Cash flows from investing activities		
Short-term loans to financial institutions	(768)	4.941
Dividend receipts	-	128
Investment in securities held to maturity	-	(8)
Receivable matured securities held to maturity	14	7
Purchase of intangible assets	(4.839)	(1.472)
Purchase of tangible assets	(3.411)	(1.778)
Purchase from other investments	(4.000)	(24.496)
Net cash flows from investing activities	(13.004)	(22.678)
Cash flows from financing activities		
Borrowings, net (credit facilities and subordinated debt)	23.176	22.757
Net cash flows from financing activities	23.176	22.757
Net increase/(decrease) in cash and cash equivalents	47.711	(75.620)
Cash and cash equivalents at the beginning of year	169.193	240.728
Net foreign exchange difference	3.338	4.085
Cash and cash equivalents at the end of year	220.242	169.193

Banja Luka, 8 April 2013

On behalf of Nova banka a.d. Banja Luka

Mr Milan Radović
General Manager

1. GENERAL INFORMATION

Nova Banka a.d. Banja Luka (hereinafter referred to as: "the Bank") was founded in October 1992 and registered with the Court Register by the Decision of the Basic Court in Bijeljina No. Fi-292/92 under the name of Eksim Banka a.d. Bijeljina. Pursuant to the Decision of the Basic Court in Bijeljina No. Fi-352/94 of July 1994, the Bank changed its name to Eksport-Import Banka a.d. Bijeljina, and as per the Decision of the Basic Court in Bijeljina No. Fi-598/99 dated 17 June 1999, the Bank officially recorded the change of its name into Nova banka a.d. Bijeljina. In 2007, pursuant to the Decision of the Basic Court in Banja Luka, the Bank moved its headquarters and started operating under the name of Nova Banka a.d. Banja Luka.

In December 2002, the Bank Shareholders' Meeting set up the Decision on the status change by acquisition of Agroprom banka a.d. Banja Luka. As at 1 January 2003, Agroprom banka a.d. Banja Luka operated as the Bank's branch.

As at 31 December 2012 major shareholder of the Bank was Adriatic Fund BV with 35,72% of share capital (31 December 2011: Adriatic Fund BV 35,72%).

The Bank is registered in Republika Srpska to conduct all banking operations. The Bank is registered to perform deposit operations, credit and guarantee operations, operations with cash, foreign currency and exchange operations, issue and depo-operations, clearing and settlement services, brokerage services, purchase and debt collection and other banking and financial activities in accordance with the Law on Banks of the Republika Srpska.

The Bank's Head Office is located in Banja Luka, 37a Kralja Alfonsa XIII Street.

The Bank operates through its headquarters in Banja Luka and 11 branches located in Bijeljina, Banja Luka, East Sarajevo, Zvornik, Brčko, Trebinje, Doboj, Sarajevo, Ljubuški, Foča, Prijedor and through special department for trading with securities-Broker Nova.

The Bank's operations are organized in divisions, departments and sectors.

As at 31 December 2012 the Bank had 550 employees (as at 31 December 2011: 485 employees).

2. ACCOUNTING POLICIES

2.1. Basis of preparation and presentation of the financial statements

The Bank's financial statements for the year ended 31 December 2012 are prepared in accordance with regulations of Republika Srpska based on the Law on Accounting and Auditing ("The Official Gazette of Republika Srpska, No. 36/2009 and No. 52/2011), the Law on Banks of Republika Srpska, the regulations of the Banking Agency of Republika Srpska and the Central Bank of Bosnia and Herzegovina and other regulations in Republika Srpska which regulate banking operations and financial reporting.

Regulations in the area of accounting and auditing, which are implemented in Republika Srpska based on the Law on Accounting and Auditing imply International Accounting Standards (IAS), International Financial Reporting Standards (IFRS), International Auditing Standards, Code of ethics for professional accountants and accompanying instructions, explanations and guidelines defined by the International Accounting Standards Board (IASB), and all accompanying instructions, explanations and guidelines defined by the International Federation of Accountants (IFAC).

IFRS and interpretations published after 1 January 2010 were not applied during the preparation of the following financial statements since the new and amended IFRS did not have the impact on accounting policies, financial position and operations of the Bank.

The financial statements of the Bank for 2012 were shown in the format prescribed/issued by the Instructions of the Banking Agency of Republika Srpska for the preparation of the financial statements and other by-laws for the financial reporting of the banks.

The Bank applied, in the composing of the following financial statements, accounting policies described in the Note 2.3. based on the accounting rules and regulations of Republika Srpska, regulation of the Banking Agency of Republika Srpska and Republika Srpska tax regulations.

The financial statements of the Bank are prepared using the historical cost method, except for securities available for sale, which are valued using fair value method. The Bank keeps and prepares financial statements expressed in Convertible Marks (KM), official reporting and functional currency of Republika Srpska. The Bank's financial statements are expressed in thousands of KM, except when otherwise indicated.

2. ACCOUNTING POLICIES (continued)

2.2. Significant accounting judgements and estimates

In the process of applying the Bank's accounting policies, management has exercised its judgments and made estimates in determining the amounts recognized in the financial statements. The most significant use of judgments and estimates are as follows:

Impairment losses on loans and advances

The Bank reviews its problematic loans and other placements at each reporting date to assess whether allowance for impairment should be recorded in the income statement. In particular, the management assesses the amount and timing of future cash flows when determining the amount required for allowance.

In addition to specific allowances against individually significant loans and placements, the Bank also forms a collective (group) impairment allowance against exposures which, although not identified as requiring a specific allowance, have a greater risk of default than when originally granted.

Long-term employee benefits

The cost of the long-term employee benefits is determined using actuarial valuation. The actuarial valuation involves making assumptions about discount rates, future salary increases, and future turnover rates. Due to the long term nature of these plans, such estimates are not very accurate.

Determing the fair value of financial instruments

Fair value of financial instruments which are used for trading in active markets at the balance sheet date is based on the quoted market prices of bid and demand, without deduction for transaction costs. Fair value of financial instruments which are not quoted on an active market is determined using appropriate techniques of valuation, which include net present value techniques, compared to similar instruments for which the market prices exist and other relevant models.

When the market inputs are not available, they are determined by estimations which involve certain level of judgment in the assessment of the “fair” value. Estimating models reflect the current state of the market on the measurement date and they do not necessarily represent market conditions before and after the measurement date. Therefore, the valuation techniques are periodically revised so they appropriately reflect the current market conditions.

2.3. Summary of significant accounting policies

Interest and fee income and expenses

Interest income and expenses including penalty and other income and expenses related to interest-bearing assets or interest-bearing liabilities are calculated on an accrual basis of income and expenses and obligatory terms defined by agreement between the Bank and customers.

The Banks derecognizes interest income for receivables for which court proceedings collection started or are deemed disputed or uncollectible. Interest accrued is written off to the extent that there is no realistic prospect of recovery.

Income and expenses from fees and commissions incurred by providing or using banking services are recognized on accrual basis of income and expenses and obligatory terms defined by agreement between the Bank and customers. Fees and commissions consist mainly of fees for domestic and international payments, guarantees and debt issued as well as other Bank services.

2. ACCOUNTING POLICIES (continued)

2.3. Summary of significant accounting policies (continued)

Foreign currency conversion

Balance sheet and income statement items in the financial statements are recorded using currency of primary economic environment (functional currency). As disclosed in Note 2.1. financial statements are stated in thousands of Convertible Marks (KM), which represents functional and official reporting currency of the Bank.

Foreign currency transactions are converted into KM upon the official mean exchange rate of the Central bank at the date of each transaction as well as at the reporting date.

Monetary assets and liabilities denominated in foreign currencies are converted into KM at the official mean exchange rates of the Central Bank of Bosnia and Herzegovina prevailing at the balance sheet date. Foreign exchange gains or losses arising upon the conversion of financial assets and liabilities are credited or debited, as appropriate, to the income statement.

Commitments and contingencies denominated in foreign currency are converted into KM at the Central Bank of Bosnia and Herzegovina's official mean exchange rate prevailing at the balance sheet date.

Loans and advances in KM, with contracted foreign currency rate clause, are converted into KM at the official mean exchange rates prevailing at the balance sheet date. Income or expenses arising upon the conversion of assets by applying contractual foreign currency clause are credited or debited, as appropriate, to the income statement.

Financial instruments

(i) Initial recognition of financial instruments

Financial assets and financial liabilities are recognized in the Bank's balance sheet on the date upon which the Bank becomes a counterparty to the contractual provisions of a specific financial instrument.

All financial instruments are initially recognized at fair value (usually equal to the consideration paid or received) including any directly attributable incremental costs of acquisition or issue, except for financial assets and financial liabilities at fair value through profit and loss.

Regular way of purchases or sales are purchases or sales of financial assets that require delivery of assets within the timeframe generally established by regulation or convention in the market place. All regular way purchases and sales of financial assets are recognized on the trading, i.e. settlement date.

The Bank classifies its financial assets in the following categories: financial assets at fair value through profit or loss; loans and receivables; held-to-maturity securities and available-for-sale financial assets. Management of the Bank determines the classification of its investments on initial recognition.

(ii) Financial assets at fair value through profit or loss

Financial assets held for trading have been primarily acquired for generating profit from short-term price fluctuations. Trading financial assets are recorded in the balance sheet at fair value. Gains or losses on financial assets held for trading are recognized in the income statement.

2. ACCOUNTING POLICIES (continued)

2.3. Summary of significant accounting policies (continued)

Financial instruments (continued)

(iii) Impairment of financial assets

All loans and advances are recognized when cash is advanced to borrowers. Loans are measured at amortized cost using the effective interest rate method, net value of any amounts written off and allowance for loan impairment.

The Bank negotiates a foreign currency clause or other form of risk protection with the borrowers in order to manage credit risk. Income and expenses arising from the use of foreign currency clause, or other form of protection, are recorded in the income statement, as exchange gains/losses.

In accordance with the Bank's internal policy, the Bank assesses at each balance sheet date whether there is any objective evidence that a financial asset or a group of financial assets is impaired. Impairment losses are incurred only if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

Criteria which the Bank uses to determine whether there is objective evidence of an impairment loss include the following: defaults in contractual payments of principal or interest, borrower is experiencing significant financial difficulty, including the probability of bankruptcy or other financial reorganization and when available data indicate measurable decrease in future cash flows such as changes within defaulted liabilities or economic conditions, which are in correlation with deviations from contracted conditions.

In accordance with the adopted internal policy, the Bank first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. Individual assessment of impairment of value is based on the assessment of the expected time of collection, the amount that should be charged and the sources from which the collection is expected to be made in part or in full. Assets that are individually assessed for impairment and for which an impairment loss is recognized are not included in the collective assessment of impairment.

If objective evidence of impairment exists, impairment loss is measured as the difference between the carrying amount of loan and its estimated recoverable amount. The estimated recoverable amount is the present value of the expected future cash flows, discounted at the financial asset's original effective interest rate. The calculation of the present value of the estimated future cash flows of a collateralized financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral. The carrying amount of the loan is reduced through the use of allowance account and the amount of the impairment loss is recognized in the income statement.

For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of the Bank's internal rating system considering credit risk characteristics such as types of loan, collateral type, presence of due receivables, past-due status and other relevant factors.

2. ACCOUNTING POLICIES (continued)

2.3. Summary of significant accounting policies (continued)

Financial instruments (continued)

(iii) Impairment of financial assets (continued)

Future cash flows which refer to the group of financial assets collectively assessed for impairment are assessed based on historical experience about losses for assets with similar credit risk characteristics. Estimates of changes in future cash flows reflect and are in accordance with the changes in available relevant data from each year.

The assessment of impairment for off-balance sheet exposures is being made at the client level by applying the average rate of impairment of value for balance sheet receivables. If the client has only one group of the balance sheet exposures, the same rate is applied for the off-balance sheet exposure, and if the client has several groups of balance sheet exposures, the average rate is applied to the off-balance sheet exposure. If the client does not have balance sheet exposure, the minimum percentage for orderly placements prescribed by the Banking Agency of Republika Srpska is applied for the off-balance sheet exposure.

The Bank regularly reviews the methodology and assumptions used for estimating future cash flows in order to reduce any differences between loss estimates and actual loss experience.

Impairment losses on loans and advances and other financial assets carried at amortized cost are charged to the income statement. Loans and related impairment losses are completely derecognized when there is no possibility of their future recovery, pursuant to a court decision or decision of the Bank’s management or Supervisory Board.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized, the previously recognized impairment loss is reversed by adjusting the allowance account. The amount of the reversal is recognized in the income statement.

(iv) Material assets obtained through collection of receivables

The Bank acquires material assets through the enforcement of collateral over loans and advances. Material assets obtained through collection of receivables are measured at the lower of its carrying amount and fair value less cost to sell.

2. ACCOUNTING POLICIES (continued)

2.3. Summary of significant accounting policies (continued)

Financial instruments (continued)

(v) Available-for-sale securities

Securities intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices are classified as “available-for-sale”. Available-for-sale securities comprise instruments of other legal entities.

After initial measurement, securities classified as available-for-sale are subsequently measured at fair value. Fair values of securities on stock market are based on market prices effected on organized market of securities on the reporting date. Unrealized gains and losses are recognized directly in equity within revaluation reserves. When it comes to disposal of assets, the accumulated losses and gains, previously recognized in equity, are recognized in the income statement within revenues or expenses. Interest gained whilst holding financial assets available-for-sale is included in interest income using the method of effective interest rate. Equity instruments that do not have quoted market price in an active market nor any other method can be used to determine their fair value, are measured at cost, less any allowance for impairment.

For investments in shares and other securities available-for-sale, at the balance sheet date the Bank assesses whether there is objective evidence of impairment of one or more investments and for equity instruments that do not have quoted market price in an active market or any other method can be used to determine their fair value, are measured at cost.

When there is evidence of impairment, the cumulative loss measured as the difference between purchase price and the current fair value is recognized as an allowance. Allowances for impairment on equity investments are not reversed through the statement od comprehensive income, but the increase in their fair value is recognized directly in equity. Allowance for impairment of equity investments, which are not quoted in an active market and whose fair value cannot be reliably estimated, are measured as the difference between carrying value and present value of expected future cash flows and are recognized in the statement od comprehensive income and not reversed until the derecognition of assets.

(vi) Renegotiated loans

Where possible, the Bank seeks to restructure loans rather than to enforce the foreclosure process if the reassessment of client’s creditworthiness allows it. This may involve extending the repayment period as well as the new loan terms. Once the terms have been renegotiated, the loan is no longer considered past due. Management continuously reviews restructured loans to ensure that all criteria are met and that future payments are likely to occur. The loan continues to be subject to an individual or collective impairment assessment, using the initial effective interest rate method.

2. ACCOUNTING POLICIES (continued)

2.3. Summary of significant accounting policies (continued)

Financial instruments (continued)

(vii) Deposits from other banks and customers

Deposits from other banks and customers, as well as other interest-bearing financial liabilities, are initially recognized at fair value, net of transaction costs, except for financial liabilities that are measured at fair value through profit or loss. After initial recognition, interest-bearing deposits and borrowings are subsequently measured at amortized cost.

(viii) Offsetting financial instruments

Financial assets and liabilities can be offset and reported in the net amount in the balance sheet if and only if the Bank has legal right to offset the recognized amounts of assets and liabilities and if there is an intention to settle on a net basis, or to realize the asset and settle the liability simultaneously.

(ix) Issued financial instruments and financial liabilities

Issued financial instruments or their components are classified as liabilities, where the substance of the contractual arrangement results in the Bank having an obligation either to deliver cash or another financial asset to the holder, or to fulfill the obligation in a different way. Such instruments include amounts due to the Government, credit institutions and customers. After initial recognition, issued financial instruments and other borrowings are subsequently measured at amortized cost using the effective interest rate method. Income and expenses are recognized in the income statement when the financial liabilities are derecognized as well as through the amortization process.

Derecognition of financial assets and financial liabilities

Financial assets

A financial asset (or part of a financial asset or group of financial assets) is derecognized where:

- the rights to receive cash flows from the asset have expired; or
- the Bank has transferred its rights to receive cash flows from the asset or has assumed an obligation to pay the received cash flows in full without material delay to a third party under a 'pass-through' arrangement; and
- either the Bank has transferred all the risks and benefits of the asset, or the Bank has neither transferred nor retained all the risks and benefits of the asset, but has transferred control of the asset.

When the Bank has transferred its rights to receive cash flows from an asset or has entered into a pass-through arrangement, and has neither transferred nor retained substantially all the risks and benefits of the asset nor transferred control of the asset, the asset is recognized to the extent of the Bank's involvement in the asset. Continuing involvement that takes the form of a ''guarantee'' over the transferred asset is measured at the lower of the original carrying amount of the asset and the maximum amount of fee that the Bank would have to pay.

2. ACCOUNTING POLICIES (continued)

2.3. Summary of significant accounting policies (continued)

Derecognition of financial assets and financial liabilities (continued)

Financial liabilities

A financial liability is derecognized when the obligation under the liability is discharged or cancelled or expires. Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of the existing liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability, the difference between the original and new amount is recognized in the income statement.

Cash and cash equivalents

Cash and cash equivalents stated in the balance sheet and statement of cash flows comprise cash on hand, current accounts with the Central Bank of Bosnia and Herzegovina, demand deposit with other banks and term deposits with banks for the period of 30 days.

Operating lease

Leased assets for which all the benefits and risks related to the ownership are retained by the lessor, respectively are not transferred to the lessor, and are classified as operating lease.

Payments under operating lease are recognized as expenses in the income statement on a straight-line basis (when incurred) during the period of the lease.

Property, equipment and intangible assets

Property, equipment and intangible assets are measured at their cost less accumulated depreciation.

Amortization is calculated using the straight-line method to the cost of property, equipment and intangible assets over their estimated useful lives. Land is not subjected to depreciation.

The applied annual depreciation rates are as follows:

Buildings	1,30%
Computers and related equipment	14,29% - 20,00%
Vehicles	12,50% - 15,00%
Intangible assets	5,88% - 20,00%
Other equipment and furniture	10,00% - 16,50%

Assets under construction are depreciated after being brought into use. Investment in leased facilities used by the Bank are depreciated over the period of lease.

Investment and current maintenance costs are recognized in the income statement as incurred, and reconstruction and improvement costs, which change the capacity or the use of fixed assets, increase the purchase value of fixed asset.

Gains or losses arising from write-offs or disposals of property and equipment are recognized in the income statement as a part of other operating income or operating expenses.

2. ACCOUNTING POLICIES (continued)

2.3. Summary of significant accounting policies (continued)

Impairment of non-financial assets

At each reporting date, the Bank reviews the carrying amounts of non-financial assets (property and equipment and intangible assets). If there is any indication that such asset may be impaired, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss. If the recoverable amount of the asset is estimated to be less than its carrying value, the carrying amount of the asset is reduced to its recoverable amount.

Financial guarantees

In ordinary course of business, the Bank gives financial guarantees, comprising payment guarantees, performance guarantees, letters of credit and other warranties. Financial guarantees are initially recognized in off-balance sheet assets at fair value. Subsequent to initial recognition the Bank's liability under each guarantee is measured at the higher of the amortized premium and the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee, depending which amount is higher.

Any increase in the liability relating to financial guarantees is recorded to the income statement. The premium received is recognized in the income statement on a straight-line basis over the life of the guarantee.

Provisions

A provision is recognized when the Bank has a present obligation (legal or constructive) as a result of a past event and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of obligation. Where the effect of the time value of money is material, the amount of provision is the present value of expenditures expected to be required to settle the obligation.

Employee benefits

Employee benefits and contributions for social security

In accordance with the regulations prevailing in Republika Srpska, the Bank has an obligation to pay contributions to various state social security funds. These obligations involve payment of contributions on behalf of employee by employer in an amount calculated by applying the specific rates prescribed by the relevant legislation. The Bank is also legally obligated to withhold contributions from gross salaries to employees, and on their behalf to transfer the withheld portions directly to appropriate government funds. These contributions payable on behalf of employee and employer are charged to expenses in the period in which they arise.

Long term employee benefits

In accordance with the Labour Law, Industry employment agreement and Manual on employment, the Bank has an obligation to disburse an employment retirement benefit to a retiree upon the retirement. Long-term liabilities relating to severance payments and jubilee awards represent present value of the defined benefit obligation determined through actuarial valuation.

2. ACCOUNTING POLICIES (continued)

2.3. Summary of significant accounting policies (continued)

Provisions for loan and other losses

In accordance with the Decision of the Banking Agency of Republika Srpska, Official Gazette of Republika Srpska no. 12/03, 85/04, 01/06, 136/10, 127/11 and 67/12 (hereinafter referred to as ''the Decision'') on Amending of the Decision on minimum standards for credit risk management and classification of assets in banks, standards and criteria that a bank has to establish and implement in the assessment, monitoring, control, credit risk management and classification of its assets are prescribed. Bank's risk-bearing assets in terms of this decision are: loans, deposits with banks, interest rates and fees, securities held to maturity, securities available for sale, shares in other legal entities and other balance sheet items in which the Bank is at risk of collection, and risk-bearing off-balance sheet items: issued guarantees, bills, acceptances and other forms of guarantees, uncovered letters of credit, irrevocable approved and unused credits and all other items that are potential liabilities.

In accordance with the Decision, loans and other balance sheet assets and risk bearing off-balance sheet items are classified into the following categories: A (“good assets”), B (“assets with special note”), C (“substandard assets”), D (“doubtful assets”) and E (“loss”). Pursuant to the Decision, the Bank makes 2% provisions for general risk-bearing provisions for category A, while the provisions for categories B, C, D and E are the following:

Category B: assets with special note	5% - 15%
Category C: substandard assets	16% - 40%
Category D: doubtful assets	41% - 60%
Category E: loss	100%

In accordance with the Decision, provisions for loan losses represents a reserve, which the Bank in assessing its asset’s quality and classification of assets, forms, taking into account the already established impairment of balance sheet assets and provisions for losses of off-balance sheet items. The amount of estimated losses, net of allowance balance sheet assets and provisions for losses of off-balance sheet items are created from retained earnings based on the decisions of the Shareholders’ Meeting and is recorded under the reserves for loan losses. If the Bank is unable to cover lacking reserves at the expense of profit, undistributed profits and other reserves formed from profit, it is still obliged to recognize uncovered amount of reserves for loan losses as the deduction to the capital, as long as the Bank does not cover all missing loan loss reserves.

Income tax

Current taxes

Income tax is calculated in accordance with tax regulations of Republika Srpska. During the year, the Bank pays income tax in monthly installments, estimated on the basis of the prior year Tax return. Income tax is payable at 10% of the taxable income reported in Tax return. The taxable income represents profit reported in the income statement adjusted for certain income and expenses, as prescribed by the tax regulations, and it could be reduced for certain tax reliefs.

2. ACCOUNTING POLICIES (continued)

2.3. Summary of significant accounting policies (continued)

Income tax (continued)

Deferred taxes

Deferred tax is provided for using the balance sheet liability method on temporary differences at the balance sheet date between the current value of assets and liabilities in the financial statements and their carrying amounts for taxation purposes. The current tax rate at the balance sheet date is used for calculating the amount of deferred taxes.

Deferred tax liabilities are recognized for all taxable temporary differences, except where the deferred tax liability arises from the initial recognition of goodwill or for an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and in respect of taxable temporary differences associated with investments in subsidiaries and associates, where the timing of the reversal of the temporary differences can be controlled and it is probable that the temporary differences will not reverse in the foreseeable future.

Deferred tax assets are recognized for all deductible temporary differences, carryforward of unused tax credits and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences, and the carryforward of unused tax credits and unused tax losses can be utilized, except where the deferred tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and in respect of deductible temporary differences associated with investments in subsidiaries and associates when deferred tax assets are recognized only to the extent that it is probable that the temporary differences will reverse in the foreseeable future and taxable profit will be available against which the temporary differences can be utilized.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred tax asset to be utilized. Unrecognized deferred tax assets are reassessed at each balance sheet date and are recognized to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

Deferred tax assets and liabilities are measured at the tax rates that are expected to be applied in the year when the asset is realized or the liability is settled.

Current and deferred taxes are recognized as income or expense and are included in net profit/(loss) for the period.

Shareholders' equity

Shareholders' equity consists of share capital, share premium, capital reserves (general legal reserves), undistributed profits and regulatory loan loss reserves.

2. ACCOUNTING POLICIES (continued)

2.3. Summary of significant accounting policies (continued)

Earnings per share

Basic EPS is calculated by dividing the profit or loss attributable to ordinary shareholders of the Bank by the weighted average number of ordinary shares outstanding during the period.

In accordance with the regulations of the Banking Agency of Republika Srpska, the Bank is not obliged to calculate and disclose earnings per share.

Comparative data

In order to ensure consistency of the financial statements' presentation in the current year with the presentation of financial statements in the previous year, certain reclassifications of comparative data in the statements of financial position and comprehensive income are made, in accordance with the requirements of the Banking Agency of Republika Srpska. Reclassifications in the balance sheet relate to the decrease of loans and due receivables in the amount of KM 14.385 thousand for purchased receivables, and for the same amount increase in other assets, as well as decrease in other assets in the amount of KM 286 thousand for advance payments for fixed assets and increase in business premises and other fixed assets in the same amount. In the income statement reclassifications relate to the decrease of operating income in the amount of KM 2.582 thousand for credit fees and increase in interest income and other income in the same amount.

Fair value of financial instruments

Fair value is generally the amount for which an asset could be exchanged or a liability settled in an arm's length transaction. The Bank's financial instruments carried at amortized cost have short maturity terms and bear interest rates that are reflective of current market conditions. The Bank considers consequently that their carrying value approximates their fair value.

The fair value of loans and advances to customers is approximately equal to their carrying value net of related allowance for impairment. Most available-for-sale investments comprise equity instruments that do not have a quoted market price in an active market since there is no developed financial market in Republika Srpska. Since the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, these investments are carried at cost, less any allowance for impairment. Deposits from other banks and customers are mostly on demand and with short-term maturity; therefore management of the Bank is of the opinion that the fair value of deposits is approximately equal to their carrying values.

Segment information

The management monitors business units of the Bank as a single segment for the purpose of making decisions about resource allocation and performance assessment.

NOTES TO THE FINANCIAL STATEMENTS

3. INTEREST INCOME AND EXPENSES

	2012	2011
	KM thousand	*KM thousand*
Interest and similar income based on:		
Interest-bearing deposits with deposit institutions	32	1.169
Due from banks	75	281
Investments in bonds	1.666	195
Loans	62.013	48.769
Other interest and similar income	3.080	2.582
Total interest and similar income	66.866	52.996
Interest and similar expenses based on:		
Deposits	22.324	17.084
Debt issued and other borrowings	4.969	4.827
Subordinated debt and bonds	819	302
Total interest and similar expenses	28.112	22.213
Net interest and similar income	38.754	30.783

Interest and similar income and expense, analyzed by types of placements and related sources are as follows:

	2012		2011	
	Income	Expenses	Income	Expenses
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*
Banks	107	505	1.450	16
Companies	38.969	6.628	32.651	6.127
Public sector	11.237	3.195	4.714	3.205
Retail	16.162	9.322	14.014	5.605
Other customers	391	8.462	167	7.260
Total	66.866	28.112	52.996	22.213
Interest and similar income, net	38.754		30.783	

4. OPERATING INCOME

	2012	2011
	KM thousand	*KM thousand*
Foreign exchange gains, net	3.339	4.085
Credit fees	486	336
Off-balance sheet items fees	4.365	3.684
Fees for services	12.766	10.900
Income from trading activities	284	-
Other operating income	5.069	4.325
Total	26.309	23.330

4. OPERATING INCOME (continued)

Fees for services

	2012	2011
	KM thousand	*KM thousand*
Fees for internal transaction payments	6.048	5.737
Fees for foreign transaction payments	2.986	2.580
Fees for cards transactions	1.995	2.020
Fees for currency exchange services	1.222	5
Other operating income	515	558
Total	12.766	10.900

Income from fees for currency exchange services in 2012 has significantly increased. Until 22 April 2012 the Bank presented provisions for purchase and sales of EUR as exchange difference. In accordance with the Law on Foreign Exchange it is defined that buying and selling currencies for EUR to KM for transactions with retail banking and authorized transmission have to be the same as buying and selling currencies published by the Central Bank of Bosnia and Herzegovina.

As in 2012 fees for buying and selling currencies in retail banking and authorized transmission were introduced, which are 0,65% for purchase and 0,55% for sale of EUR currency compared to KM, the current exchange rate difference to the purchase and sale of EUR against the KM is amended and recorded as fees from currency exchange services.

Other operating income

	2012	2011
	KM thousand	*KM thousand*
Collected, written-off receivables	1.047	534
Gains on sale of securities held to maturity	-	26
Credit cards membership fees	296	307
Income from purchased receivables	1.557	1.371
Dividend income	1	131
Income from decrease of liabilities	309	39
Income from changes in the value of securities	807	594
Operating lease income	443	482
Other operating income	609	841
Total	5.069	4.325

Income from decrease of liabilities in the amount of KM 309 thousand relates to closure of account balances of large number of clients that are obsolete and are in line with the management's decisions.

5. OPERATING AND DIRECT EXPENSES

	2012	2011
	KM thousand	*KM thousand*
Net impairment for risk-bearing balance sheet items and reserve for risk-bearing off-balance sheet items	7.944	5.301
Other operating and direct expenses	3.801	2.966
Total	11.745	8.267

a) Income and expenses upon indirect placement write-offs and provisions

	2012	2011
	KM thousand	*KM thousand*
Impairment losses and provisions		
Impairment for credit risks (Note 11)	21.164	17.403
Provision for risks of other assets (Note 15)	2.220	853
Provision for risks of off-balance risk assets (Note 19)	2.247	1.718
	25.631	19.974
Reversal of impairment and provisions		
Reversal of indirect write-off loans (Note 11)	14.999	12.516
Reversal of indirect write-off of other assets (Note 15)	794	697
Release of provision for the off-balance sheet items (Note 19)	1.894	1.460
	17.687	14.673
Net impairment for risk-bearing balance sheet items and reserve for risk-bearing off-balance sheet items	7.944	5.301

b) Other operating and direct expenses include:

	2012	2011
	KM thousand	*KM thousand*
Fees and commissions – Central Registry and Stock Exchange	97	254
Fees for payment cards operations	869	746
Fees for banking services	1.456	845
Other fees and commissions	839	700
Fees for payment transactions	540	421
Total	3.801	2.966

6. OPERATING AND OTHER EXPENSES

	2012	2011
	KM thousand	*KM thousand*
Operating expenses	36.974	31.555
Other expenses	4.663	4.016
Total	41.637	35.571

a) Operating expenses include:

	2012	2011
	KM thousand	*KM thousand*
Costs of net salaries and other fees	9.850	8.194
Taxes and contributions on salaries	6.578	5.320
Business premises, fixed assets and overheads	9.960	8.979
Other operating expenses	10.586	9.062
Total	36.974	31.555

6. OPERATING AND OTHER EXPENSES (continued)

b) Business premises, fixed assets and overheads include:

	2012	2011
	KM thousand	*KM thousand*
Office supplies, overhead costs, fuel	1.617	1.458
Fixed asset maintenance cost and rentals	4.269	3.303
Depreciation (Note 13)	4.074	4.218
Total	9.960	8.979

c) Other operating expenses include:

	2012	2011
	KM thousand	*KM thousand*
Production services	2.640	2.316
Intangible expenses	7.158	5.484
Other personal expenses	262	192
Other expenses	526	1.070
Total	10.586	9.062

Cost of production services includes marketing costs in the amount of KM 1.213 thousand (2011: KM 905 thousand), and postal services and electronic communication costs in the amount of KM 1.218 thousand (2011: KM 1.102 thousand). Of the total reported intangible costs, the most significant expenses relate to the cost of insurance and security deposit in the amount of KM 1.784 thousand (2011: KM 1.597 thousand), money transportation costs, security, archiving, printing in the amount of KM 3.344 thousand (2011: KM 2.225 thousand) and the external services in the amount of KM 913 thousand (2011: KM 823 thousand).

d) Other expenses relate to:

	2012	2011
	KM thousand	*KM thousand*
Production expenses-fees	1.688	1.515
Provisions for legal claims, net (Note 20)	(17)	62
Jubilee awards, net (Note 20)	(36)	(2)
Expenses from changes in the value of securities	277	234
Expenses from direct write-off of receivables	294	1.205
Expenses from sale and impairment of material assets	748	312
Expenses from court decisions and off court settlements	266	169
Expenses from write-off of fixed assets	48	69
Expenses for court and administrative fees	397	297
Other expenses	998	155
Total	4.663	4.016

Production expenses amounting to KM 1.688 thousand refer to e-banking services, swift and credit card operations (2011: KM 1.515 thousand).

7. INCOME TAX

Current tax for the year ended on 31 December 2012 was calculated by applying the rate of 10% on taxable income reported in the Tax return for Tax authorities of Republika Srpska.

The components of the income tax expense for the year ended 31 December 2012 are:

	2012 *KM thousand*	2011 *KM thousand*
Current income tax	1.650	1.313
Deferred income tax	(22)	104
Total	1.628	1.417

Reconciliation between tax balance sheet positions (income, expenses and tax basis) with tax rate applicable in Republika Srpska for the year 2012 and 2011 can be analyzed as follows:

	2012 *KM thousand*	2011 *KM thousand*
Accounting profit before tax	11.681	10.275
Accounting profit multiplied by the applicable tax rate of 10%	1.168	1.028
Tax effect on expenses not deductable for income tax purposes	482	285
Income tax expense reported in the income statement	1.650	1.313

Deferred tax expense reported in the income statement amounting to KM 22 thousand for 2012 relates to temporary differences between the carrying value of fixed assets and intangible assets and their tax basis (2011: KM 104 thousand).

8. CASH AND CASH DEPOSITS WITH DEPOSIT INSTITUTIONS

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Cash on hand and non-interest bearing deposits		
Cash on hand – local currency	8.960	7.217
Cash on hand – foreign currency	9.626	7.210
Business unit gyro account	591	369
Checks denominated in foreign currency	105	47
Other monetary assets in foreign currency	-	66
	19.282	14.909
Interest bearing deposits		
Short-term loans and placements denominated in KM	-	13.000
Foreign currency accounts with foreign banks	57.335	24.086
Balances with Central bank	143.625	117.198
	200.960	154.284
Total	220.242	169.193

Balances with Central bank

Within reserves with Central Bank of Bosnia and Herzegovina mandatory reserve for the maintenance period of 21 to 31 December 2012 is included. The average mandatory reserve requirement for the specified period amounting to KM 69.735 thousand includes the average mandatory reserve to one year in the amount of KM 39.754 thousand and the average mandatory reserve over one year in the amount of KM 29.981 thousand.

The mandatory reserve is maintained in the manner defined by the Decision of the Central Bank of Bosnia and Herzegovina on determination and maintenance of mandatory reserves and determination of fee on the reserves, whereby the following are prescribed: the basis for mandatory reserve calculation, calculation period, mandatory reserve rate, as well as calculation of fee for the mandatory reserve account with the Central bank.

Deposits and funds borrowed represent the basis for calculating the mandatory reserve, regardless of their currency. The mandatory reserve is calculated according to the balance at the end of each working day during the calculation period, proceeding the maintenance period. The period for calculating the mandatory reserve begins on 1^{st}, 11^{th} and 21^{st} day of each month and concludes on 10^{th}, 20^{th} and the last day in a month. The Bank is obligated to submit a report to the Central bank on the balance of its deposits and borrowings denominated in KM, within three days after the end of the period.

In line with the Decision on determining and maintaining obligatory reserves and determination of fee on the reserves, which was in place in period from 1 February 2011 to 1 August 2011, the mandatory reserve rate applied by the Central bank is 10% on deposits and borrowed funds with agreed maturity up to one year (short-term deposits and borrowed funds) and 7% on deposits and borrowed funds with agreed maturity over one year (long-term deposits and borrowed funds). The Central bank calculates the compensation amount for the funds in the reserve account as follows: the amount of required reserves and the amount above the required reserves.

In line with the Decision on the amendment of the Decision on determining and maintaining mandatory reserves and determination of fee on the reserves, which came into force on 1 August 2011, the compensation amount that Central bank calculates for the funds in the reserve account has changed as follows: 70% of a weighted average interest rates achieved by the Central bank on deposits invested up to one month during the same period on the market applied on the amount of the required reserve, while 90% of a weighted average interest rates achieved by the Central bank on deposits invested up to one month during the same period on the market applied on the amount above required reserve.

9. SECURITIES HELD FOR TRADING

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Securities held for trading		
- Securities of state and government bodies	31.606	27.200
- Other securities held for trading	2.151	1.909
Balance as at 31 December	33.757	29.109

Bonds of Republika Srpska date from 2011 and 2012. In accordance with the Decision of Republika Srpska Government on the first issue of bonds of Republika Srpska through the public offering on 12 October 2011, and based on the Decision of the Credit Committee on 2 November 2011, the Bank purchased bonds in the amount of KM 27.150 thousand. Through the public offering of the Government of Republika Srpska for registration and payment of issue of bonds of Republika Srpska on 5 April 2012, and based on the Decision of the Credit Committee on 19 April 2012, the Bank purchased bonds of Republika Srpska in the amount of KM 4.000 thousand. Interest rate for bonds in the amount of KM 27.150 thousand is 5% annually on the nominal value of bonds and for bonds in the amount of KM 4.000 thousand is 6% annually. Interest payments are made twice a year at the end of each semester from the date of registration. Based on the investment in securities of state and government bodies, the Bank generated interest income in the amount of KM 1.666 thousand in 2012 and income from changes in value of securities in the amount of KM 456 thousand.

10. DUE FROM BANKS

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Foreign currency accounts at foreign banks – separate deposit	1.774	880
Other short-term placements with banks and banking institutions	272	121
Total	2.046	1.001

The separated funds amounting to KM 1.774 thousand were allocated on the account with Deutsche Bank and Commerzbank AG Frankfurt as collaterals for counter-guarantees and letters of credit.

11. LOANS AND ADVANCES TO CUSTOMERS

a. Summary by type of loans:

	Short-term *KM thousand*	Long-term *KM thousand*	Total 2012 *KM thousand*	Short-term *KM thousand*	Long-term *KM thousand*	Total 2011 *KM thousand*
Loans to:						
- Corporate customers	106.121	336.274	442.395	140.856	284.194	425.050
- State and local Authorities	394	68.876	69.270	828	29.006	29.834
- Government	-	133.851	133.851	459	76.580	77.039
- Banks and banking institutions	-	-	-	833	-	833
- Retail customers	22.173	198.053	220.226	21.814	158.185	179.999
- Other customers	2.508	4.411	6.919	-	123	123
Overdue loans	40.726	-	40.726	29.420	-	29.420
Loans and advances to customers, gross	171.922	741.465	913.387	194.210	548.088	742.298
Allowance for impairment losses	(18.795)	(18.770)	(37.565)	(16.846)	(16.955)	(33.801)
Loans and advances to customers, net	153.127	722.695	875.822	177.364	531.133	708.497

b. Maturities of loans to customers

Maturity structure of loans to customers in terms of the remaining maturity as at 31 December 2012 is as follows:

	31 December 2012 *KM thousand*	31 December 2011 *KM thousand*
Up to 30 days	63.547	52.356
From 1 to 3 months	52.068	44.614
From 3 to 12 months	202.520	196.306
From 1 to 5 years	402.529	288.563
Over 5 years	192.723	160.459
Loans and advances to customers, gross	913.387	742.298
Impairment	(37.565)	(33.801)
Loans and advances to customers, net	875.822	708.497

11. LOANS AND ADVANCES TO CUSTOMERS (continued)

c. Concentration of loans to customers

As at 31 December 2012 the concentration of the Bank's total placements to customers was significant in the following industries:

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Agriculture, hunting and fishing	28.315	13.984
Mining and industry	217.233	202.854
Civil construction	44.828	35.666
Trade	159.035	140.273
Services, tourism and catering	9.918	8.459
Transportation, warehousing, telecommunication	26.707	17.089
Finance	28.034	20.257
Real estate trading	4.686	28.788
Administration and other public services	134.177	84.165
Retail	226.933	185.834
Other	33.521	4.929
Loans and advances to customers, gross	913.387	742.298
Impairment	(37.565)	(33.801)
Loans and advances to customers, net	875.822	708.497

Changes in impairments were as follows:	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Balance at beginning of the year	33.801	28.914
New impairments (Note 5)	21.164	17.403
Reversal of impairments (Note 5)	(14.999)	(12.516)
Reversal of impairments	(2.401)	-
Balance as at 31 December	37.565	33.801

12. SECURITIES HELD TO MATURITY

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Securities held to maturity		
- Government securities	56	56
- Other securities	142	170
Balance as at 31 December	198	226

13. BUSINESS PREMISES AND OTHER FIXED ASSETS

Fixed assets and changes in fixed assets in 2012 and 2011 are as follows:

	Land and business premises	Equipment and other assets	Fixed assets under construction	Total fixed assets	Intangible assets
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*
Cost:					
Balance as at 1 January 2011	13.357	23.092	810	37.259	9.964
Additions	-	-	3.158	3.158	1.062
Transfer	1.436	1.720	(3.156)	-	-
Disposals	(171)	(1.263)	-	(1.434)	-
Balance as at 31 December 2011	14.622	23.549	812	38.983	11.026
Balance as at 1 January 2012	14.622	23.549	812	38.983	11.026
Additions	-	-	4.434	4.434	5.005
Transfer	1.123	3.011	(4.134)	-	-
Disposals	(184)	(729)	-	(913)	(57)
Balance as at 31 December 2012	15.561	25.831	1.112	42.504	15.974
Amortisation and impairment:					
Balance as at 1 January 2011	310	14.846	-	15.156	5.121
Impairment	120	2.876	-	2.996	1.222
Disposals	(12)	(1.042)	-	(1.054)	-
Balance as at 31 December 2011	418	16.680	-	17.098	6.343
Balance as at 1 January 2012	418	16.680	-	17.098	6.343
Impairment	133	2.462	-	2.595	1.479
Disposals	(8)	(622)	-	(630)	(57)
Balance as at 31 December 2012	543	18.520	-	19.063	7.765
Net carrying value:					
Balance as at 31 December 2012	15.018	7.311	1.112	23.441	8.209
Balance as at 31 December 2011	14.204	6.869	812	21.885	4.683

As at 31 December 2012 the Bank has no buildings pledged as collateral for borrowings or other financial liabilities. The Bank owns immovable property certificates for buildings.

The management considers that the Bank’s property, equipment and intangible assets in use as at 31 December 2012 are not impaired.

14. INVESTMENTS IN NON-CONSOLIDATED RELATED PARTIES

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Equity investments and other securities available-for-sale		
Equity investments	2.028	2.042
Impairment	(263)	(136)
Balance as at 31 December	1.765	1.906

As at 31 December 2012 the Bank has investments in other legal entities. The most significant investment refers to Nova leasing (63%) in the amount of KM 860 thousand (net amount KM 597 thousand) and to Nova Real Estate (10%) in the amount of KM 450 thousand.

As at 31 December 2012 equity investments in single legal entity do not exceed 5% of the Bank's share capital. Also as at 31 December 2012 total net carrying value of the Bank's equity investments in other legal entities and their subsidiaries do not exceed 20% of the Bank's share capital whereas the total amount of equity investments in other non-financial legal entities do not exceed 25% of share capital.

15. OTHER ASSETS

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Interest and fees receivable	6.836	6.450
Purchased receivables	13.613	14.790
Advances for other purposes	4.558	4.626
Receivables from employees for damages	162	184
Foreign currency deposit for payment transactions by credit cards	1.247	1.059
Receivables from sale of material assets obtained through collection of receivables	303	450
Material assets obtained through collection of receivables	5.657	2.313
Receivables for payment under the guarantee	792	792
Due from banks and other legal entities for cash payments	1.401	969
Receivables from clients based on distributed inflow	2.141	205
Receivables for given deposits on behalf of litigation bids	581	-
Accrued interest on loans	2.746	2.002
Accrued interest on securities	225	181
Accrued interest on rental savings	4.100	1.921
Accrued interest on prepayments	1.166	781
Accrued income	83	119
Receivables from sale of fixed assets	82	79
Inventories	592	78
Receivables from refunding fees	169	180
Other receivables from business activities	2.069	965
Total	48.523	38.144
Impairment	(3.142)	(1.782)
Other assets, net value	45.381	36.362

15. OTHER ASSETS (continued)

Interest and fees receivable to customers as at 31 December were as follows:

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Interest and fees receivable		
Banks	1	19
Corporate	5.431	5.063
Retail	1.312	1.360
Foreign entities	1	1
Government and other government institutions	91	7
Balance as at 31 December	6.836	6.450

Changes on impairment are as follows:	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Balance at the beginning of the year	1.782	1.625
New impairments (Note 5)	2.220	853
Reversal of impairment (Note 5)	(794)	(697)
Derecognition of impairment	(66)	-
Foreign exchange gains/losses	-	1
Balance as at 31 December	3.142	1.782

16. DEPOSITS

Deposits by customers:

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Interest bearing deposits		
Banks and banking institutions	3.807	12.369
Public and state-owned enterprises	172.273	97.748
Corporate	78.347	83.687
Non-industrial customers	74.476	55.871
Government and other government institutions	114.574	124.213
Foreign entities	653	284
Retail	277.249	170.805
Other	-	2.516
Total interest bearing deposits	721.379	547.493
Non-interest bearing deposits		
Banks and banking institutions	2.016	806
Public and state-owned enterprises	403	443
Corporate	40.404	32.598
Non-industrial customers	204	646
Government and other government institutions	1.360	1.237
Foreign entities	13.204	1.836
Retail	68.188	65.200
Other	88	361
Total non-interest bearing deposits	125.867	103.127
Balance as at 31 December	847.246	650.620

16. DEPOSITS (continued)

Deposits by maturity:

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Current accounts and demand deposits		
Government and other government institutions	86.822	71.393
Corporate customers	96.693	87.625
Banks and banking institutions	1.757	779
Retail customers	98.737	79.278
Other	14.722	12.772
Total current accounts and demand deposits	298.731	251.847
Short-term deposits		
Government and other government institutions	4.077	25.659
Corporate customers	40.123	35.466
Banks and banking institutions	178	12.000
Retail customers	28.924	24.659
Other	17.919	7.894
Total short-term deposits	91.221	105.678
Long-term deposits		
Government and other government institutions	25.035	28.398
Corporate customers	155.554	92.076
Banks and banking institutions	3.888	396
Retail customers	230.570	133.497
Other	42.247	38.728
Total long-term deposits	457.294	293.095
Balance as at 31 December	847.246	650.620

17. DEBT ISSUED AND OTHER BORROWED FUNDS

	31 December 2012	31 December 2011
Liabilities upon short-term loans	*KM thousand*	*KM thousand*
IRB RS - Development and Employment Fund of RS	-	663
IRB RS - Fund for development of the eastern part of RS	-	248
IRB RS - Housing fund	-	147
FMF-ODRAZ-World Bank - IBRD	17	4
Total liabilities upon short-term loans	17	1.062
Liabilities upon long-term loans		
IRB RS - Development and Employment Fund of RS	2.833	4.902
IRB RS - Housing fund of RS	49.716	48.475
IRB RS - Development and Employment Fund	84.631	77.318
IRB RS - Fund for development of the eastern part of RS	34.619	30.380
PCU - Ministry of Finance of RS	1.275	1.485
Ministry of Finance of RS	946	1.035
Federal Ministry of Finance	1.725	2.110
Ministry of Industry of Canton Sarajevo	1.349	1.888
FMF - ODRAZ-World Bank-IBRD	848	223
IRB RS - World Bank – IBRD	26.503	13.209
IFC	1.422	4.267
EFSE	6.066	10.466
Total liabilities upon long-term loans	211.933	195.758
Balance as at 31 December	211.950	196.820

Part of long-term loans with maturity up to one year amounted to KM 17 thousand (31 December 2011: KM 1.062 thousand).

Long term loans from funds managed by IRB RS are related to single agreements with maturity from 3 to 20 years and annual interest rate from 1,20% to 4,29%. Funds were borrowed in order to fund agriculture, enterprises and entrepreneurs, for retail housing loans and loans for local self-management units.

Long-term loans from the International Finance Corporation (IFC) relate to an Agreement on credit line signed in May 2006. The Bank's commitments under the contract as at 31 December 2012 are KM 1.422 thousand. Loan is due on 15 June 2013.

Long-term borrowings from the European Fund for Southeast Europe (EFSE) relate to general agreement on granting individual loans signed by the Bank and the European Fund for Southeast Europe (the Fund) on 26 June 2006. In accordance with the Agreement, the loan is granted in the amount of EUR 17.000 thousand and it is to be repaid in semi-annual installments (on 31 March and 30 September) starting from 31 March 2007. Annual interest rate represents the sum of 6m EURIBOR and a margin which is defined in each individual loan agreement.

Debt of KM 26.503 thousand to IRB RS is reported in accordance with the Agreement of subsidiary funding (World Bank IBRD) as at 20 December 2010 between IRB RS, which manages Development and Employment Fund of RS and Nova Banka a.d. Banja Luka.

17. DEBT ISSUED AND OTHER BORROWED FUNDS (continued)

In accordance to the agreement it is defined that the IBR RS will forward loan of IBRD (Subsidiary financing) exclusively to fund sub loans, and that subsidiary financing to Bank will be identical when it comes to amount, maturity, grace period as well as sub loans which Bank approved to final borrowers. In line with the agreement, the Bank determines interest rate for final borrowers in dependence with the estimated risk of the final user of the loan and quality of the collaterals and the interest rate for the final borrower must be related with 6m Euro Libor increased for the Bank margin. Withdrawn and outstanding amount of subsidiary financing will have interest rate calculated as average 6m Euro Libor for the period of previous six months, according to calculations which World Bank reports on June 15 and December 15 increased for 2%. IRB RS will calculate and charge the Bank fee of 0,25% one-off for each subsidiary loan Bank that will allow the end user. Bank will repay principal amount of subsidiary user which has due in accordance with plan which is estimated in agreement annexes and repay of the debt will be quarterly on March 1st, June 1st, September 1st, December 1st each year on the account which IRB RS determines according to repayment plan.

18. SUBORDINATED DEBT AND BONDS

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Subordinated loan (domestic currency)	18.000	10.000
Subordinated loan (foreign currency)	740	869
Balance as at 31 December	18.740	10.869

Subordinated liabilities in the total amount of KM 18.000 thousand date from 2011 in the amount of KM 10.000 thousand and from 2012 in the amount of KM 8.000 thousand.

On the basis of subordinated debt in the amount of KM 10.000 thousand, on the 11 May 2011 Shareholders' Meeting of the Bank, with the consent of Banking Agency of Republika Srpska decided to broadcast 17th issue of the securities, the First issue of bonds by public offer in the amount of KM 10.000 thousand. On 4 August 2011 Securities commission adopted the decision and declared the 17th issue of securities (the First issue of the bonds) as successfully entered into the registry of issuers. In accordance with the decision on issuing the first issue of bonds through public offer, bonds with the maturity of 7 years and with a fixed annual interest rate of 8% are issued. During the first 3 years from the bond registration date, the Bank will pay interest twice a year (grace period), and after the period of 3 years, the Bank will in the following 4 years pay principal semi-annually in eight equal amounts, together with the related interest.

On the basis of subordinated debt in the amount of KM 8.000 thousand, in line with the 10 May 2012 Shareholders' Meeting of the Bank, with the 14 November 2012 consent of Banking Agency of Republika Srpska, Supervisory Board of the Bank decided to broadcast 19th issue of the securities. The Second issue of bonds by public offer emitted 80 thousand bonds with nominal value of KM 100 each, giving the total amount issued of KM 8.000 thousand, with annual interest rate of 8% and maturity of 7 years with 5-year grace period with equal semi-annual installments after the grace period. On 31 December 2012 Securities Commission adopted the decision and declared the the Second issue of bonds as successfully entered into the registry of issuers.

18. SUBORDINATED DEBT AND BONDS (continued)

In acordance with the decision of the Banking Agency of Republika Srpska, the Bank must not make repayments of subordinated debt within 5 years, and after the expiry of 5 years, if the equity declines below prescribed level, it must require prior approval of the Banking Agency of Republika Srpska to begin the repayment of subordinated debt.

The First issue of bonds in amount of KM 10.000 thousand was bought by: Development and Employment Fund of RS (KM 2.500 thousand), Restitution Fund of RS (KM 2.500 thousand) and Equity Fund of RS (KM 5.000 thousand). The Second issue of bonds in amount of KM 8.000 thousand was bought by: Development and Employment Fund of RS (KM 2.000 thousand), Restitution Fund of RS (KM 2.000 thousand) and Equity Fund of RS (KM 4.000 thousand).

As at 31 December 2012 the Bank also has subordinated loan in the amount of KM 740 thousand, relating to liabilities for the loan withdrawn from USAID. In 2003 the Bank acquired loan portfolio from USAID for the amount of KM 4.825 thousands. The amount of KM 2.895 thousand was paid in August 2003 while for the remaining amount of KM 1.930 thousand subordinated loan agreement was signed. In accordance with the Agreement on subordinated loan, the Bank is obligated to pay the subordinated debt in equal quarterly installments starting from 1 December 2003 to 1 September 2018, with a fixed annual interest rate Euro Libor.

19. PROVISIONS FOR OFF-BALANCE SHEET ITEMS

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Provision for off-balance sheet items:		
- Guarantees	1.962	1.505
- Irrevocable commitments	477	552
- Borrowings and credit cards	159	194
- Uncovered letters of credit	17	11
Balance as at 31 December	2.615	2.262

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Movements in provision for off-balance sheet items:		
Balance at the beginning of the year	2.262	2.004
Provisions in the current year (Note 5)	2.247	1.718
Reversal of provisions (Note 5)	(1.894)	(1.460)
Balance as at 31 December	2.615	2.262

20. OTHER LIABILITIES

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Interest and fees payable	95	440
Liabilities to suppliers	370	226
Liabilities for the payment of the share capital of other companies	411	282
Other liabilities - advance installments charged for loans	2.284	1.895
Accrued income - fees collected in advance	5.031	3.963
Accrued interest in local currency	4.166	2.344
Accrued interest in foreign currency	3.301	1.988
Deferred liabilities for other accrued income	477	421
Liabilities for payment cards realized in other banks	159	98
Taxes and contributions payable	133	152
Income tax liabilities	484	124
Deferred tax liabilities	82	104
Net salary liabilities	196	228
Liabilities for nostro transfers	6.208	383
Liabilities with respect to postal orders	111	191
Liabilities on commission activities	135	135
Transfer accounts for the payment of loans to companies	-	2.882
Provisions for litigations	45	62
Provisions for retirement benefits	305	341
Other liabilities	791	559
Balance as at 31 December	24.784	16.818

As at 31 December 2012 liabilities for nostro transfers amounting to KM 6.208 thousand mainly related to nostro transfers of client Krajinalijek ad Banja Luka (KM 5.155 thousand), distributed on 3 January 2013.

Movements in provisions for retirement benefits:

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Balance at the beginning of the year	341	343
Provisions in the current year (Note 6)	-	88
Reversal of provisions (Note 6)	(36)	(90)
Balance as at 31 December	305	341

Movements in provisions for litigations:

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Balance at the beginning of the year (Note 6)	62	-
Provisions in the current year (Note 6)	49	113
Reversal of provisions (Note 6)	(66)	(51)
Balance as at 31 December	45	62

21. SHAREHOLDERS' EQUITY

Shareholders' equity structure

Shareholders' equity comprises the following:

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Share capital – ordinary shares	70.863	70.863
Share premium	8.070	8.070
Retained earnings from previous years	7.881	1
Retained earnings from current year	10.053	8.858
Capital reserves	3.338	2.923
Regulatory loan loss reserves	5.321	4.758
Total	105.526	95.473

Share capital

The authorized share capital as at 31 December 2012 consist of 70.863.294 ordinary (common) shares (2011: 70.863.294) in the nominal value of KM 1 each.

The largest shareholders as at 31 December 2012 are as follows:

	Ordinary shares	% of ordinary shares
Adriatic Fund BV, Amsterdam	25.315	35,72%
International Finance Corporation, Washington	5.577	7,87%
Avlijaš Goran	3.839	5,42%
Radanović Slobodan	3.778	5,33%
DUIF Invest Nova a.d. Bijeljina	3.251	4,59%
Prva group plc	2.173	3,07%
Prva osebna zavarovalnica d.d. Ljubljana	1.335	1,88%
Gajić Zoran	1.321	1,86%
Ćurčić Slobodan	1.210	1,71%
Pavlović Gordan	1.081	1,53%
Sivrić Zdenko	1.060	1,50%
Radovanović Radovan	949	1,34%
Andžić Milorad	871	1,23%
LD DOO, Bijeljina	862	1,22%
Babić Radislav	838	1,18%
Kaldera Kompani d.o.o. Laktaši	752	1,06%
Lazarević Dušan	730	1,03%
Other	15.921	22,47%
Total	70.863	100,00%

Share capital registered in the court register amounts to KM 53.292.992. In 2010 the Bank issued the 15th issue of shares from retained earnings amounting to KM 9.852.762, and in 2011 the 16th issue of shares, also from retained earnings, amounting to KM 7.717.540. Shares from emissions are registered in the Central Registry of Securities a.d Banja Luka. The procedure for registration of the two issues in the court registry is in progress.

21. SHAREHOLDERS' EQUITY (continued)

Shareholders' equity structure (continued)

As at 31 December 2012 the Bank has monetary amount of equity of KM 70.863 thousand. The Law on Banks of Republika Srpska prescribes the minimum required amount of monetary capital as KM 15.000 thousand.

Article 90 Paragraph 3 of the Law on Banks of Republika Srpska and Decision on minimum standards for managing share capital of banks prescribe the minimum capital adequacy ratio of 12% and the method of its calculation. As at 31 December 2012, capital adequacy ratio was 13,2% (31 December 2011: 14%).

Share premium

Share premium amounting to KM 8.070 thousand as at 31 December 2012 and 2011 refers to the positive difference between the value paid for shares and their nominal value from the share issue.

Reserves

The Bank's reserves are formed in accordance with law, regulations and statute of the Bank. These reserves are not the subject of distribution. As at 31 December 2012 they are KM 3.338 thousand.

Regulatory loan loss reserves

Regulatory reserves for loan losses are formed in accordance with the Decision and decisions on amendment the Decision on minimum standards for credit risk management and classification of assets in banks issued by the Banking Agency of Republika Srpska. Regulatory loan loss provisions are reserves that the Bank is obliged, when assessing the quality of assets and classification of items of assets, to form minimum in accordance with the above mentioned decision, considering previously formed impairment of balance sheet assets and provisions for losses on off-balance sheet items. The amount of estimated losses, net of impairment of balance sheet assets and provisions for losses of off-balance sheet items are transfered from retained earnings based on the decisions of the Shareholders' Meeting and is recorded under the allowance for loan losses. As at 31 December 2012 loan loss reserves amount to KM 5.321 thousand (31 December 2011: KM 4.758 thousand). In line with the decision of Shareholders' General Meeting dated 10 May 2012 the amount of loan loss reserves from profit increased by KM 563 thousand.

Retained earnings

Based on the decision of Shareholders' General Meeting dated 10 May 2012, profit in the total amount of 8.858 thousand is distributed to regulatory reserves for loan losses amounting to KM 563 thousand, and in line with the regulations of Banking Agency of Republika Srpska, to legal reserves amounting to KM 415 thousand and to net profit amounting to KM 7.880 thousand, which will be distributed to shareholders in proportion to their percentage in the Bank's share capital through the issue of shares.

22. OFF-BALANCE SHEET ITEMS

In order to meet the financial needs of clients, the Bank provides various forms of guarantees and other commitments and contingent liabilities. Although these liabilities are not recognized in the balance sheet, they include credit risk and therefore make an integral part of the whole risk of the Bank.

Total balance of contingent liabilities is as follows:

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Active off-balance positions		
Payment guarantees	49.145	29.759
Performance guarantees	104.479	62.463
Uncovered letters of credit	1.277	784
Irrevocable loan commitments	67.593	66.801
Total active off-balance positions	222.494	159.807

Guarantees and other commitments and contingencies

Letters of credit and guarantees commit the Bank to make payment in favor of the user if the required conditions are fulfilled.

Guarantees and „stand–by“ letters of credit carry the same type of risk for the Bank as loans.

Irrevocable commitments

Irrevocable commitments relate to unused approved loans and revolving loans (credit cards and loans). Irrevocable commitments usually have fixed expiration dates or other provisions concerning expiration. Since the irrevocable commitments can expire before loan withdrawal by the customer, the total contracted amount does not necessarily represent future cash outflows.

However, potential credit loss is lower than total unused commitments because most of commitments are potential and depend on fulfillment of certain conditions by the client. The Bank monitors maturity of the irrevocable commitments in respect of unused approved loans, because long-term commitments have higher level of credit risk than short-term commitments.

23. LITIGATION

Litigation is a common occurrence in the banking industry due to the nature of the business undertaken. The Bank has formal controls and policies for managing legal claims. Once professional advice has been obtained and the amount of loss reasonably estimated, the Bank makes adjustments to account for any adverse effects which the claims may have on its financial standing. As at 31 December 2012 for legal claims brought against the Bank, the Bank's management estimates that materially significant losses on litigations in progress will not arise.

24. RELATED PARTY TRANSACTIONS

Balances at year end and the effects of transactions with members of the Management Board, Supervisory Board and other key personnel and their related parties are shown in the table below.

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Short-term loans	1.173	839
Long-term loans	2.032	1.706
Credit card receivables, overdrafts and other loans	-	160
Interest and fee receivables	-	131
Other assets	6	-
Deposits	693	147
Impairment losses	118	-
Other liabilities	20	-
Guarantees	25	-
Interest income	147	196
Interest expenses	12	6
Fee income	11	1

Total loans granted to individuals related to the Bank (the Bank's management, members of the management, employees, significant shareholders) does not exceed 1% of the Bank's share capital for individuals. As at 31 December 2012 the Bank had loans granted to legal entities where the Bank has equity investments (Nova Leasing) in total amount of KM 271 thousand (loan is secured by collateral) and loan granted to shareholder which owns more than 5% of the Bank's share capital in the amount of KM 819 thousand (loan is secured by quality collateral).

Loans to related parties are granted under standard market conditions and in accordance with the Bank's business policies.

25. RISK MANAGEMENT

25.1. Introduction

Risk is inherent in the Bank's activities but it is managed through a process of ongoing identification, measurement and monitoring, subject to risk limits and other controls. This process of risk management is critical to the Bank's continuing profitability and each individual within the Bank is accountable for the risk exposures relating to his or her responsibilities. The Bank is exposed to credit risk, liquidity risk and market risk. The Bank pays special attention to the operational risks, the risk of exposure to one person or group of related persons, the risk of investing in other legal entities and assets, as well as the impact of the risks related to the country of origin where the Bank is exposed. This risk management system enables the timely and full information of the management for all risks that arise or may arise, and provides adequate and timely response in case of the same.

The primary role for managing risks in the Bank have the following parts:

Supervisory Board and the Board of Directors

Supervisory Board and the Board of Directors are ultimately responsible for comprehensive approach to risk management and for approving strategy and risk management principles. The document "appetite for risk" defines the basic parameters (limits) for different types of risk.

Asset and Liabilities Management Committee

Asset and Liabilities Management Committee has overall responsibility for strategy development and implementation of risk management principles, frameworks, policies and limits. The Board is responsible for the fundamental findings in terms of risk, as well as management and monitoring of relevant decisions related to all types of risk. Following the trend of certain types of risks the Asset and Liability Committee makes proposals and measures to improve them.

The Audit Committee

The Audit Committee has responsibility for monitoring the overall process of risk in the Bank.

Internal audit and internal control

The process of risk management at the Bank is controlled by internal audit, which examines the adequacy of the procedures, as well as the Bank's compliance with the adopted procedures, manner of risk management and efficiency of the established system. Internal Audit discusses the results of their work with the Bank's management and reports to the Audit Committee about findings and recommendations. Also, internal control in accordance with its program, controls the critical points in the liquidity and cash resources management system and reports to the management of the Bank.

Risk management

The Bank has Risk Management Division organized with the following departments:

- for credit risk management
- for early payment
- for bad loans management
- operational risk management and
- market risk management

The Bank has procedures relating to the functioning of all departments within the Risk Management Division, which determine rules and responsibilities for monitoring compliance with the principles, policies and limits defined in the Bank, including monitoring of risks to the defined limits, as well as complete coverage of risks in the system of risk measurement and reporting.

25. RISK MANAGEMENT (continued)

25.1. Introduction (continued)

Risk management (continued)

In the implementation of credit policy, the Bank adheres to certain principles established by the Business and Bank credit policy, and thus is protected from excessive exposure to credit risk. Credit Risk Management Department deals with the management of credit risk at the level of individual transactions, as well as at the level of the total loan portfolio, while Bad Loans Management Department and Department for early payment are organized with the aim of complete centralization of the due loans management process and their collection in a short period at the lowest costs to the Bank.

Within the Risk Management Division, there is a Market Risk Management Department organized, which also aims to manage liquidity risk. Liquidity of the Bank, as its ability to execute duties on time, depending primarily from the Bank's balance sheet structure and compliance of inflow and outflow of funds. Minimum standards for creating and implementing liquidity policy should be established to ensure the Bank's ability to fully and promptly execute all obligations on the maturity date.

In order to manage liquidity risk, the Bank conducts activities to ensure compliance of the structure of assets and liabilities and off-balance sheet items of the Bank, or its cash flows (inflows and outflows) and the continuous monitoring and planning of future cash flows, taking into account changes in the operational, economic and other conditions of business environment of the Bank. To manage liquidity risk, the Bank also conducts stress tests that are intended to identify potential liquidity gaps that may occur in certain periods, based on the outflow of deposits, impossibility of transformation of parts of assets in liquid assets, increased outflow of cash and other and accordingly identify potential additional sources of funding that will allow to cover the formed gap.

Risk management and reporting systems

Bank risks are measured using a method that reflects the expected losses that may occur under the normal circumstances, and unexpected losses which represent the final estimate of losses based on statistical models. Models are using the probability derived from historical data, adjusted to reflect the current economic environment. The Bank also uses the worst scenarios method that could occur as a result of extreme events that are unlikely to happen.

Monitoring and controlling of risks is primarily based on the procedures and the establishment of limits. These limits reflect the business strategy and market environment of the Bank, and the level of risks that the Bank is willing to accept. Information gathered from all business activities are reviewed and processed to identify, analyze and control risks. This information is presented and explained to the Bank's management and Supervisory Board. Reports contain total credit exposure, forecast investments, deviations from defined limits, measurement of market risk, liquidity ratios and others.

Concentrations of credit risk arise when a number of counterparties are engaged in similar business activities, or activities in the same geographic region, or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Concentrations indicate the relative sensitivity of the Bank's performance to developments affecting a particular industry or geographical location.

In order to avoid excessive concentrations of risk, the Bank's policies and procedures include specific guidelines to focus on maintaining a diversified portfolio. Identified concentrations of credit risks are controlled and managed accordingly.

25. RISK MANAGEMENT (continued)

25.2. Credit risk

Credit risk is the risk that one party does not fulfill its obligations and so cause financial loss of the other. Exposure to credit risk, which is expressed as the inability to collect loans and other receivables with the related interest in a timely manner, is continuously monitored by the Bank through the analysis of financial condition and operations of the borrower, and the degree of collectability of loans (daily, monthly, quarterly monitoring), control of purposeful use of resources and assessment of degree of risk of the loan portfolio.

When implementing credit policy, the Bank adheres to certain principles established by the Business and Bank credit policy, and thus is protected from excessive exposure to credit risk. In the Risk Management Division, the Bank has the Credit Risk Management Department which deals with the management of credit risk at the level of individual transactions, as well as at the level of the total loan portfolio.

Credit Risk Management Department is continuously developing and its main activities are the establishment, monitoring and control of policies, rules, guidelines in all aspects of loan operations, identification of risks in the approval process through the control of the standard deviations in the process of loan approval, a realistic assessment of the quality of the customer, adequate valuation of collateral or instruments of protection against default, limitation of risks in terms of setting limits and acceptable level of risks by segments, taking adequate measures to protect the loan portfolio from adverse movements and compliance of credit conditions with the level of risk taken.

The objective of the Bank is to use credit policy and program to manage credit risks by using available risk assessment models, for the purpose of approving loans that carry low risk.

25. RISK MANAGEMENT (continued)

25.2. Credit risk (continued)

a) Maximum exposure to credit risk without considering any collateral and other credit enhancements

The table below shows the maximum exposure to credit risk for the components of the balance sheet. The maximum exposure is shown gross, before the effect of any collateral and other credit enhancements.

	31 December 2012	31 December 2011
	KM thousand	*KM thousand*
Cash and cash deposits with deposit institutions	201.656	154.766
Securities available-for-sale	33.757	29.109
Due from banks	2.046	1.001
Loans and advances to customers	875.822	708.497
Securities held to maturity	198	226
Investments in non-consolidated related parties	1.765	1.906
Other assets	32.317	31.142
Total	1.147.561	926.647
Contingent liabilities	154.901	93.006
Irrevocable commitments	67.593	66.801
Total	222.494	159.807
Total credit risk exposure	1.370.055	1.086.454

Where financial instruments are recorded at fair value the amounts shown above represent the current credit risk exposure but not the maximum risk exposure that could arise in the future as a result of changes in values.

Details of the maximum credit risk exposure to each class of financial instruments will be disclosed in the notes relating to the specific financial instrument.

25. RISK MANAGEMENT (continued)

25.2. Credit risk (continued)

b) Risk concentration at maximum exposure to credit risk

Concentration of risk is managed by setting limits to credit exposure by counterparty, by geographical region and by industry sector. The maximum credit risk exposure to any counterparty or group of related counterparties as at 31 December 2012 was KM 28.294 thousand (31 December 2011: KM 29.384 thousand).

The Bank's financial assets, before taking into account any collateral held or other credit enhancements, can be analyzed by the following geographical regions:

	Cash and cash deposits with deposit institutions	Due from banks	Loans and advances to customers	Securities and equity investments	Other assets	Contingencies and commitments	Total 2012
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*
Bosnia and Herzegovina	144.321	272	875.822	35.720	32.317	222.494	1.310.946
European Union	57.335	1.774	-	-	-	-	59.109
Total	201.656	2.046	875.822	35.720	32.317	222.494	1.370.055

	Cash and cash deposits with deposit institutions	Due from banks	Loans and advances to customers	Securities and equity investments	Other assets	Contingencies and commitments	Total 2011
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*
Bosnia and Herzegovina	130.686	121	708.497	31.241	31.142	159.807	1.061.494
European Union	24.080	880	-	-	-	-	24.960
Total	154.766	1.001	708.497	31.241	31.142	159.807	1.086.454

25. RISK MANAGEMENT (continued)

25.2. Credit risk (continued)

b) Risk concentration at maximum exposure to credit risk (continued)

An industry sector analysis of the Bank's credit risk exposure, before the effect of any collateral and other credit enhancements, as at 31 December 2012 and 2011 is as follows:

	Gross maximum exposure 2012	*Gross maximum exposure* 2011
	KM thousand	*KM thousand*
Retail	233.529	194.221
Processing industry	237.626	226.063
Trade	211.595	174.642
Financial services	32.874	25.958
Agriculture, forestry and water management	27.608	12.688
Construction	88.626	55.860
Transportation	65.192	47.786
Services, tourism and hospitality	10.057	9.133
Real-estate	5.238	7.293
Governent and govermnent institutiuons	177.595	130.024
Banks and banking institutions	203.430	155.646
Other	76.685	47.140
Total	1.370.055	1.086.454

Collateral and other credit enhancements

The Bank’s collateral policy defines acceptable collateral for individual types of loans.

The main types of collateral obtained are as follows:

- Cash deposits, securities, guarantees of insurance companies and banks, pledge on movable and immovable property and waranties

Management monitors the market value of collateral, requests additional collateral in accordance with the underlying agreement, and monitors in accordance with internal regulations the market value of collateral obtained during its review of the adequacy of the allowance for impairment losses.

25. RISK MANAGEMENT (continued)

25.2. Credit risk (continued)

c) Credit quality of financial instruments by class of financial assets

The Bank manages credit quality of financial assets using internal credit ratings, based on regulations prescribed by the Banking Agency of Republika Srpska. The table below shows the credit quality by class of asset for loan-related balance sheet items, based on the Bank's credit rating system:

	Neither past due nor impaired					
	High grade	Standard grade	Substandard grade	Past due but not individually impaired	Individually impaired	Total 2012
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*
Due from banks	2.046	-	-	-	-	2.046
Loans and advances to customers	795.874	41.765	6.460	7.660	24.063	875.822

	Neither past due nor impaired					
	High grade	Standard grade	Substandard grade	Past due but not individually impaired	Individually impaired	Total 2011
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*
Due from banks	1.001	-	-	-	-	1.001
Loans and advances to customers	624.701	56.833	5.346	6.101	15.516	708.497

Past due but not impaired loans as at 31 December 2012 and 2011:

Balance sheet positions	Up to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total 2012
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*
Retail lending	175	135	69	2.181	2.560
Corporate lending	799	694	196	3.411	5.100
Total financial assets	974	829	265	5.592	7.660

Balance sheet positions	Up to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total 2011
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*
Retail lending	136	118	75	2.465	2.794
Corporate lending	741	260	300	2.006	3.307
Total financial assets	877	378	375	4.471	6.101

25. RISK MANAGEMENT (continued)

25.2. Credit risk (continued)

Impairment assessment

Criteria the Bank uses to determine whether there is objective evidence of impairment includes the following: default in payment of interest and/or principal, indications that the borrower is experiencing significant financial difficulties, including the likelihood that there will be bankruptcy or other financial reorganization and when available data indicate that there is a measurable decrease in future cash flows, such as changes in arrears or economic conditions that correlate with the agreed conditions. The Bank assesses impairment at two levels, individual and group.

Individually assessed allowances

In accordance with the adopted internal regulations, the Bank firstly performs individual assessment to determine whether there is objective evidence of impairment for financial assets that are individually significant and individual or group assessment for financial assets that are not individually significant. Individual assessment of the impairment is based on an assessment of the expected time of payment, the amount that will be charged, and the sources from which payment is expected in full or in part. Assets that are individually assessed for impairment and for which a loss on impairment is recognized, are not included in a collective assessment of impairment. Allowance assessment is performed at each balance sheet date, unless unforeseen circumstances require much more attention and more frequent assessment.

Individual assessments is performed for portfolio of bad loans, meaning for loans over a certain amount of exposure that the Bank has defined as significant, and for bad loans that are individually below significant amount, assessment is done by taking the average allowance rates calculated on a sample basis through individual assessments of exposures that are not indididually significant.

Collectively assessed allowances

For the purpose of a collective assessment of impairment, financial assets are grouped on the basis of the classification system used by the Bank, taking into account the credit risk characteristics such as types of loans, collateral type, the existence of accounts receivable, days of delays and other relevant factors. For the purpose of a collective evaluation of impairment, migration matrix is created which analyses total number of loans being active in previous period that have migrated from category A and B to other categories or are repaid in current period.

The assessment of impairment of retail loans is made on a basis of matrix of migration that are made by groups of products, considering the intervals of days of delay as main criteria. On forming each matrix, identification of loans that had previously been in one of six possible days of delay interval is done, and for each interval their number in the first period is determined. After the identification of the number of loans that in the current period are in one of the six possible intervals on the delay, the identification of the number of loans repaid is performed.

Assessment of impairment for off-balance sheet items is made at the client level by applying the average rate of allowance estimated for balance sheet items. If the client has only one account with balance sheet exposure, the same rate is applicable for the off-balance sheet exposure, and if the client has more accounts with balance sheet exposure the average rate of allowance estimated for balance sheet items is applicable for the off-balance sheet exposure. If the client does not have balance sheet exposure, minimum rate for orderly loans prescribed by the Banking Agency of Republika Srpska is applied to off-balance sheet exposure.

25. RISK MANAGEMENT (continued)

25.2. Credit risk (continued)

Loan loss reserves

For loans to corporate and retail customers, the Bank calculates loan loss reserves in accordance with regulations of the Banking Agency of Republika Srpska, that is, with Decision and decisions on amendment the Decision on minimum standards for credit risk management and classification of assets of bank.

In accordance with the Decision, regulatory loan loss reserves are allowance reserves that the Bank is obliged, when assessing the quality of assets and classification of items of assets, to form minimum in accordance with the above mentioned decision, considering previously formed impairment of balance sheet assets and provisions for losses on off-balance sheet items.

The amount of estimated losses, net of allowance balance sheet assets and provisions for losses of off-balance sheet items is created from retained earnings based on the decisions of the Shareholders' Meeting and is recorded under the allowance for loan losses. If the Bank is unable to cover lacking reserves at the expense of profit, retained earnings from previous years and current year or other reserves from profit, it is still obliged to recognize uncovered amount of allowances for loan losses as the deduction to the capital, as long as the Bank does not cover all missing loan loss reserves.

Renegotiated loans

Renegotiated loans are loans and other placements that are restructured and where inicially contracted terms are changed due to the inability of the client to meet its payment obligations in line with the terms defined in the contract because of operating business problems and deterioration of financial indicators. As at 31 December 2012 gross restructured loans and placements amount to KM 47.731 thousand (31 December 2011: KM 32.658 thousand).

25.3. Liquidity risk

Liquidity risk represents the risk that the Bank will be unable to meet its payment obligations when they fall due. In order to reduce or limit this risk, the Bank has arranged diversifying its funding sources, by system management of assets and liabilities considering liquidity, and monitoring future cash flows and liquidity on a daily basis.

The Bank maintains a portfolio of highly marketable and diverse assets that can be easily liquidated in the event of an unforeseen interruption of cash flow. The Bank also maintains required level of mandatory reserves according to the regulations of Central Bank of Bosnia and Herzegovina, as well as the required foreign currency balances with foreign banks to meet the clients' needs. The Bank also identifies additional sources of funds that can use to meet liquidity needs.

25. RISK MANAGEMENT (continued)

25.3. Liquidity risk (continued)

The table below shows the carrying value of assets and liabilities based on the remaining period to the contractual maturity date as at 31 December 2012:

Assets	On demand	Up to 3 months	From 3 to 12 months	From 1 to 5 years	Over 5 years	Total 2012
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*
Cash and cash deposits with deposit institutions	220.242	-	-	-	-	220.242
Securities available-for-sale	33.757	-	-	-	-	33.757
Due from banks	272	894	880	-	-	2.046
Loans and advances to customers	34.692	65.518	199.361	394.878	181.373	875.822
Securities held to maturity	-	-	-	198	-	198
Business premises and other fixed assets	-	-	-	-	31.650	31.650
Investments in non-consolidated related parties	-	-	-	1.765	-	1.765
Other assets	16.767	11.016	14.300	219	3.079	45.381
Total assets	305.730	77.428	214.541	397.060	216.102	1.210.861
Liabilities						
Deposits	187.971	117.287	306.825	230.353	4.810	847.246
Debt issued and other borrowed funds	17	5.173	21.132	103.475	82.153	211.950
Subordinated debts and bonds	-	32	96	8.015	10.597	18.740
Provision to off-balance sheet items	-	-	-	2.615	-	2.615
Other liabilities	9.430	95	15.250	9	-	24.784
Total liabilities	197.418	122.587	343.303	344.467	97.560	1.105.335
Net exposure to liquidity risk as at 31 December 2012	108.312	(45.159)	(128.762)	52.593	118.542	105.526

25. RISK MANAGEMENT (continued)

25.3. Liquidity risk (continued)

The table below shows the carrying value of assets and liabilities based on the remaining period to the contractual maturity date as at 31 December 2011:

Assets	On demand	Up to 3 months	From 3 to 12 months	From 1 to 5 years	Over 5 years	Total 2011
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*
Cash and cash deposits with deposit institutions	166.193	-	3.000	-	-	169.193
Securities available-for-sale	29.109	-	-	-	-	29.109
Due from banks	121	-	880	-	-	1.001
Loans and advances to customers	23.079	66.248	182.985	284.372	151.813	708.497
Securities held to maturity	-	-	-	226	-	226
Business premises and other fixed assets	-	-	-	-	26.568	26.568
Investments in non-consolidated related parties	-	-	-	-	1.906	1.906
Other assets	11.019	4.668	20.170	505	-	36.362
Total assets	229.521	70.916	207.035	285.103	180.287	972.862
Liabilities						
Deposits	178.154	103.744	258.686	105.569	4.467	650.620
Debt issued and other borrowed funds	1.624	4.804	20.668	87.501	82.223	196.820
Subordinated debts and bonds	-	32	97	5.515	5.225	10.869
Provision to off-balance sheet items	-	-	-	2.262	-	2.262
Other liabilities	5.669	440	10.689	20	-	16.818
Total liabilities	185.447	109.020	290.140	200.867	91.915	877.389
Net exposure to liquidity risk as at 31 December 2011	44.074	(38.104)	(83.105)	84.236	88.372	95.473

25. RISK MANAGEMENT (continued)

25.3. Liquidity risk (continued)

The table below shows the Bank's contingent liabilities and irrevocable commitments by contracted maturity as at 31 December 2012 and 2011:

	On demand	Up to 3 months	From 3 to 12 months	From 1 to 5 years	Over 5 years	Total 2012
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*
Contingent liabilities	-	51.810	50.917	51.330	844	154.901
Commitments	-	15.134	30.093	20.288	2.078	67.593
Total	-	66.944	81.010	71.618	2.922	222.494

	On demand	Up to 3 months	From 3 to 12 months	From 1 to 5 years	Over 5 years	Total 2011
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*
Contingent liabilities	-	28.386	44.911	19.329	380	93.006
Commitments	30	8.239	37.042	17.583	3.907	66.801
Total	30	36.625	81.953	36.912	4.287	159.807

The Bank does not expect any of the contingent liabilities or irrevocable commitments to be withdrawn before their maturity.

25.4. Market risk

Market risk is the risk that the fair value or future cash flows of financial instruments will fluctuate due to changes in market variables such as interest rates and foreign exchange rates.

Market risk management is defined by the procedures approved by Supervisory Board and are in line with the strategy of risk management. Within the Risk Management Sector, Market Risk Management Division is organized which is aimed to manage market risks. Its activities primarly involve monitoring market risks according to defined limits, and monitoring risks arising from the introduction of new products and complex transactions.

Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair values of financial instruments.

The Bank's business policy determines the principles by which contracting, billing and charging interest on loans and other placements (active interest) is made, as well as the principles by which calculation and payment of interest on deposits is made, roles and other funds received (passive interest).

Interest rate is determined on the basis of maturity, amount, purpose, source, currency and other parameters. All interest rates are determined annually, except in case when another period of time is defined. Passive and active interest rates are fixed or variable and agreed in accordance with the type of product, source of funding, maturity and amount.

In order to manage interest rate risk, the Bank uses stress tests to analyze sensitive assets and liabilities, to determine possible interest gaps and to define measures for maintaining interest risk at the level acceptable for the Bank.

25. RISK MANAGEMENT (continued)

25.3. Liquidity risk (continued)

Interest rate risk (continued)

The two tables below analyse the Bank's interest rate risk exposure as at 31 December 2012 and 2011. The Bank's assets and liabilities are categorized by the earlier of contractual repricing date or maturity date.

Assets	Up to 1 month	Up to 3 months	From 3 to 12 months	Over 1 year	Non-interest bearing	Total 2012
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*
Cash and cash deposits with deposit institutions	200.960	-	-	-	19.282	220.242
Securities available-for-sale	31.606	-	-	-	2.151	33.757
Due from banks	621	545	880	-	-	2.046
Loans and advances to customers	48.663	51.547	199.361	576.251	-	875.822
Securities held to maturity	-	-	-	-	198	198
Business premises and other fixed assets	-	-	-	-	31.650	31.650
Investments in non-consolidated related parties	-	-	-	-	1.765	1.765
Other assets	5.674	5.777	7.642	3.079	23.209	45.381
Total assets	287.524	57.869	207.883	579.330	78.255	1.210.861
Liabilities						
Deposits	226.490	78.768	188.889	227.232	125.867	847.246
Debt issued and other borrowed funds	33	5.157	21.132	185.628	-	211.950
Subordinated debt and bonds	-	32	96	18.612	-	18.740
Provision to off-balance sheet items	-	-	-	-	2.615	2.615
Other liabilities	1.674	-	-	-	23.110	24.784
Total liabilities	228.197	83.957	210.117	431.472	151.592	1.105.335
Interest sensitivity gap as at 31 December 2012	59.327	(26.088)	(2.234)	147.858	(73.337)	105.526

25. RISK MANAGEMENT (continued)

25.3. Liquidity risk (continued)

Interest rate risk (continued)

Assets	Up to 1 month	Up to 3 months	From 3 to 12 months	Over 1 year	Non-interest bearing	Total 2011
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*
Cash and cash deposits with deposit institutions	151.284	3.000	-	-	14.909	169.193
Securities available-for-sale	27.200	-	-	-	1.909	29.109
Due from banks	121	-	880	-	-	1.001
Loans and advances to customers	39.756	49.571	182.985	436.185	-	708.497
Securities held to maturity	-	-	-	-	226	226
Business premises and other fixed assets	-	-	-	-	26.568	26.568
Investments in non-consolidated related parties	-	-	-	-	1.906	1.906
Other assets	11.019	3.600	5.004	3.400	13.339	36.362
Total assets	229.380	56.171	188.869	439.585	58.857	972.862
Liabilities						
Deposits	213.970	67.928	155.559	110.036	103.127	650.620
Debt issued and other borrowed funds	1.702	4.765	20.668	169.685	-	196.820
Subordinated debt and bonds	-	32	97	10.740	-	10.869
Provision to off-balance sheet items	-	-	-	-	2.262	2.262
Other liabilities	827	-	-	-	15.991	16.818
Total liabilities	216.499	72.725	176.324	290.461	121.380	877.389
Interest sensitivity gap as at 31 December 2011	12.881	(16.554)	12.545	149.124	(62.523)	95.473

Since the Bank's interest bearing financial assets and financial liabilities are not dominantly based on variable interest rates, the Bank considers that sensitivity of its income and expenses to changes in market interest rates is not significant.

Currency risk

Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. In order to manage foreign exchange risk, the Bank uses modern information server Thomson Reuters to obtain timely information on market trends, creditworthiness of countries with which it has business relations, and on this basis it makes timely decisions about managing funds in foreign currency in order to minimize or disperse risk. Foreign exchange positions are managed on a daily basis with the support of several application systems, which provide so-called real time information on all foreign exchange transactions conducted within the Bank, which could eventually affect the risk of open positions and accordingly the Bank takes measures to protect and maintain its acceptable level.

The tables below indicates the currencies to which the Bank had significant exposure as at 31 December 2012. The analysis calculates the effect of a reasonably possible movement of the currency rate against KM, with all other variables held constant on the income statement. Positive amounts in the table reflect potential net increases in income statement or equity.

25. RISK MANAGEMENT (continued)

25.3. Liquidity risk (continued)

Currency risk (continued)

As at 31 December 2012 the Bank had significant exposure in EUR, however the Bank is not exposed to currency risk as the value of that currency compared to domestic currency is fixed, considering the fact that the Central Bank of Bosnia and Herzegovina since 1997 maintains monetary stability in line with the "currency board arrangement" (1 EUR = 1,95583 KM).

	Changes in foreign exchange rates (%) 2012	Effect on the income statement 2012	Changes in foreign exchange rates (%) 2011	Effect on the income statement 2011
		KM thousand		*KM thousand*
CHF	2%	25	2%	(3)
USD	6%	18	6%	12

The table below summarizes the Bank's exposure to foreign currency exchange rate risk as at 31 December 2012. Assets and liabilities at their carrying values are presented:

Assets	EUR	USD	CHF	Other foreign currencies	Total foreign currency	Total local currency	Total 2012
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*
Cash and cash deposits with deposit institutions	41.264	17.445	6.575	1.782	67.066	153.176	220.242
Securities available-for-sale	-	1.481	-	-	1.481	32.276	33.757
Due from banks	1.825	61	-	-	1.886	160	2.046
Loans and advances to customers	579.217	-	-	-	579.217	296.605	875.822
Securities held to maturity	-	-	-	-	-	198	198
Business premises and other fixed assets	-	-	-	-	-	31.650	31.650
Investments in non-consolidated related parties	-	-	-	-	-	1.765	1.765
Other assets	349	1.250	-	-	1.599	43.782	45.381
Total assets	622.655	20.237	6.575	1.782	651.249	559.612	1.210.861
Liabilities							
Deposits	611.572	19.873	5.272	5.711	642.428	204.818	847.246
Debt issued and other borrowed funds	10.929	-	-	-	10.929	201.021	211.950
Subordinated debt and bonds	740	-	-	-	740	18.000	18.740
Provision to off-balance sheet items	-	-	-	-	-	2.615	2.615
Other liabilities	3.533	66	30	-	3.629	21.155	24.784
Total liabilities	626.774	19.939	5.302	5.711	657.726	447.609	1.105.335
Net open position as at 31 December 2012	(4.119)	298	1.273	(3.929)	(6.477)	112.003	105.526

25. RISK MANAGEMENT (continued)

25.3. Liquidity risk (continued)

Currency risk (continued)

The table below summarizes the Bank's exposure to foreign currency exchange rate risk as at 31 December 2011. Assets and liabilities at their carrying values are presented:

Assets	EUR	USD	CHF	Other foreign currencies	Total foreign currency	Total local currency	Total 2011
	KM thousand	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*	*KM thousand*
Cash and cash deposits with deposit institutions	18.340	8.152	3.969	948	31.409	137.784	169.193
Securities available-for-sale	-	1.130	-	-	1.130	27.979	29.109
Due from banks	918	19	-	-	937	64	1.001
Loans and advances to customers	499.179	-	-	-	499.179	209.318	708.497
Securities held to maturity	-	-	-	-	-	226	226
Business premises and other fixed assets	-	-	-	-	-	26.568	26.568
Investments in non-consolidated related parties	-	-	-	-	-	1.906	1.906
Other assets	429	1.064	-	-	1.493	34.869	36.362
Total assets	518.866	10.365	3.969	948	534.148	438.714	972.862
Liabilities							
Deposits	487.693	10.121	4.137	753	502.704	147.916	650.620
Debt issued and other borrowed funds	18.858	-	-	-	18.858	177.962	196.820
Subordinated debt and bonds	869	-	-	-	869	10.000	10.869
Provision to off-balance sheet items	-	-	-	-	-	2.262	2.262
Other liabilities	2.569	45	-	2	2.616	14.202	16.818
Total liabilities	509.989	10.166	4.137	755	525.047	352.342	877.389
Net open position as at 31 December 2011	8.877	199	(168)	193	9.101	86.372	95.473

25. RISK MANAGEMENT (continued)

25.5. Operational risk

Operational risk is the risk of loss arising from systems failure, human error, fraud or external events. When controls fail to perform, operational risks can cause damage to reputation, have legal or regulatory implications, or lead to financial loss. The Bank cannot expect to eliminate all operational risks, but through a control framework and by monitoring and responding to potential risks, the Bank is able to manage the risks. Controls include effective segregation of duties, access, authorization and reconciliation of procedures, staff education and assessment processes, including the use of internal audit.

The Bank manages operational risks based on obtained data about adverse events, by monitoring key indicators about operational risks, operational risks assessment in making decisions about the business changes, and the Bank's management is informed on the results of operational risk management.

The Bank monitors operational risks on a daily basis through the set of key risk indicators (KRI), risk assessment of physical security, information security according to standard ISO 27000, and the risks associated with the health of people in accordance with the provisions of the Law on Protection at Work. To estimate the risks of business lines, self-assessment questionnaires (CRSA) are used.

In order to effectively manage operational risk, the Bank uses software for recording operational losses, which enables more effective creation of data base and monitoring of trends which provides opportunity to make timely decisions and create long-term basis for an advanced model of operational risk management.

25.6. Country Risk

Risk relating to the country of origin of entities to which the Bank is exposed to relates to adverse effects that might affect its financial results and equity, due to the Bank's inability to collect receivables from these entities for reasons that are consequence of political, economic and social conditions in the country of origin.

The Bank mainly places loans to customers from Republika Srpska, while it is exposed to the country risk where funds in certain moments can be placed to defined limits to foreign banks.

Risk Management Sector issued the methodology for defining limits to placements in other banks. Based on the analyses Resources Department makes proposals on which Risk Management Sector defines limits in line with risk assessment and sends for approval to Asset and Liability Management Committee.

The Bank also mimimises the country risk by policy of placements abroad, mainly through short-term deposits in first class foreign banks.

25. RISK MANAGEMENT (continued)

25.7. Capital management

The Bank's objectives relating to the management of capital include not only compliance with the regulations of the Banking Agency of Republika Srpska in terms of maintaining the capital requirements but also:

- to safeguard the Bank's ability to continue as a going concern so that it can continue to provide returns for shareholders and benefits for other stakeholders; and
- to maintain a strong capital base to support the development of its business.

Management regularly monitors capital structure, capital adequacy ratio and supervises the maintenance of statutory limits related to capital positions. The Law on Banks and the Banking Agency of Republika Srpska require the minimum amount of capital equivalent of KM 15 million and capital adequacy ratio of at least 12%.

The table below shows capital structure as at 31 December 2012 and 2011 as well as capital adequacy ratio in accordance with regulations of the Banking Agency of Republika Srpska:

	2012 *KM thousand*	2011 *KM thousand*
Regulatory capital:		
- Tier I capital	81.943	77.192
- Tier II capital	49.005	35.724
Deductible items	(895)	(563)
Total capital	130.053	112.353
Risk weighted assets and loan equivalents:	911.443	734.127
Weighted operational risk	71.092	70.301
Total weighted risks	982.535	804.428
Capital adequacy ratio as at 31 December	13,2%	14,0%

In accordance with the regulations of Republika Srpska capital of the Bank consists of:

- Tier I capital, which comprises ordinary shares and corresponding share premium, reserves and retained earnings from previous period less intangible assets
- Tier II capital, which consists of general reserves for loan losses for assets estimated as good assets, amount of accumulated profit in the current year which has been revised and subordinated debt up to 50% of Tier I capital.

25. RISK MANAGEMENT (continued)

25.8. Fair value of financial assets and liabilities

The Bank has a policy on disclosure of fair value information of those components of assets and liabilities for which published or quoted market prices are readily available, and of those for which the fair value may be materially different than their carrying amounts.

The Bank's management believes that amounts of financial assets and liabilities presented in accompanying financial statements reflect the most valid and useful reporting values under the present market conditions.

Financial instruments with fair value approximate their carrying value

It is assumed that the carrying values of liquid financial assets and short-term liabilities with maturities up to 3 months approximate their fair value. This assumption also relates to sight deposits, savings deposits without maturity and variable rate financial instruments.

Fixed-rate financial instruments

Fair value of fixed interest rate financial assets and liabilities carried at amortized cost are estimated by comparing market interest rates when they were initially recognized with current market rates for similar financial instruments based on quoted market prices. For those instruments issued where quoted market prices are not available, a discounted cash flow model based on current interest rate yield curve appropriate for the remaining term to maturity is used.

Financial instruments measured at fair value

Financial instruments, such as securities available-for-sale, are measured at fair value based on available market information, i.e. quoted market prices at the reporting date.

KM thousand

	Level 1	Level 2	Level 3	Total
Financial instruments available-for-sale				
Quoted shares – Bonds of Republika Srpska	-	33.757	-	33.757
Total securities, equity investments and investment units at fair value	-	33.757	-	33.757
Non quoted shares and equity investments	-	-	1.168	1.168
Other investments	-	-	-	-
Total securities, equity investments and investment units	-	33.757	1.168	34.925

26. EXCHANGE RATES

The official exchange rates used in the conversion of balance sheet items denominated in foreign currencies as at 31 December 2012 and 2011 into convertible mark (KM) are as follows:

31 December	2012	2011
EUR	1,9558	1,9558
USD	1,4836	1,5116
CHF	1,6191	1,6089

27. SUBSEQUENT EVENTS

There have been no significant events subsequent to the reporting date, which would require adjustments or disclosures in the notes to the accompanying Bank's financial statements for 2012.