NATIONAL BANK OF THE REPUBLIC OF NORTH MACEDONIA

Pursuant to Article 47 paragraph 1 item 6 of the Law on the National Bank of the Republic of Macedonia (Official Gazette of the Republic of Macedonia No. 158/10, 123/12, 43/14, 153/15, 6/16 and 83/18) and Article 68 paragraph 1 item 1 of the Banking Law (Official Gazette of the Republic of Macedonia No. 67/07, 90/09, 67/10, 26/13, 15/15, 153/15, 190/16, 7/19 and 101/19), the National Bank of the Republic of North Macedonia Council adopted the following

DECISION
on the methodology for risk management
(Official Gazette of the Republic of North Macedonia No. 113/19)

I. GENERAL PROVISIONS

1. This Decision shall prescribe the methodology for managing risks the bank is exposed to in its operations.

2. Pursuant to this Decision, risk management shall denote identification, measurement or assessment, control or mitigation and monitoring of the risks.

II. DEFINITIONS

3. The terms used in this Decision shall denote the following:

3.1. "Risk" shall mean the risk of certain activity or event to have direct adverse influence on the bank's solvency, liquidity and/or profitability, or to impede the fulfillment of the bank's development plan and business policy.

3.2. "Material risks" shall denote those risks having significant influence on the bank's operations, i.e. that considerably influence the bank's solvency, liquidity and/or profitability, or considerably impede the fulfillment of the bank's development plan and business policy.

3.3. "Credit risk" shall denote the risk of loss to the bank due to the inability of its client to repay his/her liabilities in the agreed amount and/or as set by the contractual terms.

3.4. "Liquidity risk" shall denote the risk of loss due to bank's inability to provide enough funds for settlement of its liabilities at their maturity, or it can provide the necessary funds at very higher costs.

3.5. "Currency risk" shall be the risk of loss due to change in cross-currency exchange rates and / or change of value of Denar against the value of other foreign currencies.

3.6. "Market risk" shall be a risk of loss arising from the change in the price of financial instruments and commodities intended for trading.

3.7. "Operational risk" shall denote the risk of loss as a result of:

- inadequate or failed internal processes,
- inadequate personnel and inadequate or failed systems of the bank,
- external events.

The operational risk shall also include the legal risk, as well as the risk of money laundering and financing of terrorism, IT risk and other operational risks.

3.8. "Legal risk" shall be a risk of loss, caused by violation / non-adherence to laws and bylaws, agreements, prescribed practices, ethics standards, or as a result of misinterpretation of the regulations, rules, agreements and other legal documents.

3.9. "Risk of money laundering and terrorist financing" shall denote the risk for the bank to be misused for money laundering and terrorist financing or that certain business relation, transaction or product will be indirectly or directly used for money laundering and terrorist financing.

3.10. "IT risk" shall be the risk of loss for the bank arising from losing, unauthorized utilization, or unavailability of information, information assets and/or services the bank provides.

3.11. "Conduct risk" shall mean the risk of loss to the bank due to inappropriate supply and sale of products and services, including cases of intentional or negligent misconduct with bank customers.

3.12. "Concentration risk" shall denote the risk of loss to the bank arising from direct or indirect exposure of the bank to a person/entity, activity, geographical location, instrument, market, etc.

3.13. "Interest rate risk in the banking book" shall denote a risk of loss arising from adverse changes in interest rates, affecting the positions in the bank's banking book.

3.14. "Country risk" shall denote a risk of loss due to the bank exposure to a customer from a certain country, arising from the regulatory, economic, social and political environment in the customer's domicile country.

3.15. "Counterparty credit risk" shall denote a risk that the counterparty would default on liabilities owned to the bank arising from financial instruments, prior or on the settlement date.

3.16. "Reputation risk" shall denote the risk arising from adverse perceptions of the bank by the customers, creditors, shareholders, investors and supervisory bodies.

3.17. "Strategic risk" shall denote the risk of loss arising from changes in the business environment, adverse business decisions, improper implementation of the decisions or lack of bank responsiveness to the changes in the business environment, as well as inadequate implementation of the development plan and the bussiness policy.

3.18. "Risk capacity" shall mean the maximum level of risk that the bank is able to take, given its solvent and liquidity position, the risk management system and liabilities to depositors, shareholders and other stakeholders, as well as regulatory or supervisory requirements.

3.19. "Risk appetite" shall mean the aggregate level of risk that the bank is willing to take to achieve its long-term goals, as well as the types of risks it is willing to take within its risk capacity.

3.20. "Risk appetite statement" shall mean a formal document adopted by the bank's Supervisory Board, stating the aggregate level of risk and the types of risks that the bank is willing to take or avoid to achieve its long-term goals.

3.21. "Risk management system" shall denote the risk appetite framework which covers the overall approach (strategies, policies, rules, practices, controls, processes, systems, etc.) for defining, communicating and monitoring the bank's risk appetite.

3.22. "Risk culture" shall mean the approach, awareness and behavior of the bank towards risk taking and management, which influence the decision making related to risks.

3.23. "Risk profile" shall mean quantitative and/or qualitative presentation of the level of measurable and immeasurable risks the bank takes in its operations. Measurable risks shall be those risks the influence of which on the solvency, liquidity and/or profitability of the bank can be measured. Immeasurable risks shall be those risks, the influence of which on the the solvency, liquidity and/or profitability of the bank is determined on the basis of estimate, i.e. appraisal (for example, strategic and reputation risk).

3.24. "Reverse stress testing" shall imply a stress testing method that starts from a predicted outcome (for example, assumed level of solvency or liquidity) identifying the causes, events, scenarios, changes in risk factors that may lead to such an outcome.

3.25. "Outsourcing service" shall mean any service, process or activity that another entity performs instead of the bank.

3.26. "Significant outsourcing service" shall denote the services, processes or activities that another entity performs, whose failure to perform or improper performance can significantly affect:

- the ability of the bank to meet the criteria and conditions for obtaining a founding and operating license, pursuant to the Banking Law and the bylaws thereof, as well as the ability to meet regulatory and supervisory requirements;
- its profitability;
- smooth execution of financial activities performed by the bank.

Significant outsourcing service should also be considered the activities that require licence, approval or other type of permit from a competent authority in the country or abroad, in accordance with law.

3.27. "Regulatory capital for risk coverage" shall be the capital requirement for risk coverage determined according to the regulations of the National Bank of the Republic of North Macedonia (hereinafter referred to as: the National Bank) on the methodology for determining capital adequacy.

3.28. "Internal capital for covering individual risk" shall mean the assessment of the amount of the current and future capital requirements for covering individual material risk the bank is or can be exposed in its operations.

3.29. "Total internal capital for risk coverage" shall mean the the sum of all internal capital for covering individual material risks to which the bank is or may be exposed in its operations.

3.30. "Internal liquidity" shall mean an assessment of the current and future needs of liquid assets and stable sources of funds to cover the bank's liquidity risks under normal operating conditions and emergency.

Terms not defined with this Decision shall have the meaning as defined in the Banking Law and the bylaws thereof.

III. RISK MANAGEMENT SYSTEM

4. The bank shall be required to establish a risk management system, as part of bank's corporate governance. The risk management system and its scope should be in line with the bank's development plan and business policy, be adequate to the nature, type and scope of the financial activities the bank performs and should be regularly updated taking into account changes in the external environment, the bank's risk profile, the growth of bank's markets' presence, etc.

5. The risk management system shall encompass at least the following risks:
- credit risk, including the country risk and the counterparty credit risk;
- liquidity risk;
- currency risk;
- market risk;
- interest rate risk in the banking book;
- concentration risk;
- operational risk.

The bank shall be required to include in the risk management system other material risks it is exposed to in its operation, which are not stipulated in paragraph 1 of this item.

The important elements of managing individual risks are prescribed with the separate bylaws adopted pursuant to the Banking Law and the annexes enclosed as an integral part of this decision.

6. The risk management system shall include:
- efficient risk management process based on the risk appetite statement and established risk culture;
- adequate organizational layout of the risk management;

- internal capital adequacy and assessment process (hereinafter referred to as: ICAAP) and internal liquidity adequacy assessment process (hereinafter referred to as: the ILAAP).

IV. EFFICIENT RISK MANAGEMENT PROCESS

7. Risk management shall include identification, measurement or assessment, control or mitigation and monitoring individual risks and it shall be based on the risk appetite statement and established risk culture.

An efficient risk management process shall mean adoption, establishment and implementation of at least:

- policies and other internal acts for identification, measurement or assessment, control or mitigation and monitoring of individual risks;
- stress testing rules;
- rules for introduction of new product, activity or a system in the bank;
- rules for engaging outsourcing service providers;
- information system.

Risk Appetite Statement

8. The risk appetite statement shall include at least the following:

- qualitative and / or quantitative indicators of risk exposure and their thresholds;
- internal limits on risk exposures;
- assumptions the bank takes into account in determining the risk appetite;
- the manner of communicating the established risk appetite with the persons involved in both, risk taking and management.

9. Thresholds of the qualitative and the quantitative indicators from item 8 indent 1 of this Decision shall represent the risk appetite.

In order to monitor and evaluate the progression of a given indicator towards the defined threshold, the bank should also establish early warning triggers in order to ensure timely actions by the bank's bodies.

10. The internal limits on risk exposures from item 8 indent 2 of this Decision (hereinafter referred to as: internal limits) shall be set taking into account the bank's risk profile and should allow limitation of the bank's risk exposure within the established risk capacity.

If the bank has provided exceptions to the defined internal limits, those exceptions should also take into account the established risk capacity.

11. Qualitative and quantitative indicators, their thresholds and internal limits can be determined for risk-weighted assets, expected losses, asset quality, revenues, own funds, liquid assets, specific portfolio, specific transaction, entity or the like.

12. Within its internal acts, the bank shall establish procedures for taking actions in case of exceeding the thresholds of the qualitative and quantitative indicators and the internal limits, which shall define at least: the reporting lines, scope and reporting time

frame, possible actions to be undertaken to eliminate the exceeding and the organizational units or bodies responsible for their undertaking.

In addition to the elements referred to in paragraph 1 of this item, the procedure for taking actions in case of exceeding the internal limits must include:
- decision-making procedure when exceeding defined internal limits,
- prescribing possible exceptions regarding the defined internal limits and responsibilities for decision-making on the implementation of those exceptions;
- defining the responsibility of the risk management function, the member of the Management Board responsible for monitoring the performance of the risk management function (if the bank has appointed such member of the Management Board), the Risk Management Committee and / or the Supervisory Board, when exceeding the defined internal limits and when deciding whether to apply any exceptions.

13. Defined qualitative and / or quantitative indicators, their thresholds and internal limits shall be determined on the basis of data and information from the relevant organizational units in the bank, taking into account the results of the regular stress tests, including stress tests performed for the purposes of the ICAAP, ILAAP and recovery plan.

14. The vank shall, at least once a year, or in the event of a significant change in the risk management system, examine the need to revise the risk appetite statement and if necessary, revise it.

Risk culture

15. Within the established corporate culture and values, the bank should establish and implement an appropriate risk culture based on the principles and expectations for responsible and ethical behavior when undertaking risks within all of bank’s activities.

The bank should provide clear communication (training, etc.) of corporate values and objectives of the established risk management system, in a scope and details that will not violate the confidentiality of sensitive information, and will enable to create and maintain risk awareness of the bodies and employees and their duties and responsibilities when undertaking and managing risks.

Risk culture also involves open communication between the Supervisory Board, the Management Board and the persons in charge of control functions prior to decision-making related to risk management, in order to ensure that control functions effectively perform their responsibilities.

The risk culture shall at least cover the following elements:
- clear lines of responsibility in undertaking and managing risks, having regard to the provisions of Section V of this Decision;
- an efficient information system (reporting system), having regard to the provisions of item 28 of this Decision, and promoting open communication in the decision-making process;
- a remuniration policy that aligns risk-taking with the bank's risk profile and long-term goals.

Risk management policy and other internal acts (rules, procedures, etc).

16. The bank should adopt policies and other internal acts on risk management that should enable identification, measurement or evaluation, control or mitigation and monitoring of individual risks, in accordance with the provisions of this Decision and the provisions prescribed in the by-laws for managing individual risks, adopted on the basis of the Banking Law.

Stress testing rules

17. The bank shall perform stress testing, in accordance with the provisions of this Decision and the provisions prescribed in the bylaws for managing individual risks, adopted on the basis of the Banking Law.

The bank shall perform the stress testing referred to in paragraph 1 of this item, at least as of the end of the year.

18. The stress tests shall be performed in order to assess the potential influence of one, or several internal or external risk factors on the value of the banks' assets and liabilities, i.e. on the own funds, capital adequacy, profitability and liquidity.

19. The stress testing the bank performs should correspond to the nature, the type and the scope of the financial activities it performs or it will perform and it should encompass all material risks it is or it will be exposed to, including the possible interaction between individual risks.

Some of the risks referred to in item 5 paragraph 1 of this Decision may be excluded from the stress testing, if the bank considers that those risks are not material for its operation. The bank shall be obliged to have written document which shall contain the reasons for not including certain risks in the stress tests.

20. The stress tests shall be based on the selection of extreme and theoretically plausable simulations and / or scenarios that can be specific for the bank (internal factors) and that can arise from the market conditions the bank operates in (external factors).

The stress tests can include: the impact of the deterioration of part or the whole credit portfolio of the bank, the impact of change in the interest rates on the financial markets, the impact of change in the cross-currency exchange rates and the value of the denar against other currencies, the impact of change in the prices of the other financial instruments, impact of the changes in GDP, inflation, employment, changes in the political factors, etc.

Depending on the nature, type and extent of the financial activities performed or to be performed by the bank, stress testing should include the correlation between the macroeconomic factors (for example: GDP, exchange rates, the level of interest rate, foreign investments, exports, etc.) and the bank risk measures (for example non-performing loan ratio, open currency position, economic value of the banking book, liquidity ratios, rates of return on assets and equity, etc.).

In addition to the stress testing by applying individual simulations and /or scenarios, the bank shall conduct testing by combining several simulations and/or scenarios (for example: changing the currency structure of banks' loan portfolio, deteriorating loan portfolio quality, changing interbank rates and the value of the denar against foreign currencies, changing interest rates in financial markets, etc.), as well as testing the impact of detoriation of bank's reputation on the bank's liquidity and solvency (significant deposit outflows, inadequate liquidity or solvency, etc.).

Stress tests encompasses various techniques, methods and procedures for assessing the potential impact of one or more extreme and theoretically plausible shocks on the financial standing of the bank (solvency, profitability and/or liquidity). In order to determine the risk capacity, the bank shall also conduct reverse stress tests.

21. The bank shall in its internal acts determine the resoponsibilities of individual bodies, organizational units or persons for conducting stress testing and for deciding, implementing and monitoring activities undertaken on the basis of stress testing and defining techniques, methods and assumptions used in the stress testing, as well as determine the manner of reporting on stress test outcomes.

22. The bank shall revise the assumptions it uses during the stress tests, document the obtained results, as well as document the undertaken activities by the respective bodies on the basis of those results, including ICAAP and ILAAP related activities.

Regardless of the purpose for which the stress test is performed (regular stress testing, part of the ICAAP or ILAAP, part of the recovery plan, etc.), the stress testing outcomes should encourage appropriate action by the bank's bodies, related to the elements of the risk management system (for example: revising defined thresholds and internal limits, strengthening the internal control system, strengthening the reporting system, changes in pricing policy, etc.).

Introduction of new product, activity or system in the bank

23. The bank shall have internal acts, which shall define the following:

- the meaning of new product, activity or system, including significant change of a current product, activity or system;
- what are the rules and procedures for introducing new product, activity or system;
- the manner of determining the price of the new product (interest rate, commission or other similar fee);
- what are the roles and responsibilities for introduction and approval of new product, activity or system.

Introduction of new product, activity, or system shall also mean introduction of new service, process, distribution channel etc., including their significant change.

Before the introduction of a new product, activity or system, the risk management function shall perform an analysis, which includes:

- description of the risks arising from the introduction of the new product, activity, or system;
- analysis of the impact of the new product, activity or system on risk appetite, the bank's risk profile and, if measurable, on the bank's profitability;
- analysis of the influence of the new product, activity, or system on the risk management process;

- analysis of changes needed in the internal control system to monitor the risks associated with the new product, activity or system;
- analysis of the manner of determining and the value of the price of the new product.

When introducing a new product, activity or system in the bank, the relevant persons / organizational units of the bank from different areas should be included (for example: legal, accounting, information system security, compliance, etc.).

The new product, activity or system for which, through the analysis referred to in paragraph 3 of this item, it is determined that they may have a significant influence on bank's risk appetite and risk profile, shall be approved by the Supervisory Board.

Outsourcing services

24. The bank that uses outsourcing for performing financial activities, shall have an outsourcing policy. This policy shall include, at least the following elements:

- basic principles and guidelines for risk management arising from the outsourcing;
- criteria for defining significant outsourcing services;
- manner of selection of the outsourcing service provider;
- manner of verification of the quality of services provided by outsourcing providers and conditions for efficient monitoring of their operation, including monitoring of the operations of persons/entities the outsourcing provider engages when performing bank services;
- manner of ensuring continuity in the performance of outsourcing provider’s services, and which are important for the bank’s operations;
- defining measures, in case of termination of the contractual relationship with outsourcing service provider;
- exit strategy.

25. The bank shall ensure accurate definition of the provisions of the contract concluded with the outsourcing service provider, enabling clear segregation of the rights and responsibilities between the bank and the outsourcing service provider, as well as:

- clause envisaging possibility for early termination of the contract upon the bank’s request;
- provisions for protecting the confidentiality of the bank's data;
- provisions for providing compliance of the outsourcing service provider’s operations with the respective regulations and/or standards;
- provisions enabling the bank free access and possibility to inspect the premises and the outsourcing service provider’s data, pertaining to the service the outsourcing service provider performs for the bank.

The provisions referred to in paragraph 1 of this item shall also apply to the persons/entities engaged by the outsourcing service provider when performing bank services.

26. The bank may not enter into contracts with outsourcing service providers that impede the performing of effective supervision, including the undertaking of corrective measures by the National Bank.

27. The bank cannot delegate the execution of the control functions to an outsourcing service provider.

Information system (reporting system)

28. The bank shall establish information system that will enable adequate measurement, or assessment of risks, establishing ICAAP and ILAAP, as well as adequate and timely reporting of the employees participating in undertaking and managing risks and the bank bodies on the bank's risk profile and the results of the established ICAAP and ILAAP, as a basis for adequate business decision-making.

The risk reports shall fulfill at least the following conditions:
- transparency - to contain clear, understandable and accurate data related to risks;
- completeness - to ensure enough data on all material risks and to enable comprehensive analysis and assessment of the bank's exposure to risks;
- usefulness - to contain the most important data related to risks;
- comparableness with previous reports - the reports should be largely consistent, depending on the data they contain;
- enable monitoring of the implementation of the risk appetite statement, including monitoring of individual qualitative and quantitative indicators, their thresholds, internal limits, exceeding of threshold and internal limits, as well as monitoring of approved exceptions;
- timeliness - to enable timely decision-making regarding taking and managing risks.

29. ICAAP reports contain at least the following information and data:
- a description of the approaches used to determine internal capital and the differences in the approaches prescribed by the National Bank regulations on the methodology for determining capital adequacy;
- a description of the stress test that the bank takes into consideration in the ICAAP and a description of its results;
- amount of internal capital to cover individual risk and total internal capital and current and future needs of own funds;
- activities that are taken for reaching/ maintaining the required level of own funds and/or capital adequacy:

30. ILAAP reports shall contain at least the following information and data:
- a description of the criteria for identifying the material risks affecting the bank's liquidity;
- a description of the methodology for measuring or assessing the risks that have an impact on the bank's liquidity;
- a description of the stress test that the bank has in mind for the ILAAP and a description of its results;
- internal liquidity, and
- activities undertaken to reach / maintain the required internal liquidity, including current and potential use of funds from the National Bank.

V. ORGANIZATIONAL LAYOUT FOR RISK MANAGEMENT

31. The organizational layout for risk management shall consist of clear organizational structure and efficient internal control system in line with the National Bank regulations on the rules for good corporate governance.

32. The bank shall establish an organizational structure that ensures clearly defined competencies and responsibilities between the persons and organizational units performing risk-taking activities on the one hand and the persons and organizational units performing risk-management activities on the other.

33. The bank shall by internal act clearly define the competences of the Supervisory Board, Risk Management Committee and the Bank's Management Board in risk management, as well as their cooperation and exchange of information in risk management. The bank shall have in mind the competencies, the responsibilities and mutual relations of these bodies, set forth in Banking Law and National Bank regulations on the rules for good corporate governance and take into account the scope of the risk management system under Section III of this Decision.

34. If the bank has appointed a member of the Management Board responsible for monitoring the performance of the risk management function, it should be fully independent in monitoring the performance of the risk management function and should not be directly responsible for activities that constitute risk-taking. This person should have access to all the information needed to perform its duties effectively.

35. The individual / organizational unit responsible for risk management (risk management function) shall ensure implementation and / or coordination of activities and processes related to:

- identification, measurement or assessment, control or mitigation and monitoring of all risks within their competence;
- implementation of the policies and the internal acts for identification, measurement or assessment, control or mitigation and monitoring of the risks;
- regular monitoring of the internal limits, as well as regulatory and supervisory exposure limits.
- determining and regular revision of the bank's risk profile according to the risk capacity and the risk appetite;
- determining the level of total internal capital for risk coverage and internal liquidity;
- consideration of the results of the performed stress testing;
- regular reporting to the Supervisory Board, the Risk Management Committee, the Audit Commitee and other bank bodies on the bank's exposure to individual risks and on the results of the performed stress testing;
- monitoring the compliance of the decisions made by the organizational units responsible for taking risks with the risk appetite and reporting to the Supervisory Board, Management Board and Risk Management Committee;
- monitoring of established qualitative and quantitative indicators and their thresholds;
- monitoring of the early warning triggers;
- proposing measures for improving the risk management system;
- independent assessment of the reasons for non-compliance with policies, procedures or defined internal limits, proposing measures to eliminate the reasons for non-compliance and providing appropriate reporting to the responsible persons of the risk-taking organizational units, as well as to the Supervisory Board, Management Board and Risk Management Committee.

The bank should ensure the independence and proper organization of the risk management function, which will enable its involvement in making risk management decisions, access to the bank's employees and bodies and obtain all information necessary for the effective fulfillment of its responsibilities.

The risk management function should be performed by persons who have adequate knowledge in taking and / or managing risks, as well as knowledge in products and services offered by the bank and the market they are offered at.

36. The bank's Internal Audit Department shall audit the functioning of the risk management system, pursuant to the Annual Internal Audit Plan.

37. The competences of the Audit Committee, the persons in charge of the control functions and the responsible person for the security of the information system from the aspect of the risk management process shall be specified in the Banking Law and the bylaws thereof.

VI. INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS (ICAAP) AND INTERNAL LIQUIDITY ADEQAUCY ASSESSMENT PROCESS (ILAAP)

38. The bank shall be obligated to establish ICAAP and ILAAP that will provide:

- identification, measurement, or assessment of the material risks;
- adequate capital or liquidity level in terms of bank's risk appetite and risk profile by determining the total internal capital for risk coverage i.e. internal liquidity;
- further improvement of the risk management system.

ICCAP and ILAAP shall be appropriate to the nature, type and scope of bank's financial activities, its risk management system and its risk profile. ICAAP and ILAAP shall cover the influence of the business cycle, environmental factors that may have a negative impact on the capital adequacy and liquidity, development plan and the bank business policy and their dependence from macroeconomic factors, as well as the results from the performed stress tests.

The bank shall be obligated to use the ICCAP and ILAAP results at least amid:

- determining and monitoring the implementation of the development plan and business policy and bank's risk culture;
- determining the risk appetite statement, especially while determining the quantitative and qualitative indicators and their thresholds and internal limits;
- making important business decisions (ex: when introducing a new product, activity or system, entering new markets etc.).

Providing adequate internal capital i.e. internal liquidity, pursuant to ICAAP and ILAAP, shall not be considered as an appropriate substitute for a weak and non-efficient risk management system.

39. The Internal Audit Department shall be obliged to audit the ICAAP and ILAAP, their implementation, as well as the implementation of measures taken based on ICAAP and ILAAP results, pursuant to the Annual Internal Audit Plan.

40. The bank preparing a recovery plan shall be obligated to take into account the activities, indicators and procedures determined in ICAAP or ILAAP.

41. The bank shall be obligated to provide ICAAP and ILAAP documentation and adequate explanations for the scope, methodologies and procedures used in ICAAP and ILAAP, including the documentation of the reasons of (non)identification of the material risks.

ICAAP and ILAAP shall be clear and understandable, thus ensuring that their unique application by all persons involved in their implementation and assessment of their suitability by the National Bank.

Internal capital adequacy assessment process

42. The bank shall be obligated to conduct ICAAP and determine the total internal capital for risk coverage at least once a year and in cases of any significant change in the risk profile.

Total internal capital for risk coverage shall at least be equal to the regulatory capital for risk coverage and shall be higher than the regulatory capital in cases when the bank shall determine the necessity of:

- higher level of internal capital for covering individual risks covered by the National Bank regulations for the methodology on determining capital adequacy, compared to the level of capital determined pursuant to that methodology;
- additional internal capital for covering other material risks not covered by the National Bank regulations for the methodology on determining capital adequacy.

In cases referred to in paragraph 2 of this item, the bank shall be obligated to ensure fulfillment and maintenance of the total internal capital for risk coverage with an appropriate level of own funds.

Amid establishing, implementing and documenting the ICAAP, the bank shall follow the guidelines set in Annex no. 8 of this Decision.

Internal liquidity adequacy assessment process

43. The bank shall be obligated to conduct ILAAP and shall determine the internal liquidity at least once a year, as well as in cases of a significant change in the risk profile or in cases of significant change due to the presence of new markets, introducing new products and services etc.

Internal liquidity shall enable the bank to fulfill its obligations within their maturity and cover the liquidity needs, in normal operating conditions or emergency.

In its internal acts, the bank shall address the manner of using the National Bank funds, while clearly distinguishing between using the funds in regular operations and potential use in the case of emergency.

Amid establishing and documenting the ILAAP, the bank shall follow the guidelines set in Annex no. 9 of this Decision.

ICAAP and ILAAP on consolidated basis

44. The bank which is a subsidiary in a banking group and is not subject to consolidated supervision, shall not be obligated to establish ICAAP and ILAAP, but shall be obligated to provide the bank which is subject to consolidated supervision with all the necessary data and information for determining the total internal capital for coverage of banking group risks, as well as all other data and information necessary for determining the banking group internal liquidity.

The bank which is subject to consolidated supervision shall establish ICAAP and ILAAP on both individual and consolidated basis.

VII. REPORTING TO THE NATIONAL BANK

45. The bank shall be obligated to submit to the National Bank a risk appetite statement referred to in item 8 of this Decision, within ten days after its adoption i.e. revision.

46. The bank shall be obligated to submit the analysis referred to in item 23 paragraph 3 of this Decision, to the National Bank, within ten days after introducing the new product, activity or system.

47. The bank shall be obligated to notify the National Bank on the stress test results as of the end of the year referred to in item 17 paragraph 2 of this Decision, no later than 31 May of the following year.

If the bank has performed a stress test as of another date different to the date referred to in item 17 paragraph 2 of this Decision, it shall be obligated to notify the National Bank on the results, within 30 days after the performed stress testing.

48. The bank shall be obligated to notify the National Bank for the ICAAP and ILAAP results and shall submit the ICAAP Report and ILAAP Report from Section VI and Annexes no. 8 and 9 from this Decision, no later than 31 May in the year to which the Reports refers to.

Together with the reports referred to in paragraph 1 of this item, the bank shall be obligated to also submit the following to the National Bank:

- description of the bank's business model, including the identification of the core business lines, markets, bank's subsidiaries and/or branches;
- description of the risk management organizational structure;
- description of the stress testing framework that the bank applies, with particular emphasis on stress tests conducted for the ICAAP and ILAAP purposes;
- a summary overview of all the internal acts that refer to the development, implementation, revision and monitoring the ICAAP and ILAAP, including the internal acts which specify the manner of identifying the material risks for ICAAP and ILAAP purposes;
- amount of loss in the previous year as a result of the exposure to operational risk, together with a description of the events that the bank considers as exposures to operational risk and listing the manner of determining a significant event and significant loss from operational risk;
- overview of all changes made to ICAAP and ILAAP compared to the previous year (change in approach/methodology, change in approach elements etc.),

as well as all changes in the internal acts that are relevant to the ICAAP and ILAAP, made in relation to the previous year;
- a summary overview of the final conclusions from the ICAAP and ILAAP, especially regarding the identified need for changes of the ICAAP and/or the ILAAP, as well as regarding the planned changes in the business model and/or individual elements of the risk management system, as a result from the implemented ICAAP and ILAAP;
- any other information that the bank considers relevant for the ICAAP and ILAAP implementation and results.

By derogation of paragraph 1 of this item, the bank which is subject to consolidated supervision shall be obligated to submit Report for ICAAP and Report for ILAAP within 30 days after the deadline referred to in paragraph 1 of this item.

If the bank, due to a significant change in the risk profile or at the request of the National Bank, has conducted a ICAAP and/or ILAAP during the year, it shall be obligated to submit Report for ICAAP and/or Report for ILAAP, within 30 days after the completion of the process.

49. The bank shall be obligated to notify the National Bank for each significant adverse event and/or significant loss from operational risk, with a description of the significant event/loss, within fifteen days from the day of identifying the adverse event i.e. loss.

50. The bank shall be obligated to notify the National Bank for concluding an outsourcing agreement, within ten days from concluding the agreement.

Along with the notification referred to in paragraph 1 of this item, the bank shall also submit an explanation for the type of outsourcing service, the criteria on the basis of which it has been determined that it is a significant service, time period for which the agreement has been concluded, as well as other information that the bank considers significant for the outsourcing service.

VIII. TRANSITIONAL AND CLOSING PROVISIONS

51. The provisions of this Decision that apply to banks shall also apply to foreign bank branches and savings houses in accordance with the Banking Law and bylaws adopted based on this Law.

By derogation of paragraph 1 of this item, the bank which is a subordinated entity in a banking group and is not subject to consolidated supervision, foreign bank branches and savings houses shall not be obligated to apply the provisions from Section VI, Annex no. 8 and Annex no. 9 of this Decision.

52. The implementation of this Decision shall supersede the Decision on risk management (Official Gazette of the Republic of Macedonia No. 42/11 and 165/12).

53. This Decision shall enter into force on the eighth day from the date of its publication in the Official Gazette of the Republic of Macedonia, and shall apply from 31 December 2019.

D No. 02-15/VI-1/2019
30 May 2019
Skopje

Governor
and Chairman
of the Council of the National Bank
of the Republic of North Macedonia
Anita Angelovska Bezhoska

Annex:

Annex no. 1	–	Core principles for concentration risk management
Annex no. 2	–	Core principles for country risk management
Annex no. 3	–	Core principles for counterparty risk management
Annex no. 4	–	Core principles for strategic risk management
Annex no. 5	–	Core principles for reputational risk management
Annex no. 6	–	Core principles for operational risk management
Annex no. 7	–	Core principles for market risk management
Annex no. 8	–	Core principles of the internal capital adequacy and assessment process
Annex no. 9	–	Core principles of the internal liquidity adequacy assessment process

ANNEX NO. 1
Core principles for concentration risk management

1. The bank shall be obligated to establish a concentration risk management policy. Depending on the characteristics of the exposures of the bank exposed to concentration risk, the policy shall at least contain the following elements:
   - definition of concentration risk;
   - measurement of the concentration risk (ex. to individual person/entity or concentration by activity), through using relevant internal methods (ex. the Herfindahl-Hirschman Index);
   - system for identifying connected persons/entities and persons/entities connected with the bank;
   - measurement of the concentration risk in the trading book;
   - definition of internal limits (ex. by person/entity, activity, currency, financial instrument, employer, geographical region, type of collateral etc.);
   - possible exceptions regarding the defined internal limits and decision-making responsibility on those exceptions;
   - manner of stress testing for concentration risk by persons/entity, activity, product, geographic region, type of collateral etc., in order to assess the potential losses in cases of the materialization of this risk.

   The concentration risk management policy referred to in paragraph 1 of this item may be a separate document or an integral part of another policy or another internal act of the bank.

2. For the purposes of the policy referred to in item 1 of this annex, the bank shall establish an information system which will provide data and reports on the concentration of bank’s exposure by:
   - individual person/entity or persons connected with;
   - credit or other type of bank product/service;
   - activity;
   - financial instrument;
   - geographic region;
   - type of collateral;
   - currency etc.

ANNEX NO. 2
Core principles for country risk management

1. The bank shall be obligated to establish a country risk management policy.

2. Depending on the amount and characteristics of the bank's exposures to individual countries, the policy referred to in item 1 of this annex shall at least include:
   - definition of exposure to country risk;
   - establishing internal limits by country;
   - possible exceptions regarding the defined internal limits and decision-making responsibility on those exceptions;
   - defining a list of countries to which bank shall not have exposures;
   - manner of measuring the losses from country risk;
   - defining a system for monitoring exposures by individual country, as well as the manner of informing the bank's Risk Management Committee, Management Board and Supervisory Board.

   The country risk management policy referred to in paragraph 1 of this item may be a separate document or an integral part of the credit risk management policy.

3. Amid determining the expected credit loss i.e. impairment and special reserve resulting from the risk to an individual country, the bank may use data from foreign source (such as international credit rating agencies) or domestic sources (such as specialized country risk assessment institutions), or to establish its own country risk measurement system.

4. Depending on the level and characteristics of bank's exposures to certain countries, the bank shall be obligated to conduct stress testing for exposures to certain country and the total bank's exposure to country risk, considering the macroeconomic, political and other factors present in the relevant country.

5. The bank establishes an information system that provides data and reports on the following: exposures to certain countries and total bank's exposure to a country risk, sectoral, currency and maturity structure of the exposure to a certain country and total bank's exposure to country risk, level of expected credit loss i.e. impairment and special reserve arising from the exposure to a certain country, as well as from the total bank's exposure to country risk.

ANNEX NO. 3
Core principles for counterparty credit risk management

1. The bank shall be obligated to establish a counterparty credit risk management policy which shall at least include:
   - definition of the financial instruments which may expose the bank to a counterparty credit risk;
   - manner of determining the exposure to counterparty credit risk;
   - manner of monitoring the counterparty credit risk;
   - manner of informing the bank's Risk Management Committee, Management Board and Supervisory Board;
   - definition of internal limits;
   - possible exceptions regarding the defined internal limits and decision-making responsibility on those exceptions;

   The counterparty credit risk management policy referred to in paragraph 1 of this item may be a separate document or an integral part of the credit risk management policy.

2. The bank establishes an information system that provides data and reports on the following: exposure to counterparty credit risk by certain financial instruments, as well as total bank's exposure to counterparty credit risk.

ANNEX NO. 4
Core principles for strategic risk management

1. The bank shall be obligated to establish a strategic risk management policy, which shall at least include:
   - strategic risk definition;
   - strategic risk sources (external and internal);
   - instruments/factors for strategic risk mitigation;
   - manner of managing strategic risk;

   External strategic risk sources are considered those in which the bank cannot or may have limited influence on, such as: competition, information technology changes, regulation changes (prudent, taxing etc.). Internal strategic risk sources are considered those that the bank can control, but may also have an impact on achieving the long-term goals, such as: organizational setup, workflow and procedures, employees, information, information technology etc.

   Strategic risk mitigation factors are considered the following: electing appropriate members of the Supervisory Board and Management Board, setting appropriate long-term goals, electing staff with appropriate expertise and knowledge and their continuous training, efficient risk management system, adequate access to information etc.

2. The Supervisory Board shall be obligated to adopt a development plan and business policy.

   Bank's development plan and business policy shall be consistent and correspond with the nature, type and scope of the financial activities that the bank performs and plans to perform, its risk appetite, business and macroeconomic environment in which it operates, as well as to take into account the development plan and business policy of the group to which it belongs (if the bank is a member of a group established in the country or abroad).

3. The development plan shall be for a three-year period at least and shall comply with the bank's long-term goals.

4. The bank's business policy shall be consistent with the bank's development plan and shall cover all bank's business processes.

5. The bank shall be obligated to annually access the need for the revision of the development plan, as well as to monitor the fulfillment of the development plan and its business policy.

   While preparing and revising the development plan and the business policy, the bank shall consider the analysis for the current and assumptions for the future macroeconomic environment, market developments, competition, regulatory environment, financial plan and financial report projections, new products and services it offers, bank's human and technical resources etc.

6. The bank establishes an information system which provides data and reports on the indicators through which the bank monitors the exposure to strategic risk,

including the significant changes in these indicators which point to changes in the bank's risk profile.

ANNEX NO. 5
Core principles for reputational risk management

1. The bank shall be obligated to determine and monitor the possible impact from (non)realization of the development plan and business policy and disrespecting the corporate culture and values and risk culture on its reputation.

2. The bank establishes and implements strict procedures for protecting client data privacy, pursuant to the Banking Law and other provisions which regulate data confidentiality.

3. The bank shall establish internal act for handling consumer complaints and ensure its appropriate implementation. The internal act defines the person or organizational unit which shall be obligated to prepare a Report on the received complaints and their handling on a regular basis, which shall be submitted to the Risk Management Committee. The compliance function monitors the bank consumers' complaints and participates in the complaint handling activities.

4. The bank establishes and implements an internal act for timely and accurate reporting to regulatory, supervisory and other bodies, pursuant to the regulations (National Bank, Public Revenue Office etc.).

5. Bank's Supervisory Board and Management Board shall be obligated to:
   - provide conditions for all bank employees to contribute to creating and maintaining a good image of the bank in the public;
   - ensure compliance with the corporate culture and values and risk culture;
   - ensure compliance with the regulations and compliance with the recommendations and requirements of regulatory, supervisory and other authorities.

ANNEX NO. 6
Core principles for operational risk management

1. The bank shall be obligated to establish an operational risk management policy which shall at least include:
   - definition of all types of operational risks (legal risk, risk of money laundering and terrorist financing, IT risk etc.);
   - manner of identifying, measuring, controlling or mitigating and monitoring the operational risk;
   - definition of internal limits;
   - possible exceptions regarding the defined internal limits and decision-making responsibility on those exceptions;
   - scope of data and information, which are part of the information system for managing operational risk;
   - description of the manner of operational risk assessment;
   - clearly defined operational risk management responsibilities;
   - definition of significant losses from operational risk and definition of significant loss events.

2. The bank shall be obligated to identify and assess all material events which represent or may represent exposure of the bank to operational risk.

   The efficient identification of the operational risk shall consider the internal and external factors which may have a negative impact of the bank's risk profile.

3. Operational risk identification and assessment may be conducted through:
   - internal audit reports;
   - internal losses of risk events databases;
   - self-assessment of the risk which includes a description of the operational risk, identification of risk events, determining the event carriers (persons/entities, organizational units, products or services, systems etc.) determining the persons/entities which undertake appropriate activities for control and mitigation of the operational risk;
   - matrices for converting qualitative into quantitative assessments that allow ranking of the different risk events;
   - grouping individual organizational units, functions or processes according to the operational risk type;
   - risk indicators (such as number of unsuccessful trades, human resources flow rate, frequency and/or size of errors and omissions etc.);
   - scenario analysis which include the definition of the scenario, source and type of data which are being used, analysis dynamics and the manner of determining the impact of losses on bank's profitability and solvency.

4. The internal losses of risk events database shall include all losses as well as near misses and may include information on: type and date of risk event, amount of loss, event carrier, errors or weaknesses in the control systems, amount of potential return as a result of operational risk mitigation techniques, undertaken activities for overcoming the weaknesses of the operational risk management system etc. These databases may relate to all loses, regardless of their amount, or only to those that the bank considers as significant (the minimum amount of loss over which the bank enters data in the database is determined).

5. The bank establishes an information system that provides data and reports for at least: the type of loss from operational risk incurred, main reasons that led to the loss, amount of loss and undertaken measures.

   Depending on the level and characteristics of the operational risk to which the bank is exposed, the bank's information system shall provide reports on exposures to operational risk by individual business lines, organizational units, transaction groups, risk events etc. The reports shall fully cover all determined problems and shall serve as the basis for decision-making by bank's Supervisory Board and Management Board Directors for undertaking timely and efficient additional measures for covering/reducing the operational risk.

6. For the purposes of managing operational risk, the bank shall be obligated to adopt internal acts which at least refer to:
   - defining rules on performing activities in the area of bank's physical security;
   - defining rules for the employee's behavior regarding the bank's physical security;
   - defining security zones in the bank and determining the rules for their protection, including an access control system, during and over working hours;
   - defining rules for video surveillance, handling, storing and protecting videos from security zones and ATMs;
   - defining procedures for safeguarding and securing the premises of the safes rented for use (civil safes) and defining the way of using the safes;
   - defining procedures for safeguarding and securing the vault;
   - defining rules for performing and providing the transportation/transfer of cash into and out of the populated area, as well as the procedure for receiving and delivering cash;
   - defining the criteria that shall be met by the security companies if the bank uses outsourcing services;
   - defining the criteria that shall be met by the insurance companies amid insuring events related to bank's physical security.

   Physical security denotes securing bank's employees and clients for the purposes of their personal protection and securing the bank's property against access by unauthorized persons, destruction, damage, unlawful seizure and other forms of harmful activities.

   In cases when using services from persons/entities referred to in paragraph 1 of this item, the bank shall be obligated to meet the requirements referred to in item 24 of this decision.

7. The bank manages the risk of money laundering and terrorist financing and the IT risk, as part of the operational risk management, given the provisions of this decision and the bylaws adopted pursuant to the Banking Law which regulate the management of these two risks.

Legal risk management

8. In the policy referred to in item 1 of this annex or in other internal acts, the bank determines the manner of identifying, measuring, controlling or mitigating and monitoring the legal risk.

9. Amid identifying the legal risk sources, the bank covers all the business processes, activities, products and services that it offers. The bank shall be obligated to identify and measure the legal risk that arises from another risk (such as risk from money laundering and terrorist financing, reputational risk).

10. In the context of legal risk management, the bank shall also consider the conduct risk which may arise form a wide range of business processes and bank's activities, covering at least the inappropriate sale and advertisement of bank's products and services, unfair competition, giving inaccurate data and inappropriate information to the public, inappropriate handling of consumer complaints, violation of good business practices and trade practices etc.

11. As part of the operational risk database, the bank shall be obligated to collect legal risk data (such as fines, damage costs, costs of lost lawsuits etc.).

12. Amid identifying the legal risk sources, the bank shall be obliged to at least provide:
    - a description and updated documentation of court proceedings where the bank is a party or interested party;
    - documented evidence of the process of making and amending contracts with bank's clients and outsourcing service providers;
    - analysis of the impact from the risk of money laundering and terrorist financing, reputational risk on legal risk.

13. The bank shall be obligated to document the process of determining the degree of uncertainty from the legal proceedings against the bank and the special reserve for these proceedings.

14. The bank shall be obligated to establish a process of regular reporting to the bank's bodies at least on:
    - legal risk sources;
    - court proceedings;
    - measures and actions undertaken for mitigating the legal risk.

Business Continuity and Contingency Plan

15. The bank shall establish a Business Continuity and Contingency Plan.

    The Business Continuity Plan shall be a document that includes procedures for ensuring continuity of the bank's most important processes and systems. The Business Continuity Plan shall be aimed at ensuring availability of the supporting capacities intended in case of emergency as soon as possible.

    The Contingency Plan shall be an integral part of the Business Continuity Plan and shall define the technical and organizational measures and actions for business resumption, i.e. continuity and for minimizing the effects of the business discontinuity, i.e. disturbance of the work environment.

16. Business Continuity and Contingency Plan shall also include:
    - definition of the events considered as contingencies or seriously disturbed work environment;

- division of competences and determining persons with special rights and responsibilities and/or employees in the bank who will be responsible for undertaking appropriate activities amid emergencies or severely disturbed working conditions;
- creating conditions for continuity of the most important systems and processes of the bank;
- deadlines for ensuring continuity of the most important systems and processes;
- procedures for ensuring continuity of the most important systems and processes;
- manner of informing in the case of serious disturbance of the work environment.

17. The bank shall be obliged to provide full information to the employees about the contents and relevance of the Business Continuity Plan and the Contingency Plan.

18. The bank shall ensure testing of the Business Continuity Plan and Contingency Plan at least once every year and in case of any significant change in the bank's exposure to operational risk. The bank's Supervisory Board and the Management Board shall be informed on the results of these tests.

19. The bank shall be obligated to ensure periodic revision of the Business Continuity Plan and Contingency Plan in order to comply with the current activities, business processes and development plan and business policy.

ANNEX 7
Core principles for market risk management

1. The bank shall establish a clear operational and organizational distinction between the front and back office, including clear distinction between the responsibilities and competences of persons with special rights and responsibilities which are competent for the front and for the back office activities.

2. The bank shall establish a market risk management policy and/or other internal acts for identifying, measuring, controlling and monitoring the market risk.

3. Market risk measurement shall include loss assessment amid normal operating conditions and emergency.

4. The bank shall conduct an adequate stress testing regarding trading book and all transactions that are exposed to market risk, as well as shall possess appropriate methods for back-testing of the market risk measurement systems. The results from the conducted stress testing and back-testing are an integral part of the overall risk management process.

5. The bank shall provide daily monitoring of the risks that arise from trade activities, at least on data for:
   - realized trading activities, realized level of defined thresholds and internal limits and their exceeding;
   - results from realized trading activities.

   The Management Board shall immediately be informed of any exceeding of the defined thresholds and internal limits.

6. For the needs of market risk management, the bank shall establish an information system which provides at least the following data and reports:
   - report on the currency structure of trade positions;
   - report on realized trade transactions during a certain period;
   - reports regarding the type of transactions, organizational units and type of financial instrument;
   - report on significant (large) transactions with deviations of market conditions;
   - report on compliance with the defined thresholds and internal limits;
   - report on exceptions from bank's procedures and policies, with a particular reference on whether the exceptions occurred within bank's procedures covering such cases;
   - review of the trading results on current and cumulative basis, at least monthly and annually.

ANNEX 8
Core principles of the internal capital adequacy assessment process

1. Establishing of ICAAP shall denote the implementation of the following stages:
   - identification of the material risks;
   - measurement or assessment of individual material risks and determining the adequate amount of internal capital for covering individual risk;
   - determining the total internal capital for risk coverage;
   - comparison of the amount of the bank's own funds with the total internal capital for risk coverage and undertaking activities for fulfilling and/or maintenance of the required amount of own funds.

Identification of the material risks

2. The bank should identify all risks it is exposed to, separating the material from nonmaterial risks.

   The bank shall separate the material from nonmaterial risks, i.e. identify the material risks, on the basis of internally defined criteria, which it should constantly use.

   For ICAAP purposes, the bank does not have to consider all the risks of item 5 paragraph 1 of this Decision as material risks, if, according to internally defined criteria, it finds that certain risks are not material to its operations. For all the risks that the bank deems nonmaterial, there should be a written document with the reasons for determining these risks as nonmaterial.

3. Risks that the bank has identified as material risks and for which it determines an internal capital may be divided into the following four groups:
   - risks that are covered by the National Bank regulation on the methodology for determining capital adequacy: credit risk, market risk, currency risk and operational risk;
   - risks that are not fully covered by the National Bank regulation on the methodology for determining capital adequacy: for example, operational risk the bank can be exposed to as a result of the introduction of a new product, activity or system;
   - risks that are not covered by the National Bank regulation on the methodology for determining capital adequacy at all: interest rate risk in the banking book, concentration risk, country risk, strategic risk, reputational risk and other risks;
   - risks of external environment: risks arising from macroeconomic, business or regulatory environment in which the bank operates.

   The bank does not have to identify material risks in each of the stated groups of paragraph 1 of this item. Particular risk group may remain empty if the bank determines that there are no material risks that belong to that group or if a particular risk, due to its characteristics, can be included in any of the other risk groups.

4. In identifying and measuring or assessing the material risks covered by the ICAAP, the bank shall comply with the requirements laid down in this Decision or bylaws

adopted on the basis of the Banking Law which refer to the management of individual risks.

Measurement or assessment of risks

5. The bank shall be required to define the methodology for measuring or assessing individual risks, which it uses for determining the internal capital for covering individual risks and document and explain the method or approach for assessment of the measurable risks and the manner of assessment of the immeasurable risks.

6. When measuring the group of risks from item 3 indent 1 of this Annex, the bank can:

   - use the approach prescribed in the National Bank regulation on the methodology for determining the capital adequacy (regulatory approach), or
   - use internal approach for determining the internal capital for covering the particular risk (internal approach).

   In instances provided in paragraph 1 indent 2 of this item, the bank should explain the reason for using the chosen approach and the differences with the approach prescribed with the National Bank regulation on the methodology for determining the capital adequacy.

   Provided that the sum of the internal capitals for covering risks from this group is lower than the total amount of the regulatory capital, the amount of the regulatory capital shall be included in the determining of the total internal capital for risk coverage.

7. During the measurement/assessment of the risks from other groups from item 3 indents 2, 3 and 4 of this Annex, the bank should develop its own quantitative or qualitative approaches/methods for measurement/assessment of the risks.

8. The bank's internal approach to measure/assess individual risk from item 6 paragraph 1 indent 2 and item 7 of this Annex should match the bank's risk profile and characteristics of the risk management process of that particular risk. The bank may determine the internal capital for covering individual risk by using advanced techniques for measuring risk - models that use mathematical, econometric or statistical methods, if these models are more adequate to the nature, type and scope of the financial activities the bank performs.

9. Regardless of the approach the bank uses to determine internal capital for covering individual risk, the bank should have explanations of the approach and properly document all its elements, such as: assumptions, time series used, the confidence interval, the allowed level of subjectivity (e.g. using expert opinions), manner of relating quantitative with qualitative factors (if both types of factors are used), manner and frequency of testing of the approach and its results, the conditions under which changes in the approach and its elements can be made, the persons responsible for development and change of the approach and the like.

10. If the bank changes the approach for determining the internal capital for covering individual risk or changes some of the elements of the approach from item 9 of

this Annex, which leads to a lower amount of internal capital for covering that risk, at least in the first year after the change, it shall be obliged to include a certain amount of capital for covering the possible errors due to the approach change.

11. In establishing internal capital for covering individual risks, the bank should take into consideration the stress tests results, conducted on the basis of stress testing rules defined in this Decision and in the special bylaws adopted on the basis of the Banking Law.

    Stress testing should encompass all identified material risks and cover the same time period covered by ICCAP.

Determining the total internal capital for risk coverage

12. The total internal capital for risk coverage shall be calculated as a sum of the internal capitals for covering individual (material) risks.

    For the purposes of determining the total internal capital for risk coverage, the National Bank shall not recognize the effects of diversification and the correlation between individual risks.

13. The bank shall present the total internal capital for risk coverage, the manner of its calculation, as well as the basic features and elements of the ICAAP in the Report on the ICAAP, which is an integral part of this Annex.

Comparison of the amount of own funds and total internal capital

14. The bank should identify and explain all differences between the amount of the regulatory capital and the total internal capital.

15. If the amount of total internal capital is higher than the amount of regulatory capital, the bank should determine the current and future needs of its own funds.

    If the current amount of own funds is lower, equal or slightly higher than the amount of total internal capital, the bank shall be obliged to undertake activities to reach and maintain the required level of own funds and to prepare a capital plan which should refer to a period of at least next three years. The capital plan should comprise the activities that the bank will undertake for achieving and/or maintaining the required level of own funds (e.g. recapitalization, a change in the policy on the payment of dividends, changes in the assets structure, etc.).

    By derogation of paragraph 2 of this item, the bank that has activated the recovery plan that provides undertaking appropriate activities for reaching the required level of own funds, shall not be obliged to prepare the capital plan from paragraph 2 of this item.

Report on the ICAAP

1. General data

Name and address of the bank	
Period the report refers to	1.1._______ to 31.12.__________
Contact person	
Telephone and e-mail	
Organizational unit	
Member of the Management Board/member of the Management Board responsible for monitoring the risk management	
Signature/s*	

*New lines can be added, if needed.

2. Identification of material risks

2.1. List of risks the bank is or can be exposed to

Risk	**Risk definition**	**Explanation why the risk is nonmaterial**	**Treatment in ICAAP**	
			Measurable (YES/NO)	**Immeasurable (YES/NO)**
Nonmaterial risks				
Material risks				

3. Measurement or assessment of the material risks and determining the internal capital for covering individual risk

3.1. Measurement of risks

Risk	**Approach**	
	Regulatory approach (RA)	Internal approach (IA)
1	2	3
Risks covered by the National Bank regulation on the methodology for determining the capital adequacy*		
Credit risk		
Operational risk**		
Currency risk		
Market risk		
Risks that are not fully covered by the National Bank regulation on the methodology for determining the capital adequacy***		

Risks that are not covered by the National Bank regulation on the methodology for determining the capital adequacy at all* **		
Risks from the external environment* **		

* The column that fits the approach used by the bank shall be filled-in, inserting the abbreviation for the approach used: RA or IA in the appropriate column. Example: if the bank uses an internal approach, in the last column it shall enter IA.
If the bank uses an internal risk measurement approach, which meets the requirements for using the advanced approaches for measuring credit risk, operational or market risk as defined in the Basel Capital Accord, in the last column it shall insert: IAIRB.
** If the bank, for the purposes of the National Bank regulation on the methodology for determining capital adequacy, uses the basic indicator approach, while for the purposes of determining the internal capital for operational risk coverage uses a standardized approach, it shall fill-in the third column and insert: IASA. If the bank uses different approaches for measuring individual risks that are part of the operational risk (e.g. IT risk, risk of money laundering, legal risk, etc.), it shall add additional rows below the row for operational risk for each risk.
*** For all other risks, the bank shall fill-in only the last column. For risks for which the methodology for their measurement is prescribed with another bylaw of the National Bank that prescribes the management of those risks (e.g. interest rate risk in the banking book), the bank shall note whether it uses the prescribed methodology or other internal approach (if the bank uses the prescribed methodology, in the third column it shall enter: IARA).

3.2. Description of the internal approaches for measuring risks

Risk	Description of the approach

This table shall include the risks that the bank measures by using the internal approach (third column of Table 3.1). For each of the risks, the bank shall enter the following data and information:

- whether it is a quantitative or qualitative approach to measurement/assessment of risk, or the approach is a combination of quantitative and qualitative factors;
- description of the assumptions used in the approach;
- description of the statistical/mathematical parameters that approach is based on (if models for measuring the risk are used);

- differences with regulatory approach (for the risks covered by the National Bank regulation on the methodology for determining capital adequacy and for the risks the measurement of which is provided by another bylaw of the National Bank);
- the method and frequency of testing the approach and its results and organizational unit or outsourcing service provider responsible for performing the testing (if testing is performed by outsourcing service provider, the basic data on that entity, his experience in using/testing models, the reason the bank has chosen that entity, the period for which the contract was signed to perform testing by outsourcing service provider, etc. shall be stated);
- internal act that prescribes the risk measurement approach.

3.3. Description of the stress testing taken into consideration in ICAAP

Risk	Amount of internal capital as a result of stress testing (in 000 denars)	Description of the performed stress testing (assumptions and procedure)

This table shall present all the stress tests conducted by the bank which are taken into consideration in the ICAAP, regardless of whether the bank has determined a higher amount of internal capital for covering individual risk as a result of the stress testing or not.
The second column shall be filled-in only if the bank has determined a higher amount of internal capital for covering individual risk as a result of the stress testing. The last column shall give a description of the assumptions, simulations or scenarios and procedure of the performed stress testing for each risk.
If the stress test assumes a combination of multiple simulations/scenarios which cover more risks, then it shall fill-in the rows of all the risks covered by the stress testing (in the last column it shall insert the same explanation for all risks involved in stress testing).

4. Determining the total internal capital for risk coverage

in 000 denars

Risk	Regulatory capital	Internal capital
Risks covered by the National Bank regulation on the methodology for determining the capital adequacy		
Credit risk		
Operational risk*		
Currency risk		
Market risk		
Risks that are not fully covered by the National Bank regulation on the methodology for determining the capital adequacy		

Risks that are not covered by the National Bank regulation on the methodology for determining the capital adequacy at all		
Risks from the external environment		
Total internal capital for risk coverage		

* If the bank uses different approaches for measuring individual risks that are part of the operational risk (e.g. IT risk, risk of money laundering, legal risk, etc.) and as a result has determined separate internal capital for each of these risks, it shall add additional rows below the row for operational risk for each risk and shall state the internal capital for each risk for which it uses a particular approach.

5. Comparison of the own funds and the total internal capital for risk coverage

5.1. Planned balance on 31 December for the current year

in 000 denars

Regulatory capital	
Total internal capital for risk coverage	
Own funds	
Risk weighted assets	
– Credit risk	
– Operational risk	
– Market risk	
– Currency risk	

5.2. Capital plan

in 000 denars

	Current year	Current year + 1	Current year + 2
Total internal capital*			
Current and future needs for own funds			
Planned capital adequacy ratio			
Planned Tier 1 capital ratio			
Planned Common Equity Tier 1 capital ratio			
Activities for reaching the required amount of own funds/capital adequacy ratio:			
capital instruments of the Common Equity Tier 1 capital			

capital instruments of the Additional Tier 1 capital			
capital instruments of the Tier 2 capital			
Retained earnings			
assets reduction			
...			
(The bank shall provide a detailed description of the activities that will be taken to achieve and/or maintain the current and future needs of its own funds, including the instances when the bank converts one capital instrument in another.)			

* Total internal capital for the next two years (current year +1 and current year +2) shall be bank's estimations on the possible amount of total internal capital taking into consideration the results of the current ICAAP, the bank's risk profile, the development plan and the bank's business policy. If the bank's capital plan applies to more than three years, the bank shall add the appropriate number of columns (for all additional years).

6. Risk management

Organizational structure (bodies, organizational units and persons involved in the establishment and the implementation of ICAAP, along with their responsibilities and lines of reporting concerning ICAAP)
Reporting system (list of reports that are prepared for the ICAAP purposes, bodies/persons in the bank to which those reports are submitted and the frequency of the preparation and submission of the reports)
Internal and external audit (description of the latest assessment of ICAAP by the Internal Audit Department: when it is carried out, the scope and the conclusions and findings) (description of the latest assessment of ICAAP by the external auditor: when it is carried out, the scope and the conclusions and findings) (measures that have been taken as a result of the findings of internal and/or external audit and who is responsible for taking and monitoring the measures taken)

The bank shall answer in details all questions encompassed in the table.

ANNEX 9
Core principles of the internal liquidity adequacy assessment process

1. The bank shall determine the internal liquidity, as a final result of ILAAP, through the identification, the measurement or the assessment, the control or the mitigation and the monitoring of the material risks that have or may have influence on the bank's liquidity, taking into account the requirements of the National Bank regulation on liquidity risk management.

2. ILAAP shall consist of the following stages:
   - identification and monitoring of the material risks;
   - measurement or assessment of the material risks, including stress testing of the material risks;
   - determination of the internal liquidity;
   - comparison of the internal liquidity with the amount of the current liquidity.

Identification and monitoring of the material risks

3. The bank shall be required to establish process of identifying the risks that have or may have influence on liquidity, and at least on cash inflows and outflows, the maturity structure of assets and liabilities, the sources of funds and their stability and concentration and the possibility for their use without constraints, in normal operating conditions and emergency.

4. In its internal acts, the bank shall define the criteria it uses to determine the materiality of the individual risks on liquidity. The bank shall be required to determine the need for revising these criteria, as well as to identify the material risks, at least on an annual level or more frequently, in case of significant changes in its operations that could affect liquidity (e.g. introducing a new product, activity or system, expanding a certain business activity and the like).

5. For all risks determined by the bank as nonmaterial, there should be a written document with reasons for determining these risks as nonmaterial.

6. When determining whether a certain risk is material, the bank shall not take into account the impact of the possible risk mitigation instruments. These instruments are taken into account during risk measurement, i.e. when determining the bank's internal liquidity.

7. In the process of identification of the material risks, the bank shall be required to take into account all significant products, clients and signed agreements that may have influence on liquidity, thus including both the on-balance sheet and the off-balance sheet positions.

8. The bank that is member of a banking group abroad or that uses a significant amount of foreign sources of funds, should especially take into consideration the possible transfer constraints of the liquid assets, taking into account the characteristics of the counterparty, the market and the country of origin of those assets and their currency.

9. ILAAP should provide identification and monitoring of the positions in the currencies which are considered material for the bank's liquidity, in normal operating conditions and emergency. In its internal acts, the bank should determine the manner of monitoring the positions in each currency material for its liquidity.

10. ILAAP should enable linking of the identified material risks on the bank's liquidity with the Liquidity Contingency Plan, primarily in terms of the early warning indicators for existence of emergency, the possible sources of funds that can be used in the case of emergency, the period for undertaking the defined activities, as well as the possibility for undertaking the defined activities.

Measurement or assessment of the material risks

11. The bank shall be required to define the methodologies for measurement or assessment of the risks on liquidity, that match the business model, the risk profile and the nature, the type and volume of the financial activities the bank performs.

12. The bank should be able to explain the methodologies it uses and properly document all its elements, such as: assumptions for the expected inflows and outflows and for the expected maturity, time series used, the manner of determining the stability of the sources of funds, the manner of measuring concentration, the manner of monitoring and reviewing the appropriateness of the applied methodology, the stress testing used when measuring the risks and the like.

13. For ILAAP purposes, the bank should conduct stress-testing, including reverse stress-testing, conducted on the basis of stress testing rules defined in this Decision and in the National Bank regulation on managing banks' liquidity risk.

    Stress testing should encompass different time periods, including one day, different sources of funds important for the bank's liquidity, including use of funds from the National Bank, encompass the material currencies and markets, as well as the possibility for using funds within the group (if the bank is member of a group in the country and abroad).

14. The bank shall be required to carry out a regular independent assessment of the appropriateness of the methodologies from item 11 of this Annex. The assessment should be carried out by the bank's organizational units that were not involved in their development and implementation or it should be carried out by outsourcing service provider.

Determination of the internal liquidity

15. Taking into account the previous ILAAP stages, the bank shall determine the internal liquidity that should allow it to smoothly cover its liabilities.

16. The bank may convey the internal liquidity in one or more of the following ways:
    - as a higher level of the liquidity ratios than the minimal level determined by the National Bank regulation on liquidity risk management;

- as one or more internal liquidity indicators, defined by the bank according to the requirements of the National Bank regulation on liquidity risk management;
- any another manner which the bank considers as more appropriate for determining and monitoring the internal liquidity.

17. Regardless of the manner of conveying the internal liquidity, the bank shall be required to clearly distinguish the assets that can be considered highly liquid in case of emergency, as well as the other assets that can be used as collateral in order to obtain liquidity from the National Bank.

Comparison of the internal liquidity with the current liquidity

18. The bank shall be required to identify and explain all differences between the determined internal liquidity and the current liquidity.

    For ILAAP purposes, current liquidity shall denote the amount of the liquidity ratios, the ratio of liquidity indicators or another amount/ratio depending on the manner of conveying and determining the internal liquidity, in accordance with item 16 of this Annex, on the day of preparing the ILAAP.

19. If the internal liquidity is greater than the current liquidity, the bank should determine the current and future needs for liquid assets and the sources of funds, in order to cover the identified shortage and maintain adequate liquidity.

    The bank from paragraph 1 of this item shall be required to prepare a plan with activities it will undertake in order to reach and/or maintain the required internal liquidity.

    By exception to paragraph 2 of this item, the bank that has activated the recovery plan that provides undertaking appropriate activities for reaching the required level of liquid assets and sources of funds, shall not be required to prepare the plan from paragraph 2 of this item.

Report on the ILAAP

1. General data

Name and address of the bank	
Period the report refers to	1.1._______ to 31.12.__________
Contact person	
Telephone and e-mail	
Organizational unit	
Member of the Management Board/member of the Management Board responsible for monitoring the risk management	
Signature/s*	

* New lines can be added, if needed.

2. Identification of material risks

Risk	Explanation why the risk is/is not material	Treatment in ILAAP	
		Measurable (YES/NO)	Immeasurable (YES/NO)

3. Description of the methodology for measuring material risks

Risk	Description of the methodology*	Assessment of the methodology**

* The following shall be entered:
- whether it is a quantitative or qualitative approach to measurement/assessment of material risks or it is a combination of quantitative and qualitative factors;
- description of the assumptions the methodology is based on;
- description of the statistical/mathematical parameters that methodology is based on (if models for risk measurement are used);
- internal act that prescribes the approach used for risk measurement of bank's liquidity.

** The following shall be entered:
- the method and frequency of assessing the methodology and its results;
- organizational unit or outsourcing service provider that have carried out the assessment (if the assessment is carried out by outsourcing service provider, the basic data on that entity, his experience in using/assessing models, the reason the bank has chosen that entity, the period for which the contract was signed to carry out an assessment by outsourcing, etc. shall be stated);

4. Description of the stress testing taken into consideration in ILAAP

Description of the performed stress testing (assumptions and procedure)	Influence on the internal liquidity

This table shall present all stress tests conducted by the bank for the ILAAP purposes. The first column shall give a description of the assumptions, simulations or scenarios and procedure of the performed stress testing. The second column shall state whether the performed stress testing is taken into account in the determination of the internal liquidity and in what way.

5. Determination of the internal liquidity

Material risk	**Required internal liquidity**

The table shall provide a review of the internal liquidity, for each material risk for which the bank has determined current and future needs for liquid assets and sources of funds. In the second column, the bank shall state the manner of conveying the liquidity required for each material risk (e.g. as an amount, as a ratio for which the existing liquidity ratio needs to be increased, as a ratio which increases the amount of the determined internal indicator and the like).

6. Comparison of the internal liquidity and the current liquidity

	On the day of preparing the ILAAP*	**Determined internal liquidity****
1. Liquidity ratios		
LR 30		
LR 180		
2. Internal liquidity indicators***		
...		
3. Another manner of conveying the internal liquidity****		

* Parts 1 and 2 of the table shall be filled-in, whereby in the second part, the bank shall state all the liquidity indicators it has prescribed, according to the National Bank regulation on liquidity risk management. The third part shall be filled-in only if the bank uses this manner of conveying the internal liquidity.
** Only the part of the table (1, 2 or 3) that fits the manner in which the bank conveys the internal liquidity shall be filled-in.
*** The bank shall state all indicators it uses for the purposes of conveying and determining the internal liquidity (new lines shall be added, if needed).
**** The bank shall explain the manner of conveying the internal liquidity.

7. Plan for reaching and maintaining the required liquidity

	Period
Activities for reaching the internal liquidity:	
Growth of liquid assets	
Changes in the sources of funds	

Changes in the maturity structure	
...	
(The bank shall provide a detailed description of the activities that will be taken to achieve and/or maintain the current and future needs for liquid assets and sources of funding)	

8. ILAAP as part of the bank's risk management system

Planning and monitoring the cash inflows and outflows (the criteria for determining the current and the future (expected) cash inflows and outflows, as well as the time that would be necessary to turn a particular asset into cash inflow shall be stated, description of the criteria and the instruments for measuring and monitoring the daily liquidity needs shall be provided)
Establishment and maintenance of an adequate maturity structure (the assumptions for determining the expected residual maturity, the time series used to determine the expected maturity of cash inflows and outflows, the date of the last revision of the assumptions and the reason for the revision, the manner of classifying the individual inflows and outflows for the purposes of determining the expected residual maturity shall be stated)
Monitoring the sources of funds and their concentration (description of the most important sources of funds, by client, market, country, currency and the like, criteria for determining the level of stability of the individual sources of funds, manner of monitoring the diversification of the sources of funds and control of their concentration, assessment of the possibility for transfer of liquid assets among members of the group, if the bank belongs to a group in the country or abroad)
Collateral that can be used for liquidity purposes (the assets/collateral which the bank has at its disposal which can be used for obtaining credit lines from other banks or from the National Bank and the credit lines that the bank has already obtained for the purposes of providing liquidity shall be stated, assessment of the possibility/risk of using these lines, in terms of the time period for their initiation or any other event that can limit their use shall be given)
Liquidity Contingency Plan (the Liquidity Contingency Plan shall be submitted or the changes that the bank has made to the Plan submitted in the previous year shall be stated)
Organizational structure (bodies, organizational units and persons involved in the development and the implementation of ILAAP, along with their responsibilities and lines of reporting concerning ILAAP shall be stated)
Reporting system (list of reports that are prepared for the ILAAP purposes, bodies/persons in the bank to which those reports are submitted and the frequency of the preparation and submission of the reports)

Internal and external audit (description of the latest assessment of ILAAP by the Internal Audit Department: when it is carried out, the scope and the conclusions and findings) (description of the latest assessment of ILAAP by the external auditor: when it is carried out, the scope and the conclusions and findings) (measures that have been taken as a result of the findings of internal and/or external audit and who is responsible for taking and monitoring the measures)

The bank shall answer in details all questions encompassed in the table.