Grant Thornton

Financial Statements for the Year Ended 31 December 2017 prepared in accordance with IFRS and Independent Auditor's Report

MF Banka a.d. Banja Luka

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Independent Auditor's Report

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To the Supervisory Board and Shareholders of MF banka a.d. Banja Luka

Opinion

We have audited the accompanying financial statements of "MF Banka" a.d. Banja Luka (hereinafter: "the Company"), which includes the statement of financial position as of 31 December 2017 and the corresponding profit and loss statement and other overall results, statement of changes in equity and cash flow statement for the year then ended, as well as an overview of significant accounting policies and notes to the financial statements.

In our opinion, the financial statements present fairly and objectively, in all material matters, the financial position of the Joint-stock company "MF Banka" Banja Luka as of December 31, 2017, as well as the results of its operations and cash flows for the year then ended in accordance with International Financial Reporting Standards.

Basis for the Opinion

We conducted our audit in accordance with International Standards on Auditing. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics for Professional Accountants of the International Accounting Standards Board (IESBA Code), along with the ethical requirements that are relevant to our audit of the financial statements in the Republic of Srpska and we have fulfilled our ethical responsibilities in accordance with the IESBA Code. We are confident that the audit evidence we have gathered is sufficient and appropriate as a basis for our opinion.

Key matters

Key audit matters are those matters that were, in our professional judgment, of the most importance in our audit of the current financial statements. Those matters are processed in the context of the audit of the financial statements as a whole, as well as in forming of our opinion about them and we do not express specific opinion on those matters.

Independent Auditor’s Report

To the Supervisory Board and Shareholders of MF banka a.d. Banja Luka

Key matters (continued)

Key audit matters	How the audit addressed the matter
As a key matter, we have chosen loan impairment and provisions since the determination of the amount for impairment requires a significant assessment by the management of the determination of the moment of recognition of the impairment and the amount of the impairment (Note 11). In case there is a significant suspicion regarding the payment of interest or repayment of the principal, or if the Bank assesses that there is a breach of the terms of the contract, the credit risk and the value of the loan are assessed on an individual basis. The Management Board assesses the parameters it deems relevant for calculating impairment losses on loans, not limiting to the client's financial position, the period of realization and the value of the insurance instrument at the expected realization date and the expected cash flow.	We tested predecessor auditor’s procedures related to loan impairment and loss provisions, and we found that the opening balances do not contain material misstatements. We assessed and tested the design, implementation and operational efficiency of internal controls regarding the accurate recognition of impaired loans and we performed an assessment of the model used by the board to calculate the provisions. We examined a sample of individually significant credit exposures in order to estimate loss provisions that are calculated on an individual basis. We evaluated the assumptions made by management, including estimates of future cash flows, and values of the respective collaterals and estimates of recoverability. We assessed the models used, the reasonableness of the assumptions, and the completeness and accuracy of the data used by Bank to estimate the value adjustments on loans that have similar characteristics in terms of credit risk. We ensured that the Bank's methodology for assessing the provisions for potential losses was adequate and consistently applied.

Independent Auditor’s Report (Continued)

To the Supervisory Board and Shareholders of MF banka a.d. Banja Luka (continued)

Responsibilities of the Management Board and persons authorized in governing for preparation of Separate Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards and for those internal controls that the management determines are necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

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In preparing the financial statements, the Management is responsible for assessing the Company’s ability to continue operating as a going concern, disclosing, as applicable, matters related to going concern and using an accounting basis for going concern, unless the Management intends to liquidate the Company or suspend business, or have no realistic option except to do it.

Authorized persons are responsible for control of the Company's financial reporting process.

Auditors' Responsibilities for Audit of Separate Financial Statements

The objectives of our audit are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud and error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic deicions of users taken on the basis of these financial statements.

As an integral part of the audit, in line with ISA we create professional judgments and reflect on professional skepticism during the audit. We also:

- Recognize and evaluate the risks of misrepresentation of financial statements due to fraud or an error, formulate and perform audit procedures as an assessment to these risks and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not revealing a significant misstatement resulting from scams is greater than the risk of error because fraud may include secret agreements, counterfeiting, deliberate release, misrepresentation, or circumvention of internal controls;

- Establish an understanding of internal controls relevant to the audit in order to design audit procedures that are appropriate in the given circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control;

- Evaluate the appropriateness of the accounting policies used and the reasonableness of the accounting estimates and related disclosures created by the management;

Independent Auditor’s Report (Continued)

To the Supervisory Board and Shareholders of MF banka a.d. Banja Luka (continued)

Auditors' Responsibilities for Audit of Separate Financial Statements (continued)

- Conclude on the appropriateness of using the accounting basis based on the timeless management of the Company's operations and, based on the obtained audit evidence, we conclude whether there is significant uncertainty about events or circumstances that can give rise to a significant suspicion of the Company's ability to continue operating as a going concern. If we conclude that there is significant uncertainty, we are required to pay attention to our audit report on related disclosures in financial statements or, if such disclosures are not appropriate, to modify our opinion. Our conclusions are based on audit evidence obtained until the date of our audit report. However, future events or conditions may cause the Company to cease its business continuation as a going concern;

- Evaluate the overall presentation, structure and content of the financial statements, including disclosures, as well as reflect financial statements, core transactions and events in a manner that achieves fair presentation.

We communicate with those who are in charge of managing, among other issues, the volume and timing of audits, and important audit findings, including the significant disadvantages of internal controls that were discovered during our audit.

We also provide the persons authorized to manage the statement to adhere to the relevant ethical requirements regarding the independence and to share all of the relationships and other issues that can reasonably be expected to reflect on our independence, and, where applicable, the appropriate security measures.
From the matters addressed to the ones charged for governing, we determine those matters that were of the most importance in the audit of the current financial statements and, therefore, represent key audit matters.

We present those matters in our auditor's report, unless the law or regulations exclude disclosure about the matter or when, in extremely rare circumstances, we decide that the issue should not be disclosed in our report because it can reasonably expected that the negative consequences of disclosure will outweigh the public interest in disclosing this issue.

Independent Auditor's Report (Continued)

To the Supervisory Board and Shareholders of MF banka a.d. Banja Luka (continued)

Other matters

The financial statements of the Company for the year ended as of 31 December 2016 have been audited by another auditor, who expressed unmodified opinion in its report as of 23 March 2017.

Banja Luka, April 10, 2018

d.o.o. Grant Thornton Banja Luka

Grant Thornton d.o.o. Banja Luka

Aleksandar Džombić, PhD

Certified Auditor

STATEMENT OF PROFIT AND LOSS AND OTHER COMPREHENSIVE INCOME
Year Ended 31 December 2017
(Thousands of BAM)

	Note	Year Ended 31 December 2017	Year Ended 31 December 2016
Interest income	5	26.340	23.345
Interest expenses	6	(6.486)	(7.297)
Net interest income		19.854	16.048
Fee and commission income	7	4.127	3.623
Fee and commission expenses	8	(848)	(653)
Net fee and commission income		3.279	2.970
Other operating income	9	569	613
Other operating expenses	10	(10.737)	(10.118)
Foreign exchange (losses)/gains, net		(53)	19
Provisions for potential losses, net	11	(8.030)	(6.096)
Profit from operations before taxes		4.882	3.436
Income taxes	12	(619)	(475)
Net profit for the period		4.263	2.961
Other comprehensive income		-	-
Total comprehensive income for the period		4.263	2.961
Earnings per share			
Basic earnings per share (in BAM)	23	10,00	7,25

Notes on the pages 10 to 57 form an integral part of these financial statements.

These financial statements, prepared in accordance with International Financial Reporting Standards, were adopted by the Bank's Management on 23 February 2018.

Signed on behalf of MF Banka a.d., Banja Luka by:

MF banka AKCIONARSKO DRUŠTVO BANJA LUKA 1

Sandra Lonco
President of Management

Radana Štrkić
Head of Accounting and Reporting

STATEMENT OF FINANCIAL POSITION
Year Ended 31 December 2017
(Thousands of BAM)

	Notes	31 December 2017	31 December 2016
ASSETS			
Cash and cash funds held with the Central Bank	13	43.698	48.951
Loans and receivables due from banks	14	1.872	2.457
Loans and receivables due from customers	15	243.898	211.643
Property and equipment	16	6.290	6.114
Intangible assets	16	125	164
Interest accrued and other assets	17	3.936	2.280
Total Assets		**299.819**	**271.609**
LIABILITIES AND EQUITY			
Liabilities			
Deposits due to customers	18	216.017	198.407
Borrowings	19	18.442	18.189
Subordinated debt	20	6.845	6.845
Other liabilities	21	6.594	6.619
Provisions for employee retirement benefits and other contingent liabilities	11b)	169	144
Total liabilities		248.067	230.204
Equity			
Issued capital	22	46.841	40.841
Share premium		83	-
Equity reserves	22	25	-
Shortfall reserves for credit losses		62	62
Accumulated gains/(losses)		478	(2.459)
Net profit for the period		4.263	2.961
Total equity		51.752	41.405
Total liabilities and equity		**299.819**	**271.609**
Contingent liabilities and commitments	24	27.609	20.479

Notes on the pages 10 to 57 form an integral part of these financial statements.

STATEMENT **OF CHANGES IN EQUITY**
Year Ended 31 December 2017
(Thousands of BAM)

	Issued (Share) Capital	**Share Premium**	**Equity Reserves**	**Accumulated (losses) / gains**	**Total**
Balance, 1 January 2016	40.841	-	795	(3.191)	38.445
Loss absorption against reserves	-	-	(795)	795	-
Transactions with shareholders	-	-	*(795)*	*795*	-
Profit for the period	-	-	-	2.961	2.961
Other comprehensive income	-	-	-	-	-
Total comprehensive income for the period	-	-	-	*2.961*	*2.961*
Balance, 31 December 2016	**40.841**	**-**	**-**	**565**	**41.406**
Capital increase – new share issue	6.000	83	-	-	6.083
Reserves formed out of accumulated profit	-	-	25	(25)	-
Profit for the period	-	-	-	4.263	4.263
Other comprehensive income	-	-	-	-	-
Total comprehensive income for the period	-	-	-	4.263	4.263
31 December 2017	**46.841**	**83**	**25**	**4.803**	**51.752**

Notes on the pages 10 to 57 form an integral part of these financial statements.

STATEMENT OF CASH FLOWS
Year Ended 31 December 2017
(Thousands of BAM)

	Year Ended 31 December 2017	31 December 2016
Cash flows from operating activities		
Interest receipts	26.341	23.350
Fee and commission receipts	3.337	2.883
Interest paid	(7.047)	(6.923)
Fee and commission paid	(243)	(258)
Payments to employees and suppliers	(11.186)	(9.056)
Net cash generated by operating activities before changes in operating assets and liabilities	11.202	9.996
Changes in operating assets and liabilities		
Net increase in loans and receivables due from customers	(39.486)	(37.282)
Income taxes paid	(684)	(423)
Net decrease in deposits of banks	-	(1)
Net increase in deposits due to customers	17.542	35.641
Net cash generated by/(used in) operating activities	(11.426)	7.931
Cash flows from investing activities		
Purchase of intangible assets	(39)	(57)
Purchase of property and equipment	(656)	(5.043)
Net cash used in investing activities	(695)	(5.100)
Cash flows from financing activities		
Capital increase	6.083	-
Inflows from borrowings	6.856	9.508
Repayment of borrowings	(6.603)	(19.070)
Net cash (used in)/generated by financing activities	6.336	(9.562)
Net (decrease)/increase in cash and cash equivalents	(5.785)	(6.731)
Effects of the changes in foreign exchange rates	(53)	2
Cash and cash equivalents, beginning of the period	51.408	58.137
Cash and cash equivalents, end of the year	45.570	51.408
Cash and cash equivalents comprise the following line items:		
- Cash and cash funds held with the Central Bank	43.698	48.951
- Loans and receivables due from banks	1.872	2.457
	45.570	51.408

Notes on the pages 10 to 57 form an integral part of these financial statements.

1. BANK'S FOUNDATION AND BUSINESS POLICY

MF Banka a.d., Banja Luka (hereinafter the "Bank") was established on June 12, 2007 and named IEFK BANKA A.D. BANJA LUKA.

In the process of the Bank's registration, all requirements defined by the regulatory authorities with respect to the principal banking activities were fulfilled. In accordance with its Decision numbered 03-231-11/2007 of May 11, 2007, the Republic of Srpska Banking Agency (the "BARS" or "Agency") issued an operating license to the Bank, and pursuant to Decision numbered 03-657-4/2007 of July 12, 2007, the Agency issued to the Bank a license to conduct international payment transactions.

At the Shareholder Assembly meeting held on April 6, 2010, the previous owners of the Bank enacted a Decision to sell 100% of the Bank's equity (Note 22), where after an Agreement on the Purchase and Sale of Capital was signed on July 8, 2010 based on which the Bank's major shareholder became MKD Mikrofin d.o.o., Banja Luka, and as of that date this entity also assumed the management and control over the Bank.

Based on the decision enacted by the new owner of the Bank, and the decision of the competent court in Banja Luka as of November 26, 2010, the Bank changed its name into MF banka a.d., Banja Luka.

In the Republic of Srpska, the Bank is licensed to perform banking activities that include payment transfers, crediting and depositary operations in the country and abroad, and as in accordance with the Republic of Srpska banking legislation, the Bank is obligated to operate on the principles of liquidity, solvency and profitability.

The Bank is headquartered in Banja Luka, at no. 22 Vase Pelagića Street. As of 31 December 2017 the Bank had the central office Centar u Banja Luka and branch offices in Laktaši, Gradiška, Derventa, Brčko, Bijeljina, Doboj, Prijedor, East Sarajevo, Zvornik, Novi Grad, Teslić, Prnjavor, Pale, Tuzla, Bihać, Cazin, Gradačac and Živinice.

As of 31 December 2017 the Bank had 193 employees (December 31, 2016: 195 employees).

Governing bodies of the Bank consist of Bank's Assembly, Supervisory Board and Management. Mambers of the Supervisory Board are appointed by Bank's Assembly. Bank is represented by the President of Management.

The Bank established the Credit Comittee and the Asset and Liability Management Comittee.

As of 31 December 2017 the composition of governing bodies as follows:

Supervisory Board:

- Aleksandar Kremenović, president
- Mladen Bosnić, member
- Dželila Hadžović, member
- Freider Wohrmann, independent member
- Srećko Bogunović, independent member

Management:

- Sandra Lonco, president
- Dragan Đurić, member
- Bojan Luburić, member

Audit Committee:

- Đurđica Dragojević, president
- Željko Pena, member
- Radmila Bjeljac, member
- Sanja Brkić, member
- Mira Cvijan, member

Mambers of the Audit Committee are independent members.

2. BASIS OF PREPARATION AND PRESENTATION OF THE FINANCIAL STATEMENTS AND ACCOUNTING CONVENTION

2.1. Statement of Compliance

The accompanying financial statements are the annual stand-alone (unconsolidated) financial statements of the Company, prepared in accordance with International Financial Reporting Standards (IFRS).

2.2. Basis of Measurement and Preparation of the Financial Statements

The financial statements of the Bank have been prepared at cost (historical cost) principle except for certain fixed assets and financial instruments measured at revalued amounts or fair value at the end of each reporting period, as explained in the accounting policies provided in the following passages.

Historical cost is generally based on the fair value of consideration paid in exchange for goods and services.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between the market participants at the measurement date under current market conditions regardless of whether that price is directly observable or estimated using another valuation technique. Upon estimating the fair value of assets or liabilities, the Bank takes into account characteristics of assets or liabilities that other market participants would also consider upon determining the price of assets or liabilities at the measurement date.

The financial statements of the Bank were prepared in accordance with Rulebook on the Contents and Forms of Financial Statement for Banks and Other Organizations ("Official Gazzette of RS" No. 62/16) and in accordance with Rulebook on the Content and Form of Statements of Changes in Equity ("Official Gazzette" No. 63/16) within the prescribed deadline.

In preparation of statement of cash flows the Bank applied direct method of presenting the cash flows.

2.3. Functional and Presentation Currency

The figures in the accompanying financial statements have been stated in Convertible Marks (BAM), BAM being the official functional and reporting currency in Republic of Srpska and Bosnia and Herzegovina.

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2.4. Application and Impact of the New and Revised International Financial Reporting Standards ("IFRS") and International Accounting Standards ("IAS")

Initial Adoption of the New and Amendments to the Existing Standards Effective over the Current Period

The following standards and amendments to the existing standards issued by the International Accounting Standards Board (IASB) have been effective over the current period:

- IFRS 14 "Regulatory Deferral Accounts' (effective for annual periods beginning on or after 1 January 2017),
- Amendments to IAS 1 'Presentation of Financial Statements'– Disclosure Initiative (effective for annual periods beginning on or after 1 January 2017);
- Amendments to IFRS 11 "Joint Arrangements" – Accounting for Acquisitions of Interests in Joint Operations (effective for annual periods beginning on or after 1 January 2017);
- Amendments to IFRS 10 "Consolidated Financial Statements", IFRS 12 "Disclosure of Interests in Other Entities" and IAS 28 "Investments in Associates and Joint Ventures" – Investment Entities: Applying the Consolidation Exception (effective for annual periods beginning on or after 1 January 2017);
- Amendments to IAS 16 "Property, Plant and Equipment" and IAS 41 "Agriculture" – Agriculture: Bearer Plants (effective for annual periods beginning on or after 1 January 2017);
- Amendments to IAS 16 "Property, Plant and Equipment" and IAS 38 "Intangible Assets" – Clarification of Acceptable Methods of Depreciation and Amortization (effective for annual periods beginning on or after 1 January 2017);
- Amendments to IAS 27 "Separate Financial Statements" – Equity Method in Separate Financial Statements (effective for annual periods beginning on or after 1 January 2017); and

2. BASIS OF PREPARATION AND PRESENTATION OF THE FINANCIAL STATEMENTS AND ACCOUNTING CONVENTION (Continued)

- Amendments to various standards “Improvements to IFRSs (cycle 2012-2014)” resulting from the annual improvement project of IFRS (IFRS 5, IFRS 7, IAS 19 and IAS 34) primarily with a view to removing inconsistencies and clarifying wording (amendments are to be applied for annual periods beginning on or after 1 January 2017).
- Amendments to IAS 7 “Statement of Cash Flows” – Disclosure Initiative (effective for annual periods beginning on or after 1 January 2017);
- Amendments to IAS 12 “Income Taxes” – Recognition of Deferred Tax Assets for Unrealized Losses (effective for annual periods beginning on or after 1 July 2017).

2.4. Application and Impact of the New and Revised International Financial Reporting Standards (“IFRS”) and International Accounting Standards (“IAS”) (Continued)

Initial Adoption of the New and Amendments to the Existing Standards Effective over the Current Period (Continued)

- Amendments to various standards “Improvements to IFRSs (cycle 2014 - 2017)” resulting from the annual improvement project of IFRS (IFRS 1, IFRS 12 and IAS 28) primarily with a view to removing inconsistencies and clarifying wording (amendments to IFRS 12 are to be applied for annual periods beginning on or after 1 January 2017);

Adoption of these amendments to the existing standards has not led to any material changes in the Company’s accounting policies and financial statements.

(c) New Standards and Amendments to the Existing Standards in Issue, not yet Adopted

On the day of approval of these financial statements, the following Standards and Amendments to the existing Standards and the new Interpretation were issued but did not become effective:

- IFRS 9 “Financial Instruments” (effective for annual periods beginning on or after January 1, 2018);
- IFRS 15 “Revenue from Contracts with Customers” (effective for annual periods beginning on or after January 1, 2018);
- IFRS 16 “Leases” (effective for annual periods beginning on or after January 1, 2019);
- Amendments to IFRS 2 “Share-Based Payment” – Classification and Measurement of Share-Based Payment Transactions (effective for annual periods beginning on or after January 1, 2018);
- Amendments to IFRS 4 “Insurance contracts” – Applying IFRS 9 “Financial Instruments” with IFRS 4 “Insurance Contracts” (effective for annual periods beginning on or after January 1, 2018 where IFRS 9 “Financial Instruments” is applied for the first time);
- Amendments to IFRS 10 “Consolidated Financial Statements” and IAS 28 “Investments in Associates and Joint Ventures” – Sale or Contribution of Assets between an Investor and its Associate or Joint Venture and further amendments (effective date was deferred indefinitely until the research project on the equity method has been concluded);
- Amendments to IAS 40 “Investment Property” – Transfers of Investment Property (effective for annual periods beginning on or after January 1, 2018);
- Amendments to IFRS 1 and IAS 28 (effective for annual periods beginnig on or after 1 January 2018);
- IFRIC 22 “Foreign Currency Transactions and Advance Consideration” (effective for annual periods beginning on or after January 1, 2018).

IFRS 9, issued in November 2009 introduced new requirements in relation to classification and measurement of financial assets. Amendments to IFRS 9 as of October 2009 referred to classification and measurement of financial liabilities and derecognition of financial assets and financial liabilities, and amendments as of November 2013 referred to Hedge Accounting. In 2009 revised IFRS 9 was issued in order to include:
a) requirements for impairment of financial assets;
b)limited changes and amendments to the classification and introduction of a fair value category through the profit and loss statement for measurement of certain simple debt instruments.

2. BASIS OF PREPARATION AND PRESENTATION OF THE FINANCIAL STATEMENTS AND ACCOUNTING CONVENTION (Continued)

The key requirements of IFRS 9 are:

- All recognized financial assets that are within the scope of IAS 39 “Financial Instruments: Recognition and Measurement” are required to be subsequently measured at amortized cost or fair value. Specifically, debt investments that are held within a business model whose objective is to collect the contractual cash flows, and that have contractual cash flows that are solely payments of principal and interest on the principal outstanding are generally measured at amortized cost at the end of subsequent accounting periods. Debt instruments that are held within a business model whose objective is achieved both by collecting contractual cash flows and selling financial assets, and that hav.e contractual terms that give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding, are generally measured at fair value through other comprehensive income. All other debt investments and equity investments are measured at their fair value at the end of subsequent accounting periods. In addition, under IFRS 9, entities may make an irrevocable election upon initial recognition to measure an equity investment (that is not held for trading) at fair value through other comprehensive income, with only dividend income generally recognized in profit or loss.

2.4. Application and Impact of the New and Revised International Financial Reporting Standards (“IFRS”) and International Accounting Standards (“IAS”) (Continued)

- With regard to the measurement of financial liabilities designated as at fair value through profit or loss, IFRS 9 requires that the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability is presented in other comprehensive income, unless the recognition of the effects of changes in the liability's credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss. Changes in fair value attributable to a financial liability's credit risk are not subsequently reclassified to profit or loss. Under IAS 39, the entire amount of the change in the fair value of the financial liability designated as fair value through profit or loss is presented in profit or loss.
- In relation to the impairment of financial assets, IFRS 9 requires an expected credit loss model, as opposed to an incurred credit loss model under IAS 39. The expected credit loss model requires an entity to account for expected credit losses and changes in those expected credit losses at each reporting date to reflect changes in credit risk since initial recognition. In other words, it is no longer necessary for a credit event to have occurred before credit losses are recognized.
- The new general hedge accounting requirements retain the three types of hedge accounting mechanisms currently available in IAS 39. Under IFRS 9, greater flexibility has been introduced to the types of transactions eligible for hedge accounting, specifically broadening the types of instruments that qualify for hedging instruments and the types of risk components of non-financial items that are eligible for hedge accounting. In addition, the effectiveness test has been overhauled and replaced with the principle of an ‘economic relationship’. Retrospective assessment of hedge effectiveness is also no longer required.

In 2017, the Bank initiated the process of introducing IFRS. The effects of the application of IFRS 9 are explained in Note 29.3.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

3.1. Income and Expense Recognition from Interest

Interest income and expenses for all interest-bearing financial instruments, except for financial instruments classified as available for sale or carried at fair value through profit and loss, are stated at fair value of assets received or paid, and are presented as interest income or expenses, and fee and commission income or expenses in the statement of profit and loss and other comprehensive income.

Interest income is deferred and recognized using the effective interest method, which represents the rate that exactly discounts (reduces) the estimated future cash inflows over the expected life of financial instruments to the net carrying amount of such assets upon initial recognition.

Loan origination fees are deferred and amortized over the loan repayment period by applying the effective interest method and are presented within interest income

Interest income is recognized exclusively based on performing loans and other investments where there are no problems in collection, i.e., based on loans and investments that do not represent bad (impaired) assets. Calculations of interest receivables from non-performing loans and other investments, i.e. loans and investments that represent bad (impaired) assets as there are problems in collection thereof, are recorded within off-balance sheet items and recognized as income only if collected.

3.2. Foreign Exchange Translation

Transactions denominated in foreign currencies are translated into BAM at the official exchange rates prevailing at the date of each transaction. Assets and liabilities denominated in foreign currencies are translated into BAM at the statement of financial position date by applying the official rates of exchange in effect on that date. Contingent liabilities denominated in foreign currencies are translated into BAM at the official exchange rates prevailing at the statement of financial position date. Foreign exchange gains or losses arising upon translation are credited or charged to the statement of comprehensive income.

3.3. Property, Equipment and Intangible Assets

Items of property, equipment and intangible assets are recorded at cost net of any accumulated depreciation and amortization, and any accumulated impairment losses. Cost represents the prices billed by suppliers, increased by all acquisition-related costs and all costs incurred in bringing the assets to the location and condition necessary for their intended use.

Depreciation and amortization are calculated on a straight-line basis at the following prescribed annual rates in order to write off the assets over their estimated useful lives:

	Depreciation and Amortization Rate (%)	Useful Life (Years)
Computer equipment	25%	4
Automobiles	15,5%	6,5
Telephone switchboards	7%-10%	10-14,3
Buildings	1,3%	77
Furniture	10%-12,5%	8-10
Intangible Assets	20%	5

The Bank's management believes that the amortization and depreciation rates applied realistically reflect the expected patterns of future consumption of economic benefits from equipment and intangible assets.

The depreciation and amortization of assets commence when the assets are available for use and placed at the location and in condition necessary for them to operate in a manner intended by the Bank's management. If the useful life of an item of equipment is under a year, it is treated as tools or fixtures and is fully written-off once placed into use.

3.4. Impairment of Fixed Assets

At each statement of financial position date, the Bank's management reviews the carrying amounts of the Bank's equipment and intangible assets in order to determine the indications of impairment loss. If there is any indication that such assets have been impaired, the recoverable amount of the asset is estimated in order to determine the extent of impairment loss.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

3.4. Impairment of Fixed Assets (Continued)

In cases where it is impossible to assess the recoverable amount of an individual asset, the Bank assesses the recoverable value of the cash generating unit to which the asset belongs.

The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs to sell and its value in use. For the purpose of assessing value in use, estimated future cash flows are discounted to the present value by applying the discount rate prior to taxation reflecting the present market estimate of time value of cash and risks specifically related to the asset in question.

If the estimated recoverable amount of an asset (or cash generating unit) is below its carrying value, the carrying amount of the asset (or cash generating unit) is reduced to its recoverable amount. An impairment loss is immediately recognized as an expense of the current period.

When an impairment loss subsequently reverses, the carrying amount of the asset (or a cash-generating unit) is increased to the revised estimate of its recoverable amount, but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognized for the asset (or cash-generating unit) in prior years. A reversal of an impairment loss is recognized immediately in profit or loss, unless the relevant asset is carried at a revalued amount, in which case the reversal of the impairment loss is treated as a revaluation increase.

As of 31 December 2017, in the assessment of the Bank's management, there were no indications that the value of equipment and intangible assets had suffered impairment

3.5. Financial Assets

All regular way purchases or sales of financial assets are recognized and derecognized on a trade date basis, i.e. requiring delivery of assets within the time frame established by regulation or convention in the marketplace, and are initially measured at fair value including transaction costs. Financial assets are classified into the following specified categories: loans and receivables and financial assets available for sale. The classification depends on the nature and purpose of the financial assets and is determined at the time of initial recognition.

Effective Interest Method

The effective interest method is a method of calculating the amortized cost of financial assets and of allocating interest income over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash receipts through the expected life of the financial asset, or, where appropriate, a shorter period.

Income is recognized on an effective interest basis for debt instruments other than those financial assets classified as at fair value through profit and loss.

Financial Assets Available for Sale

Available-for-sale financial assets comprise investments in equity instruments of enterprises and other legal entities that are listed in an active market stated at fair value at the end of each reporting period. Investments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured are measured at cost. Gains and losses arising from the changes in the fair value directly affect the equity, i.e. the investment revaluation reserves, except for impairment losses, interest calculated using the effective rate method and foreign exchange gains or losses on monetary assets, which are recognized in profit and loss. When the investment is disposed of or is determined to be permanently impaired, the cumulative gain or loss previously accumulated in the investments revaluation reserve is reclassified to profit or loss.

The fair value of available-for-sale monetary financial assets denominated in a foreign currency is determined in that foreign currency and translated at the spot rate prevailing at the statement of financial position date. The foreign exchange gains and losses that are recognized in profit or loss and other comprehensive income are determined based on the amortized cost of the monetary asset. Other foreign exchange gains and losses are recognized within equity.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

3.5. Financial Assets (Continued)

Loans and Receivables

Loans and other receivables with fixed or determinable payments that are not quoted in an active market can be classified as loans and receivables. Loans and receivables are measured at amortized cost using the effective interest method, less any impairment. Interest income is recognized by applying the effective interest rate.

For the purpose of determining amortized cost, i.e. fair value of loans in accordance with IAS/IFRS, the Bank uses contractually agreed effective interest rate that adjusts the net present value of future cash flows to the nominal value of the loan approved, net of principal repaid.

Loans are contractually agreed with a variable interest rate according to the Bank’s business policy. The Bank receives as collaterals payment orders, guarantees, bills of exchange, mortgages assigned over property and pledge liens over movables, deposits and the like.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, monetary assets held with the Central Bank and balances on foreign currency accounts held with domestic and foreign banks and other deposits maturing within less than three months from the placement date.

Impairment of Financial Assets

Financial assets, other than those at fair value through profit and loss, are assessed for indicators of impairment at the end of each reporting period. Financial assets are considered to be impaired when there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows of the investment have been affected.

For equity investments not quoted in an active market and classified as available for sale, a significant or prolonged decline in the fair value of the security below its cost is considered to be objective evidence of impairment.

For all other financial assets, including redeemable securities classified as assets available for sale, and finance lease receivables, objective evidence of impairment could include:

- significant financial difficulty of the issuer or counterparty; or
- breach of contract, such as a default or delinquency in interest or principal payments; or
- it becoming probable that the borrower will enter bankruptcy or financial re-organization.

For certain categories of financial assets, such as trade receivables from loans approved, assets that are assessed not to be impaired individually are, in addition, assessed for impairment on a collective basis. Objective evidence of impairment for a portfolio of receivables could include the Bank's past experience of collecting payments, an increase in the number of delayed payments past the maturity dates, as well as observable changes in national or local economic conditions that correlate with default on receivables.

For financial assets carried at amortized cost, the amount of the impairment loss recognized is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the financial asset's original effective interest rate.

The carrying amount of the financial asset is reduced by the impairment loss directly for all financial assets with the exception of trade receivables, where the carrying amount is reduced through the use of an allowance account. When a trade receivable is considered uncollectible, it is written off against the allowance account. Subsequent recoveries of amounts previously written off are credited against the allowance account. Changes in the carrying amount of the allowance account are recognized in statement of profit and loss.

Except for securities available for sale, if, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized, the previously recognized impairment loss is reversed through statement of profit or loss to the extent that the carrying amount of the investment at the date the impairment is reversed does not exceed what the amortized cost would have been had the impairment not been recognized.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

3.5. Financial Assets (Continued)

Impairment of Financial Assets (Continued)

In respect of AFS equity securities, impairment losses previously recognized in statement of profit or loss are not reversed through statement of profit or loss. Any increase in fair value subsequent to an impairment loss is recognized within equity

Derecognition of Financial Assets

The Bank derecognizes a financial asset only when the contractual rights to the cash flows from the asset expire, or when it transfers the financial asset and substantially all the risks and rewards of ownership of the asset to another entity. If the Bank neither transfers nor retains substantially all the risks and rewards of ownership and retains control over a financial asset, it continues recognize such an asset.

3.6. Financial Liabilities

Financial liabilities comprise long-term and short-term trade payable and other liabilities.

Financial liabilities are initially recognized at the amounts received. Subsequent to the initial recognition, financial liabilities are measured at the initially recognized amounts net of principal repayment and increased by capitalized interest less any write-off granted by the creditor. Financial liabilities are stated at amortized cost using the effective interest rate. Interest accrued on financial liabilities is charged to finance of the respective period and presented within other current liabilities.

The Bank derecognizes financial liabilities when the Bank's obligations are discharged, cancelled or they have expired.

3.7. Taxes and Contribuions

Current Income Tax

Current income tax relates to the amount payable in accordance with the Income Tax Law. Current income tax is payable at the rate of 10% applied to the tax base determined in the taxa balance and reported in the annual corporate income tax return, being the amount of profit before taxation net of income and expense adjustment effects pursuant to the tax regulations of the Republic of Srpska.

The tax regulations in the Republic of Srpska allow for the reduction of the tax base for the amounts used in capital expenditures, for restoration of own manufacturing activity and for the amounts of the payroll taxes and contributions for over 30 newly employed staff members at the end of the financial year.

The tax regulations in the Republic of Srpska do not envisage that any tax losses of the current period be used to recover taxes paid within a specific carryback period. However, current period tax losses stated in tax return may be used to reduce or eliminate taxes to be paid in future periods but only for duration of no longer than five ensuing years.

Deferred Income Taxes

Deferred income tax is determined using the balance sheet liability method, for temporary differences arising between the tax bases of assets and liabilities components, and their carrying values in the consolidated financial statements. The currently enacted tax rates at the statement of financial position date are used to determine the deferred income tax amount. Deferred tax liabilities are recognized for all taxable temporary differences. Deferred tax assets are recognized for deductible temporary differences, and the tax effects of income tax losses and credits available for carry forward, to the extent that it is probable that future taxable profit will be available against which deferred tax assets may be utilized.

Indirect Taxes and Contributions

Indirect taxes and contributions include payroll contributions charged to the employer, property taxes, and various other taxes and contributions, included in other operating expenses.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

3.8. Employee Benefits

In accordance with regulatory requirements, the Bank is obligated to pay contributions to government social security funds and pension funds that are calculated by applying specific, legally prescribed percentages. These obligations involve the payment of taxes and contributions on behalf of employees, by the employer, in an amount calculated in accordance with the statutory regulations. The Bank is also legally obligated to withhold contributions from gross salaries to employees, and on behalf of its employees, to transfer the withheld portions directly to the applicable government funds. These taxes and contributions payable on behalf of the employees and employer are charged as expenses in the period in which they arise.

In accordance with the requirements of IAS 19 “Employee Benefits,” the Bank performs the actuarial valuation of provisions so as to determine the present value of accumulated employee retirement benefits. Upon retirement, the Bank’s employees become entitled to retirement benefits in an amount equal to three monthly salaries earned by the vesting employee.

Expenses of retirement benefits are determined using the projected unit credit method for actuarial valuation as of the reporting date.

3.9. Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all risks and rewards of ownership to the lessee. All other leases are classified as operating leases.

The Bank as a Lessor

Lease income from operating leases (rentals) is recognized in income on a straight-line basis over the lease term. Initial direct costs incurred by lessors in negotiating and arranging an operating lease are added to the carrying amount of the leased asset and recognized as an expense over the lease term on the same basis as the lease income.

The Bank as a Lessee

Lease payments under an operating lease are recognized as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user’s benefit. Contingent fees arising from operating leases are recognized as expenses in the periods in which they arise.

In the event that lease incentives are received to enter into operating leases, such incentives are recognized as a liability. The aggregate benefit of incentives is recognized as a reduction of rental expense on a straight-line basis, except where another systematic basis is more representative of the time pattern in which economic benefits from the leased asset are consumed.

3.10. Equity

Capital is not assessed and it is measured subsequently at the amount of funds paid on the basis of share issue. Capital is parsed as follows:

- Issued capital,
- Share premium,
- Retained earnings,
- Profit reserves,
- Revaluation reserves,
- Legally required reserves,
- Reserves for credit losses from regulated profit request,
- Loss.

4. SUMMARY OF SIGNIFICANT ACCOUNTING ESTIMATES

The presentation of the financial statements requires the Bank's management to make best estimates and reasonable assumptions that influence the assets and liabilities amounts, as well as the disclosure of contingent liabilities and receivables as of the date of preparation of the financial statements, and the income and expenses arising during the accounting period. These estimations and assumptions are based on information available to the management, as of the date of preparation of the financial statements. However, actual future amounts may depart from the estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimate is revised if the revision affects only that period or in the period of the revision and future periods if the revision affects both current and future periods.

Basic assumptions relating to the future events and other significant sources of uncertainties in rendering an estimate as of the statement of financial position date, which bears the risk that may lead to significant restatement of the net book value of assets and liabilities in the ensuing financial year, were as follows:

Estimated Useful Life of Equipment and Intangible Assets

The estimate of useful life of equipment and intangible assets is founded on the historical experience with similar assets, as well as foreseen technical advancement and changes in economic and industrial factors. The adequacy of the estimated remaining useful life of fixed assets is analyzed annually, or in cases where there are indications of significant changes in certain assumptions.

Impairment of Assets

At each statement of financial position date, the Bank's management reviews the carrying amounts of the Bank's assets for the indications of impairment loss. If there is any indication that such assets have been impaired, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss. If the recoverable amount of an asset is estimated to be less than its carrying value, the carrying amount of the asset is reduced to its recoverable amount.

Allowance for Impairment of Receivables

At each reporting date the bank assesses whether there is objective evidence that individual financial assets or groups of financial assets have suffered impairment. The Bank calculates the impairment of its receivables in accordance with IAS 39 "Financial Instruments: Recognition and Measurement" and IAS 37 "Provisions, Contingent Assets and Contingent Liabilities" as well as the regulations of the Banking Agency of the Republic of Srpska.

The management assesses that allowance for impairment of receivables in addition to the amount already recognized in the financial statements is not necessary.

At each month end, the Bank calculates impairment losses contingent on defaults and irrecoverability and provisions thereof by applying the following two methodologies:

1) methodology for calculation of the aforesaid provisions based on IAS 39 "Financial Instruments: Recognition and Measurement," used for internal and external reporting purposes of the Bank, and
2) methodology for calculation of the aforesaid provisions prescribed by the BARS and used exclusively for reporting to the regulator (BARS).

According to IAS 39 "Financial Instruments: Recognition and Measurement," the Bank reviews the loan portfolio in order to determine allowance for impairment and provisions on a monthly basis. When assessing whether impairment losses are to be recognized within statement of profit or loss, the Bank assesses whether there is information/evidence indicative of measurable decrease in the estimated future cash flows on a portfolio basis before such losses are identifiable on an individual basis.

Information that may indicate the losses on loans include customer creditworthiness, irregularity and defaults in settling liabilities, market and economic conditions on a local level conditioning defaults in settling liabilities and the like. Management's assessments regarding the impairment in financial instruments within the loan portfolio included in the Bank's portfolio by way of assessing future cash flows are based on actual historical losses incurred on financial assets with similar causes of impairment.
The Bank calculates impairment for all customers that are over 90 days in default with payments. The Bank recognizes impairment losses up to the amount of recoverable value of loans/investments measured at amortized cost.

4. SUMMARY OF SIGNIFICANT ACCOUNTING ESTIMATES (Continued)

Allowance for Impairment of Receivables (Continued)

Impairment loss is the difference between its present value (amortized cost) and its recoverable value. The recoverable value is the present value of expected cash inflows from assets, increased by the expected future inflows from collaterals, net of present value of collection charges.

Impairment losses are charged to the statement of profit and loss. The amounts of impairment losses on loans/ investments are reflected on the allowance account.

Where an impairment loss subsequently reverses due to events that emerged after its initial recognition, the reversal is credited to statement of profit and loss, but the amount of reversal may not exceed the amount of amortized cost that would have been determined and recognized as at the impairment reversal date had no impairment loss been previously recognized.

The Bank first assesses whether there is objective evidence of individual-level impairment for an individually significant asset or of group-level impairment for financial assets that are not individually significant. If the Bank determines that there is no objective evidence of individual-level impairment of a financial asset, whether it be significant or not, such an asset is included into a group of assets with similar credit risk characteristics and assessed for impairment collectively, i.e. on a group (portfolio) level.
According to the Bank's internal methodology for impairment allowance calculation, individually significant exposure is considered to be each exposure in excess of BAM 50 thousand. Other exposures, i.e. other Bank's receivables are subject to individual assessment for impairment due to the specificity of each individual receivable. The procedure of impairment assessment is performed for all receivables defined as materially significant by the internally adopted methodology. Materially significant amounts are amounts above:
- 1% of the individual Bank's receivable – private individual debtor, but not below BAM 20;
- 2,5% of the individual Bank's receivable – private individual debtor, but not below BAM 50;
- 2,5% of the individual Bank's receivable – private individual debtor, but not below BAM 500.

The Bank assesses whether a loan is individually significant for individually significant exposures (in excess of BAM 50 thousand) in default, i.e. those that are over 90 days past due. Based on the defined criteria the Risk Management Department finds loans eligible for individual assessment. After the review of such loans, the Risk Management Department proposes loans eligible for calculation of individual-level impairment allowance, and the remaining loans are referred to the portfolio-level assessment of impairment and calculation of impairment allowance.

The proposals made by the Risk Management Department are verified by the bank's Management.
Individual impairment allowance is calculated as the difference between the total exposure and the sum of discounted cash flows (from regular repayment and collateral foreclosure) for the specific borrower/exposure.

All loans and receivables that are not individually impaired are subject to group or portfolio-level assessment and calculation of impairment. Loans/borrowers are classified into homogeneous groups with identical or similar characteristics and subgroups depending on the number of days the repayment is in arrears and segment they belong to (and within MSME segment – depending on the product).

For all exposures included in the portfolio-level calculation of impairment allowance the exposure is divided into the secured and unsecured portion. The unsecured portion of loans is calculated as the difference between the total exposure and the recognized value of collateral. The Bank's internal methodology defines the weights for recognized value of collaterals, depending on the collateral type.

Portfolio-level impairment allowance is calculated as follows: an impairment allowance percentage defined for the specific group/subgroup of loans (obtained based on the data on the past 3 years' migration among groups) is applied to the unsecured portion of the exposure.

Fair Value

It is the policy of the Bank to disclose the fair values of those asset and liability components for which published market information is readily available, and for which their fair value is materially different from the recorded amounts. In the Republic of Srpska, there is insufficient market experience, stability and liquidity for the purchase and sale of financial assets or liabilities for which quoted prices on an active market are not presently, readily available. Hence, fair value cannot be reliably determined. The Bank's management assesses its overall risk exposure, and in instances in which it estimates that the value of assets stated in its books may not have been realized, it recognizes a provision. As per the Bank's management, amounts expressed in the financial statements reflect the fair value which is most reliable and useful for the needs of the financial reporting under the current circumstances.

4. SUMMARY OF SIGNIFICANT ACCOUNTING ESTIMATES (Continued)

Employee Benefits

The Bank's practice is to engage an independent certified actuary to calculate the present value of accumulated employee entitlements to retirement benefits on behalf of the Bank. In the calculation of the present value of accumulated employee entitlements to retirement benefits, the certified actuary used the following assumptions: the projected salary growth rate, years of service necessary for retirement, projected employee turnover based on data on historical employee turnover in the prior period, officially published mortality rates in the region in the prior period, as well as other terms necessary to exercise rights to a retirement benefit. In As per the Bank's management, amounts expressed in the financial statements reflect the fair value which is most reliable and useful for the needs of the financial reporting under the current circumstances.

5. INTEREST INCOME

	(Thousands of BAM) Period Ended 31 December	
	2017	**2016**
Interest income from:		
Retail customers	13.824	13.166
Corporate customers	12.471	10.095
Non-profit organizations	16	21
Public sector	3	1
Other	26	62
Total:	**26.340**	**23.345**

6. INTEREST EXPENSES

	(Thousands of BAM) Period Ended 31 December	
	2017	**2016**
Interest expenses:		
Retail customers	4.154	4.768
Non-banking financial institutions	972	971
Interest on subordinated debt	429	86
Interest on borrowings from banking institutions	409	1.000
Public sector	197	203
Non-profit organizations	164	121
Corporate customers	136	110
Other	25	38
Total:	**6.486**	**7.297**

7. FEE AND COMMISSION INCOME

	(Thousands of BAM) Period Ended 31 December	
	2017	**2016**
Fee and commission income from domestic and international payment transactions	2.417	1.961
Sale and purchase of currencies	770	737
Other loan fees	574	623
Fees for off-balance sheet operations	366	302
Total:	**4.127**	**3.623**

8. FEE AND COMMISSION EXPENSES

(Thousands of BAM)

	Period Ended 31 December 2017	2016
Fee and commission payable to the Central Bank for domestic payment transfers	328	168
Payment/credit card operation fees	266	208
Sale and purchase of currencies	96	101
Loan processing fees	42	93
Fee and commission expense from international payment transactions	34	24
Other fees and commissions	82	59
Total:	**848**	**653**

9. OTHER OPERATING INCOME

(Thousands of BAM)

	Period Ended 31. December 2017	2016
Collection of suspended interest written off	352	371
Other income	217	242
Total:	**569**	**613**

10. OTHER OPERATING EXPENSES

(Thousands of BAM)

	Period Ended 31 December 2017	2016
Gross salaries and benefits	5.581	5.213
Rental costs	721	740
Depreciation and amortization charge	602	580
Equipment/software maintenance	548	394
Telecommunication and postage services	451	485
Security services	416	412
Cost of materials and services	339	324
Marketing and advertising	284	145
Fees payable to the Banking Agency of RS	227	217
Taxes and contributions payable	179	165
Write-off of irrecoverable receivables	161	29
Remunerations to the Supervisory Board, Audit Committee	119	91
Membership fees	97	89
Representation Cost	88	79
Business trip expenses incurred in the country and abroad	34	95
Fees for third party engagements	31	11
Professional trainings and education of employees	29	41
Other operating expenses	830	1.008
Total:	**10.737**	**10.118**

11. PROVISIONS FOR POTENTIAL LOSSES

a) Provisions Included in Expenses, Net

(Thousands of BAM)

	Period Ended 31 December 2017	2016
Loans and receivables due from customers	(24.746)	(18.891)
Interest receivables accrued and other assets	(523)	(161)
Employee Benefits	(10)	-
Provision for litigation costs	(7)	-
Contingent liabilities and commitments	(466)	(568)
Total:	**(25.752)**	**(19.620)**

Reversal of Provisions Included in Income, Net

(Thousands of BAM)

	Period Ended 31 December 2017	2016
Loans and receivables due from customers	17.187	12.931
Interest receivables and other assets	77	46
Employee Benefits	10	1
Contingent liabilities and commitments	448	546
Total:	**17.722**	**13.524**
Provisions, Net	**(8.030)**	**(6.096)**

b) Movements for the Period on the Long-Term Provisions for Potential Losses and Commitments

(Thousands of BAM)

	Loans and Receivables due from Customers	Other Assets	Employee Benefits	Contingent Liabilities and Commitments	Total
Balance, 1 January 2016	7.385	206	27	96	7.714
Charge for the period	18.891	161	-	568	19.620
Reversal of provisions	(12.931)	(46)	(1)	(546)	(13.524)
Balance 31 December 2016	13.345	321	26	118	13.810
Charge for the period	24.746	523	10	473	25.752
Reversal of provisions	(17.187)	(77)	(10)	(448)	(17.722)
Balance 31 December 2017	20.904	767	26	143	21.840

12. INCOME TAXES

The income tax expense can be reconciled with the profit stated in statement of profit and loss as follows:

(Thousands of BAM)

	Period Ended 31 December 2017	2016
Profit before taxes	4.882	3.436
Income tax at the statutory rate of 10%	488	344
Tax reduction for tax exempt income	(789)	(624)
Expenses not recognized for tax purposes – impairment of loans and other assets	905	745
Other expenses not recognized for tax purposes	16	10
Prior years' tax losses carried forward	-	-
Deferred tax liability	(1)	-
Total current income tax expense	619	475
Effective tax rate	12,70%	13,82%

Effective tax rate

Tax liabilities are included in the Bank's income tax returns and accepted as such, but they can be subject to tax authorities' inspections within five years from their acceptance. The Bank's management is not familiar with any circumstances that could lead to any material liability in this respect or challenging the prepared income tax returns.

13. CASH AND CASH FUNDS HELD WITH THE CENTRAL BANK

(Thousands of BAM)

	31 December 2017	31 December 2016
Cash on hand:		
- in BAM	3.490	2.530
- in foreign currency	2.136	2.225
Balances with the Central Bank in BAM:		
- Obligatory reserve	24.363	22.262
- Gyro account	13.572	21.934
- Foreign currency	137	-
Total:	**43.698**	**48.951**

Pursuant to the Decision of the Central Bank of Bosnia and Herzegovina regarding reserve requirements, the Bank has to calculate and maintain an obligatory reserve of the average balance of the Bank's total deposits (which serve as a basis for computing the obligatory reserve) according to the average balance found at the end of work days of ten calendar days preceding the projection. The obligatory reserve is calculated as the sum of 10% of the total deposits maturing within a year and with over one year maturities. The basis for computing the obligatory reserve includes calculated interest, fees and commissions due and matured.

14. LOANS AND RECEIVABLES DUE FROM BANKS

(Thousands of BAM)

	31 December 2017	31 December 2016
Loans and receivables due from banks:		
- domestic banks	1.118	934
- foreign banks	754	1.523
Total:	1.872	2.457

15. LOANS AND RECEIVABLES DUE FROM CUSTOMERS

(Thousands of BAM)

	31 December 2017	31 December 2016
Short-term BAM loans	47.072	42.285
Long-term BAM loans	144.958	122.176
Guarantees paid out in foreign currencies	71	62
Current portion of long-term loans	72.701	60.465
	264.802	**224.988**
Less: Impairment allowance of loans and receivables due from customers	(20.904)	(13.345)
Total:	**243.898**	**211.643**

As of 31 December 2017 the major portion of the placed loans related to long-term loans, and smaller portion of the placed loans related to short term loans,at annual interest rates ranging from 6,50% to 15,50%. Loans were securitized with deposits, pledge liens assigned over movables and mortgages assigned over property, sureties, injuctions, bills of exchange and collection of authorisations. Organizational part of the Bank for risks continuously monitors the market value of collaterals.

Most long-term loans in BAM as of 31 December 2017 were extended to corporate and retail customers at annual interest rates ranging from 8,00 % to 15,50% plus 6-month EURIBOR, for periods of 5 years in most cases up to the maximum of 10 years. The minimum interest rate of 2,00% was approved to the customers with a 100% earmarked term deposit placed with the Bank as collateral, while the interest rates higher than 15,50% refer to the short-term loans assumed from MKD Mikrofin d.o.o. Banja Luka.

Most long-term loans in BAM as of 31 December 2016 were extended to corporate and retail customers at annual interest rates ranging from 2,00 % to 15,50 % plus 6-month EURIBOR, for periods of 5 years in most cases up to the maximum of 10 years in rare cases, with respective minimum and maximum interest rates of 2,00% and 15,50% plus 6-month EURIBOR. The interest rate of 2,00% was approved to the corporate customers with a 100% earmarked term deposit placed with the Bank as collateral, while the minimum interest rate of 2,50 % was approved to the retail customers, with a 100% earmarked term deposit placed with the Bank as collateral. The aforesaid loans were securitized mostly with high quality collaterals such as mortgages and pledge liens assigned over movables.

In 2016 the Bank approved loans from the funds of the Investment and Development Bank of the Republic of Srpska (“IDB RS“) for periods of over 10 and up to 20 years in accordance with the rules of IDB RS.

The largest portion of long-term loans approved to retail customers included general consumer loans, housing loans for purchase and construction and adaptation of homes, while the corporate long-term loans were intended for financing capital expenditures, investments and working capital.

As of 31 December 2017, the geographic concentration of loans approved to customers as included in the Bank’s loan portfolio mostly comprises customers domiciled in the City of Banja Luka (about 15,72% of the total portfolio), East Sarajevo Region (about 10,18 %), Derventa Region (5,97 %), Bijeljina Region (about 6,7 %), Brčko District (about 6,07%) and Prijedor Region (about 6,00 %).

As of 31 December 2016 the geographic concentration of loans approved to customers as included in the Bank’s loan portfolio mostly comprises customers domiciled in the City of Banja Luka (about 15,2% of the total portfolio), East Sarajevo Region (about 8,4%), Derventa Region (6,9%), Bijeljina Region (about 5,2%), Brčko District (about 5,9%) and Prijedor Region (about 5,9%).

16. PROPERTY, EQUIPMENT AND INTANGIBLE ASSETS

(Thousands of BAM)

	Leasehold Improvements	Buildings	Equipment	Equipment in Progress	Total Property and Equipment	Total Intangible Assets
Cost						
Balance,1 January 2016	306	-	2.676	2	2.984	994
Additions	8	4.834	202	(1)	5.043	57
Transfers	-	-	6	-	6	(6)
Disposals	-	-	(114)	-	(114)	(34)
Balance, 31 December 2016	314	4.834	2.770	1	7.919	1.011
Additions	223	-	502	7	732	39
Disposals	(11)	-	(72)	-	(83)	-
Balance, 31 December 2017	526	4.834	3.200	8	8.568	1.050
Accumulated Depreciation/Amortization						
Balance, 1. January 2016	117	-	1.303	-	1.420	784
Depreciation	60	36	386	-	482	98
Disposals	-	-	(97)	-	(97)	(35)
Balance, 31 December 2016	177	36	1.592	-	1.805	847
Depreciation	64	63	398	-	525	78
Disposals	(7)	-	(45)	-	(52)	-
Balance 31, December 2017.	234	99	1.945	-	2.278	925
Corrections	17	-	(17)	-	-	-
Balance as of 31 December 2017	251	99	1.928	-	2.278	925
31 December 2016	**137**	**4.798**	**1.178**	**1**	**6.114**	**164**
31 December 2017	**275**	**4.735**	**1.272**	**8**	**6.290**	**125**

As of December 31, 2017 the Bank's property and equipment were insured against general risks. The Bank had no encumbrances or pledges assigned over its property and equipment.

17. ACCRUED INTERESTS AND OTHER ASSETS

(Thousands of BAM)

	31 December 2017	31 December 2016
In BAM:		
- inventories of materials	1.416	548
- accrued receivables for calculated interest	1.175	1.054
- receivables purchased	1.101	246
- other prepaid expenses	170	130
- fee and commission receivables	65	80
- advances paid	6	6
- other receivables	651	403
- deferred tax	1	-
In foreign currencies:		
- accrued receivables for calculated expenses	60	104
- other foreign currency receivables	47	19
- foreign currency advances paid	11	11
	4.703	**2.601**
Less: Impairment allowance of accrued interest and other assets	(767)	(321)
Total:	**3.936**	**2.280**

18. DEPOSITS DUE TO CUSTOMERS

(Thousands of BAM)
18.

	31 December 2017	31 December 2016
Demand deposits in BAM:		
- government and state institutions	749	95
- corporate customers	8.760	4.741
- non-profit organizations	853	1.095
- non-banking financial institutions	7.252	9.859
- retail customers/non-residents	16.468	11.824
- other customers	73	163
	34.155	**27.777**
Demand deposits in foreign currency:		
- corporate customers	1.387	678
- non-profit organizations	340	173
- non-banking financial institutions	3.101	154
- retail customers/non-residents	5.911	4.146
- other customers	4	3
	10.743	**5.154**
Short-term demand deposits in BAM:		
- government and state institutions	622	-
- corporate customers	1.141	900
- non-banking financial institutions	25.387	18.547
- retail customers	214	219
Other	36	30
	27.400	**19.696**
Short- term deposits in foreign currencies:		
- retail customers	265	382
	265	**382**
Long- term deposits in BAM:		
- government and state institutions	7.250	7.950
- corporate customers	1.406	1.417
- non-profit organizations	3.661	2.627
- non-banking financial institutions	17.948	17.088
- retail customers	37.722	38.513
- other	650	700
	68.637	**68.295**
Long term deposits in foreign currencies:		
- corporate customers	2.231	2.427
- non-banking financial institutions	2.065	1.565
- retail customers/non-residents	69.348	71.938
- non-profit organizations	1.173	1.173
	74.817	**77.103**
Total:	**216.017**	**198.407**

18. DEPOSITS DUE TO CUSTOMERS (continued)

	31 December 2017	31 December 2016
Long-term portion of long-term deposits in BAM		
- government and state institutions	200	3.200
- corporate customers	695	652
- non-profit organizations	3.227	5
- non-banking financial institutions	6.580	9.048
- retail customers/non-residents	16.387	14.174
- other customers	-	-
	27.089	**27.079**
Foreign currency long-term portion of long-term deposits		
- corporate customers	1.173	2.427
- non-banking financial institutions	2.065	-
- retail customers	30.785	30.562
- non-profit organizations	1.173	-
	35.169	**32.989**
BAM current portions of long-term deposits		
- government and state institutions	7.050	4.750
- corporate customers	711	765
- non-profit organizations	434	2.622
- non-banking financial institutions	11.368	8.040
- retail customers/non-residents	21.331	24.335
- other customers	650	700
	41.544	**41.212**
Foreign currency current portions of deposits		
- corporate customers	1.058	-
- non-banking financial institutions	-	1.565
- retail customers	38.590	41.376
- non-profit organizations	-	1.173
	39.648	**44.114**

As of 31 December 2017 demand deposits of corporate entities and entrepreneurs in BAM and foreign currencies accrued interest at the rate between 0,00% and 0,20 % annually(as of 31 December 2016 the interest is calculated between rate of 0,00% and 1,50 %). The Bank annually applies the straight-line interest method.

As of 31 December 2017 interest on demand savings deposits of retail customers and transaction accounts in BAM is calculated at the annual rate of 0,10% using compound interest method calculation (as of 31 December 2016, the Bank calculated interest at the rate of 0,10 %, annually, using the compound method). Retail demand deposits in other currencies do not accrue interest.Savings demand deposits – open savings in BAM and EUR the Bank accrued interest at the rate of 0,80 % annually using the simple interest method calculation (as of 31 December 2016, the Bank calculated interest at the rate of 1,50%).

Short-term deposits of corporate entities and entrepreneurs in BAM and EUR were placed at the interest rates ranging from 0,50% to 1,5% annually (as of 31 December 2016 short-term deposits of corporate entities and entrepreneurs in BAM and EUR were placed at the interest rates ranging from 0.00% to 5.07% annually).As of 31 December 2017, short-term deposits of retail customers in BAM and EUR were placed at the annual interest rates from 0,10% to 1,50% (as of December 31, 2016 short-term deposits of retail customers in BAM and EUR were placed at the annual interest rates from 0,60% to 1,80 %.)

As of 31 December 2017 long-term deposits of corporate customers and entrepreneurs in BAM and EUR were placed at the interest rates ranging from 1.80 % to 2.65% annually (certain earmarked deposits were placed as collaterals to securitize loan repayment and contractually defined as non-interest bearing). As of December 31, 2016 the Bank calculated interest at the annual rate between 2.80% and 3.80%.

As of 31 December 2017 long-term deposits of retail customers in BAM and EUR were placed at the interest rates ranging from 2.15% to 2.80% annually (as of 31 December 2016 the Bank calculates interest at the annual rate ranging from 3.00% and 4.20%).

18. DEPOSITS DUE TO CUSTOMERS (continued)

The Bank applies the compound interest method on term deposits, whereas simple interest method calculation is applied to earmarked deposits, all in accordance with the specific contractually agreed terms.

Depending on the market conditions, and in cases of particular significance for the Bank, the management may enact specific decisions on the implementation of interest rates up to 1 percentage point higher than the interest rates defined by the Bank's internal laws.

19. BORROWINGS

(Thousands of BAM)

	31 December 2017	**31 December 2016**
In BAM:		
- RS Development and Employment Fund	5.235	3.450
- RS Housing Fund	7.345	6.549
- Fund for Development of Eastern Region of RS	4.744	2.881
Total in BAM:	**17.324**	**12.880**
In foreign currencies:		
- EFSE	-	1.956
- IFC	1.118	3.353
Total foreign currencies:	**1.118**	**5.309**
Total non-current portion:	**18.442**	**18.189**
Current portions:		
- EFSE	-	1.956
-IFC	1.118	2.235
- IRB	1.947	1.410
Total current portion of long-term liabilities:	**3.065**	**5.601**

As of 31 December 2017, the total balance of funds received from the funds managed by the Investment and Development Bank of RS amounted to BAM 17,324 thousand (as of December 31, 2016 12,880 thousand BAM).

The Bank entered into loan agreements with foreign creditors at the following terms:

IFC; as of September 30, 2014: loan amount EUR 4 milion – loan repayment period: 4 years with a one- year grace period; interest rate applied: EURIBOR or LIBOR plus maximum markup of 4,75%

The borrowed funds are intended for financing loans to customers for the following purposes: purchase of property, plant and equipment, financing working capital, investments, startup micro, small and medium-sized enterprises and entrepreneurs. Pursuant to the loan agreements entered into with creditors, the Bank is obligated to comply with certain procedures and accounting records that adequately reflect the Bank's operations in accordance with IAS and IFRS and certain financial covenants.

As of 31 December 2017 the Bank achieved full compliance with financial covenants agreed with the IFC creditor.

20. SUBORDINATED DEBT

(Thousands of BAM)

	31 December 2017	**31 December 2016**
EFSE, Luxembourg	6.845	6.845
Total	6.845	6.845

20. SUBORDINATED DEBT (continued)

In its Decision no. 03-1515-3/16 dated October 7, 2016, ABRS period amountedapproved of inclusion of subordinated debt into the Bank's supplementary capital in the amount of BAM 6,845 thousand.

On October 13, 2016 the Bank and EFSE, Luxembourg executed an agreement on subordinated debt amounting to BAM 6.845 thousand, for the period of 6 years, with one-off repayment at an interest rate of 6.2 % annually intended for strengthening the Bank's total capital.

The amount of the loan was transferred into account of the Bank on the October 21, 2016.

As of 31 December 2017 the Bank was not in breach of any financial Banka convenants agreed with EFSE, Luxembourg.
Costs of interest on subordinated debt for the period amounted BAM 429 thousand.

21. OTHER LIABILITIES

(Thousands of BAM)

	31 December 2017	**31 December 2016**
In BAM:		
- accrued interest liabilities	1.031	1.348
- deferred income	2.015	1.852
- trade payable	451	172
- other liabilities	856	671
In foreign currencies:		
- trade payable	22	18
- accrued interest liabilities	2.204	2.555
- other liabilities	15	3
Total:	**6.594**	**6.619**

Deferred income in BAM totaling BAM 2,015 thousand as of 31 December 2017 (as of December 31, 2016 was BAM 1.852 thousand) mostly relates to the loan processing fees collected in advance from customers.

Accrued interest liabilities amounting to BAM 1,031 thousand as of 31 December 2017 (as of December 31, 2016 amounting to BAM 1,348) mostly refer to the accrued interest payable per term deposits (BAM 1,007 BAM thousand) and, in a smaller amount, to accrued interest for IRB borrowings (BAM 24 thousand).

Accrued interest liabilities in foreign currencies amounting to BAM 2,204 thousand as of 31 December 2017 mostly refer to the accrued interest payable per retail customers' term deposits (BAM 2,081 thousand) and, in a smaller amount, to accrued interest for borrowings (BAM 4 thousand) and liabilities for subordinated debt (BAM 119 thousand).

As of December 31, 2016 accrued interest liabilities in foreign currencies amounted BAM 2,555 thousand mostly refer to the accrued interest payable per retail customers' term deposits (BAM 2,432 thousand), in a smaller amount, to accrued interest for borrowings (BAM 38 thousand) and liabilities for subordinated debt (BAM 85 thousand).

22. EQUITY

Issued Capital- Share Capital

The share capital of the Bank was formed from the initial investments of shareholders and the subsequent capital increase - share subscriptions paid in cash. The Bank's share capital as of 31 December 2017 totaled BAM 46,841 thousand (as of December 31, 2016 it totaled BAM 40,841 thousand) and was comprised of 468,410 shares (408,410 shares) with the par value of BAM 100 per share.

In 2017 Bank's capital increased , whereby the ownership structure of the Bank's capital was changed and, according to the excerpt provided by the Central Registry of Securities of the Republic of Srpska as of 31 December 2017, was as follows

22. EQUITY (continued)

	Share Count	BAM '000	%
MKD Mikrofin d.o.o., Banja Luka	366.956	36.696	78,34
Nederlandse Financierings - Maatschappij voor Ontwikkelingslanden N.V. (hereinafter: FMO). Netherlands	54.195	5.419	11,57
KfW. Germany	47.259	4.726	10,09
	468.410	46.841	100,00

The ownership structure as of 31 December 2016 was as follows:

	Share Count	BAM '000	%
MKD Mikrofin d.o.o., Banja Luka	313.892	31.389	76,86
KfW. Germany	47.259	4.726	11,57
Nederlandse Financierings - Maatschappij voor Ontwikkelingslanden N.V. (hereinafter: FMO). Netherlands	47.259	4.726	11,57
	408.410	40.841	100,00

Equity Reserves

Equity reserves totaling BAM 25 thousand were formed by allocations from profit in accordance with the the Assembly's Decision NO-60/2017 dated April 26, 2017 on behalf of legal reserves.

23. EARNINGS PER SHARE

(Thousands of BAM)

	31 December 2017	31 December 2016
Net profit for the period	4.263	2.961
Weighted average number of shares outstanding	426.163	408.410
Basic earnings per share (in BAM)	10,00	7,25

Given the fact that the Bank has no potentially diluting ordinary shares such as convertible debt and share options, the Bank does not calculate diluted earnings per share.

24. CONTINGENT LIABILITIES AND COMMITMENTS

a) Payment guarantees, performance bonds and other irrevocable commitments

(Thousands of BAM)

	31 December 2017	31 December 2016
Payment guarantees	7.524	6.144
Performance bonds	5.765	4.835
Irrevocable commitments for undrawn loans	8.453	3.520
Unused account overdrafts and credit card facilities	5.867	5.980
Total	**27.609**	**20.479**

24. CONTINGENT LIABILITIES AND COMMITMENTS (continued)

As of 31 December 2017, provisions for potential losses per off-balance sheet items totaled BAM 143 thousand (as of December 31, 2016: BAM 118 thousand, note 11 b).

b) Litigation

As of 31 December 2017 the Bank was involved in 563 legal suits filed against its debtors in attempts to collect receivables matured. The total value of claims in these proceedings received by the Legal Service of Forced Collection aggregated to BAM 12,101 thousand.

As of 31 December 2017 there were 9 lawsuits filed against the Bank. Given the nature of these lawsuits, the Committee for Assessing the Risk of Litigation Losses stated that the Bank's performance in all the above mentioned disputes is estimated at over 50 %. In accordance with the Procedure for Assessing the Bank's Success and Determining Provisions for Proceedings against "MF Banka" a.d. Banja Luka provisions for potential litigation losses ought to be made in the amount of 2% of the claim amount. The proposal of the Committee was confirmed under Management Board's Decision no. 216/2017 dated 28 June 2017.

c) Regulatory Compliance

The Bank is obligated to reconcile the volume of its business operations with the legally prescribed adequacy and performance ratios, that is to maintain the scope and structure of its assets in compliance with the accounting standards and regulations of the Republic of Srpska, established and controlled by the Banking Agency of the Republic of Srpska.

As of 31 December 2017 Bank was in full compliance with the accounting standards and regulations of the Republic of Srpska, established and controlled by the BARS per all the prescribed ratios.

25. RELATED-PARTY TRANSACTIONS

(Thousands of BAM)

Statement of Financial Position	**31 December 2017**	**31 December 2016**
Assets:		
-Loans and receivables due from the Bank's management and employees	3.358	340
Prepaid insurance costs :		
- Mikrofin osiguranje a.d., Banja Luka	-	2
Prepaid license fee:		
- MF Software d.o.o., Banja Luka	-	5
Interest claims	2	-
Accrued interest	2	1
Total assets	**3.362**	**348**
Liabilities:		
- Transaction accounts of the Bank's Supervisory Board members and management	1.239	792
- Other related private individuals	1.598	1.192
	2.837	1.984
Trade payable:		
- MF Software d.o.o., Banja Luka	88	14
- MKD Mikrofin d.o.o., Banja Luka (parent company)	11	-
Other liabilities:		
-Drvex d.o.o., Laktaši	4	5
Interest payable:		
- Mikrofin osiguranje a.d., Banja Luka	9	-
- Citizens Association Mikrofin	1	-
- Related party transactions	90	73
Balance of deposits placed by related parties:		
- MKD Mikrofin d.o.o., Banja Luka (parent company)	6.288	3.741
- MF Software d.o.o., Banja Luka	78	72
- Mikrofin osiguranje a.d., Banja Luka	5.593	4.687
- Citizens Association Mikrofin	758	827
- Zepter fond	2.500	5.500
- Drvex d.o.o Laktaši	143	167
	15.360	14.994
Total liabilities	**18.400**	**17.070**
Liabilities net	**(15.038)**	**(16.722)**

25. RELATED PARTY TRANSACTIONS (continued)

(Thousands of BAM)

	Period Ended	
Statement of profit and loss	**31 December 2017**	**31 December 2016**
Income		
Fee income:		
- MKD Mikrofin d.o.o. Banja Luka	379	423
- Mikrofin osiguranje a.d. Banja Luka	12	15
- MF SOFTWARE d.o.o. Banja Luka	1	1
- Drvex d.o.o. Laktaši	6	5
-Other	-	1
- Other related parties	15	7
Rental income	86	50
Interest income from other related parties	53	22
Total income	**552**	**524**
Expenses		
Rental costs– MKD Mikrofin d.o.o. Banja Luka	(29)	(117)
Rental costs – Drvex d.o.o. Laktaši	(16)	(16)
Rental costs – Mikrofin osiguranje a.d. Banja Luka	(51)	(51)
Software lease - MF SOFTWARE d.o.o. Banja Luka	(115)	(117)
License costs - MF SOFTWARE d.o.o. Banja Luka	(66)	(62)
Insurance expenses- Mikrofin osiguranje a.d. Banja Luka	(139)	(143)
Cost of office supplies	-	(3)
Fixed assets maintenance cost	(114)	(33)
Cost of intellectual services	-	(129)
Employee professional trainings	-	(1)
Interest expenses:		
- Mikrofin osiguranje a.d. Banja Luka	(107)	(167)
- Association of Citizens Mikrofin	(18)	(23)
-Zepter fond	(106)	(207)
- Bank's management	(18)	(23)
- Other related parties	(53)	(71)
Remunerations to the members of the Supervisory Board and Bank's management	(1.654)	(250)
Total expenses	**(2.486)**	**(1.413)**
Expenses, net	**(1.934)**	**(889)**

26. TAXATION RISKS

The Republic of Srpska and Bosnia and Herzegovina currently have several tax laws in effect, as imposed by various governmental agencies. The applicable taxes include: a value added tax, corporate income tax, and payroll (social) taxes, among others. Following their introduction, the regulations governing these taxes were not enforced for substantial periods of time; in contrast to similar legislation in more developed market economies. Moreover, the regulations defining the implementation of these laws are often unclear or non-existent. Consequently, with regard to tax issues, there is a limited number of cases that can be used as an example. Often, contrary opinions pertaining to legal interpretations exist both among, and within, governmental ministries and organizations, thus creating uncertainties and areas of legal contention.Tax returns, together with other legal compliance matters (e.g., customs and currency control matters) are subject to the review and investigation by a number of authorities that are legally enabled to impose extremely severe fines, penalties and interest charges.
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The interpretation of tax legislation by tax authorities as applied to the transactions and activity of the Bank may not coincide with that of the management. As a result, transactions may be challenged by tax authorities and the Bank may be assessed additional taxes, penalties and interest, which can be significant. In accordance with the Law on Tax Authority of the Republic of Srpska, expiration period of the tax liability is five years. This practically means that tax authorities could determine payment of outstanding liabilities in the period of five years from the origination of the liability. The afore-described situation creates tax risks in the Republic of Srpska and Bosnia and Herzegovina that are substantially more significant than those typically existing in countries with more developed tax systems.

27. CURRENT ECONOMIC SITUATION AND ITS IMPACT ON THE BANK

During 2017 the Bank’s operations were under the impact of the global economic and financial crisis and significantly reduced economic activity in Bosnia and Herzegovina. However, in the course of 2017 the Bank had no liquidity problems despite the significant lending activity.

So far, the ongoing financial crisis has had a limited impact on the financial position and performance of the Bank, mainly due to the internal risk management policies and regulatory restrictions. In a timely manner the Bank took a number of measures to prevent risk deterioration such as:

- revision of loan approval policies and procedures, credit risk assessment and risk management policies and procedures;
- adjustment of product and service mix to the needs of customers and to the structure of the available resources;
- approval of loan rescheduling in order to adjust repayment to the actual and realistic customers’ sources of financing; and
- revaluation of collaterals upon loan re-approval and restructuring/rescheduling.

The Bank closely monitors the credit, liquidity, interest rate and foreign exchange risks on an ongoing basis. The management expects that the Bank’s liquidity will be satisfactory in the forthcoming period as well.

The economic situation in the country will probably impact the position of certain industries and the ability of certain customers to discharge their liabilities per borrowings obtained from the Bank. This may consequently influence the amount of the Bank’s provisions for impairment losses after 31 December 2017, and other areas that require estimates to be made by management, including the valuation of collaterals and of securities. The Bank’s financial statements contain significant estimates with respect to impairment losses and asset and collateral valuation. The key priority of the Bank after 31 December 2017 will be attention to the management of the financial portfolio adjusting to the changing economic environment.

28. COMMITMENTS FOR LEASE OF BUSINESS PREMISES

The Bank's commitments arising from cancellable agreements on the lease of business premises were as follows:

(Thousands of BAM)

	31 December 2017	**31 December 2016**
Within a year	29	34
From 1 to 5 years	1.543	623
Over 5 years		-
Total:	1.572	657

29. FINANCIAL INSTRUMENTS

29.1. Financial Risk Management

The Bank is exposed to various types of financial risks based on its activities which include, but are not limited to, analyzing, assessing, assuming a certain level of risk or combination of risks, as well as managing these risks. Assumption of risks is inherent in financial business, while operational risks accompany any business. The Bank aims to strike a balance between risks assumed and return on its investments, and to minimize potential adverse effects of these risks on the Bank’s financial result.

The Bank’s risk management policies are used to identify and analyze these risks, to establish adequate limitations and controls, to review risks and to observe the limitations set by the reliable and updated information systems. The Bank regularly reexamines its risk management policies and systems, making sure that these respond to the changes on the market, changes of products and new best practices.

The Bank has the risk management system in place in order to be able to identify, estimate and monitor risks it exposed to in its operations in a timely manner.

The organizational structure of risk management in the Bank is set up in accordance with the Law on Banks of the Republic of Srpska and effective BARS decisions.

29. FINANCIAL INSTRUMENTS (continued)

29.1. Financial Risk Management (continued)

The Supervisory Board

The Bank's Supervisory Board is responsible for defining the Bank's overall risk management strategy and capital management strategy as well as risk management policy and for supervision of risks assumed by the Bank in its regular activities.

The Supervisory Board adopts the program, policies and procedures for risk identification, measurement assessment and management. The Supervisory Board is to ensure full compliance of the Bank with the defined strategy and adopted policies and procedures.

The Supervisory Board is also in charge of large exposure risks (whether it be to a single entity or a group of related entities), and decides on approval of all requests for risk-weighted products of the Bank (at the proposal of the Bank's Credit Committee) in excess of BAM 1,000,000 of individual exposure and in excess of BAM 1,500,000 of total exposure (to a single entity and a group of related entities, respectively).

The Supervisory Board appoints members of the Bank's Credit Committee and relieves them of duty.

The Management

The Bank's Management of the Bank is responsible for creation of proposals for developing programs, policies and procedures for risk identification, measurement, assessment and management and timely submission of such proposals to the Supervisory Board.

The Management is also responsible for implementation of the defined risk management strategy and capital management strategy as well as the Bank's risk management policies.

The Management oversees the work of all lower management levels within the Bank and controls the implementation of the adopted policies and procedures. The Management monitors the trends and analyzes risk management at least quarterly and regularly informs the supervisory Board thereof. In instances certain activities are not defined by the strategy or policy, the Bank's Management is obligated to notify the Supervisory Board thereof.

The Credit Committee

Within the defined crediting policy of the Bank, the Bank's Credit Committee makes decisions on loans from BAM 200 thousand to BAM 1,000 thousand of exposure to a single entity and loans totaling between BAM 300 thousand and BAM 1,500 thousand of total exposure to a single entity or a group of related entities. Decisions on loans below the aforesaid amounts falls under remit of Credit Committees of branches or Heads of Branches.

The Risk Management Department

The Risk Management Department plays key role in identification, measurement, assessment and management of risks assumed by the Bank in the regular course of business. The Risk Management Department is under obligation to express opinions in writing on all loan requests in excess of BAM 150 thousand, or in excess of BAM 200 thousand. An opinion of the Risk Management Department is an integral part of the loan proposal, i.e. loan case to be discussed by the Credit Committee.

As a member of the Bank's Credit Committee, the Manager of the Risk Management Department can exercise its veto power upon deciding on loans discussed by the Bank's Credit Committee. The Risk Management Department expresses an opinion on each new risk-generating credit product as well as other risk-generating areas.

The Asset and Liability Management Committee (ALCO)

The principal function of the Bank's Asset and Liability Management Committee (ALCO) is to identify, measure, and manage risks inherent in the Bank's balance and off-balance sheet items, primarily liquidity and interest rate risks by setting adequate risk limits and measures for elimination of adverse risk impact on profitability.

29. FINANCIAL INSTRUMENTS (continued)

29.1. Financial Risk Management (continued)

Loan Management Committee

The principal role of the Loan Management Committee is to oversee the quality of the Bank's assets, credit risk monitoring process and its efficiency, monitor collection processes within the Loan Restructuring and Legal Affairs – Workout Departments, and monitor the realization of these processes in conformity with the business goals of the Bank. The Committee's task is monitoring the credit process in all its phases is, in the event that a bottle-neck is identified, prepare a proposal to the Management of the Bank for definition of measures, actions and responsibilities to eliminate such situations. In addition, its role is to coordinate and strategically direct the processes and activities among all the business functions of the Bank involved in the credit process in order to optimize the process in all its phases and achieve the targeted goals and amounts, along with the regular control related to such processes. This Committee is also competent to approve of the departures from the defined collection procedures and of the proposals for improvement of the loan portfolio quality.

Liquidity Commission

The Bank's Liquidity Commission, comprised of three members appointed by the Bank's Supervisory Board – a member of the Management, the Manager of the Treasury and Transactions Department and Manager of the Risk Management Department, has meetings at least on a monthly basis. The Commission monitors and assesses daily liquidity based on the liquidity plan as of the certain date, submitted by the Treasury and Transactions Department on a daily basis to the members of the Commission and Management.

The Commission analyzes the liquidity plan and its realization on a monthly basis, proposes measures and defines tasks for liquidity maintenance so that the Bank can avoid the risk of adverse effects on its financial performance due to its inability to discharge it current liabilities as these fall due.

The Treasury and Transactions Department

The Bank's Treasury and Transactions Department manages current liquidity through the following activities:

- planning cash inflows and outflows on a daily basis;
- monitoring transactions and cash balances on the accounts of reserves held with the Central Bank, balances on the accounts held with domestic and foreign correspondent banks and balances of cash on hand in foreign and local currencies (Bank's vault) and cash offices of the Bank;
- obtaining the shortfall amounts of funds or investing surplus liquid funds in the financial markets;
- monitoring large individual inflows/outflows of funds of depositors and loan disbursements in order to maintain the foreign currency position, maturity match and timely settlement of all liabilities matured;
- analyzing the structure and maturities of deposits, undertaking re-contracting of maturities for deposits matured;
- maintaining and allocating the obligatory legal reserve as the minimum amount of funds set aside on the account held with the Central Bank;
- preparing daily, monthly and semi-annually liquidity plans as the method for estimating future liquidity;
- reporting on liquidity movements both internally and externally.

The most significant risks to which the Bank is exposed are credit risk, market risk, liquidity risk and operational risk.

29. FINANCIAL INSTRUMENTS (Continued)

29.2. Risk Management and Mitigation Techniques

The bank inevitably encounters various types of risks that may produce negative effect on the bank's operations. Bank's Risk Management encompasses risk management strategy and policy, appropriate internal organizational structure of the Bank, effective and efficient process of managing all risks that the bank is exposed to, adequate internal control system and appropriate information system as well as adequate process of internal estimates of capital adequacy.
In order to efficiently manage risk, taking in consideration the requirement to minmize the conflict of interest between risk taking, risk level and control constraints, as well as audit of the management system, a coprehensive risk management system of the Bank was established in line with „The Three Lines of Defense“ principle. The main objectives of the „First Line of Defense“ are: identification, assessment, mitigation, monitoring and risk control in accordance with the risk limits determined in the „Second Line of Defense“.
The „Second Line of Defense“ aims at ensuring the compliance with the established limits, independently of the „First Line of Defense“. The objective of the „Third Line of Defense“ is independent assessment of risk management system compliance with internal and external requirements.

In its operations, the Bank applies techniques to mitigate credit risks associated with the exposure or exposures which the bank has, including material and non-material credit protection.

Material credit protection is a credit risk mitigation technique according to which the reduction in the credit risk of a bank's exposure stems from the right of that bank to, in the event of the occurrence of the default status of the other contractual party or the occurrence of other specified credit events associated with the other counterparty, to assign or retain certain assets or amounts, or to reduce the amount of exposure to the amount of the difference between the amount of exposure and the amount of credit protection. Non-material credit protection is a technique for reducing credit risk according to which the reduction of the credit risk by exposure of a bank stems from the obligation of a third party to pay a certain amount in the event of the occurrence of the default status of the debtor's obligations or the occurrence of other specified credit events.

29.3. Allowance for Impairment of Receivables (application of IFRS 9 – Financial Instruments)

As of 31 December 2017, the applicable standard was IFRS 39, which classified financial instruments and did not require a specific definition of a business model, except when they are available for sale, which directly leads to its classification at fair value through profit or loss (FVTPL). However, the standard stipulated that the way in which a particular group of financial instrument is managed and the targets that are to be achieved essentially constitute a business model. Based on the GAP analysis of current types of the contracts, the Bank performs its operations on a business model aimed at collecting contractual cash flows. Due to a conservative approach, the Bank's financial instruments (loans approved) in its portfolio are held solely for the purpose of collecting the expected cash flows, which exclusively refer to collection of principal amount and interest accrued,as a result of compensation for the time value of money, credit risk and other risks associated with money lending.

As of 1 January 2018 IFRS 9 is officially applicable. From that date, the Bank has had clearly defined strategies, policies and procedures related to Bank's business model, which represent an evidence of formal documentation of existing business models, defining new models and its adaptation to IFRS 9.

It is necessary to ensure that IFRS 9 analysis of defined business models is carried out prior to and after implementation of the following changes:

- Changes in the manners of managing financial assets;
- Redefining the business or Bank's organization (organizational changes, changes in product types),
- Redefining the Key Performance Indicator and the bonuses of the managers responsible for managing the portfolio of financial instruments.

Defining new business lines and analyzing business models can be incorporated into accounting policies and procedures, but the Bank's management is responsible for clearly defining a business model. Financial instruments, classified as 'hold-to-collect contractual cash flows' may be sold, while maintaining the business model in following cases:

- Sale in the event of a significant increase in the credit risk of financial instrument;
- Sales do not occur frequently (even if the amount is of material importance),
- Sales are not of a material significance individually or in total (although they occur frequently);
- The sale is executed close to the maturity date of the instrument and return from sale is approximately equal to the amount that would be received by collecting the expected cash flows.

29. FINANCIAL INSTRUMENTS (continued)

29.3. Allowance for Impairment of Receivables (application of IFRS 9 – Financial instruments) (continued)

Sale of financial instruments under other circumstances would not lead to their reclassification after initial recognition, but it potentially indicates the need to redefine an existing business model. If it is established that the characteristics of the business model do not correspond to the defined strategy, the Bank will define a different business model that would be in line with the practice. Change of the business model requires reclassification of all business instrument that were, at that time, included to in the prior business model (with the potential one-time impact on the income statement). The Bank had no recorded sales of financial instruments in the previous period.

On the grounds of GAP analysis of current loan agreements, it was established that in the current practice Bank uses only 6M EURIBOR as a variable part of the interest rate. The Bank defined the rescheduling of the variable part of the interest rate on precisely determined dates as follows:

- On semi-annual basis, on precisely defined dates– 30 June and 31 December
- On semi-annual basis, on precisely defined dates – 31 March and 30 September.

The Bank takes into consideration that six-month rescheduling of the six-month interest rate on certain dates may produce a discrepancies in expected cash flows if the date of the contract conclusion does not coincide with one of the rescheduling dates. The impact of those discrepancies may potentially be material compared to the loan amount in the given period. In such cases the analysis are to be carried out to track historical interest rate movements in a given period in order to predict materiality effect of the mentioned discrepancies. It is estimated that current movement of EURIBOR in the market will not lead to material deviations in the expected cash flows.

The Supervisory Board of the Bank adopted the Methodology for calculation of expected loss impairment in accordance with IFRS 9 (hereinafter 'the Methodology') which defines the methods and techniques used in MF Banka a.d. Banja Luka (hereinafter: 'the Bank') in order to calculate the individual and group impairment of the balance sheet and off-balance sheet items of the Bank, i.e. the total financial assets in the scope of the Standard.

Methodology defines criteria for determination of type of financial assets, criteria for identification of receivables that need to be individually assessed and criteria for evaluating the claims that are subject of the group assess arisingment. The Methodology applies at the Bank's level in a systematic manner and by its permanent use and consistent application enables timely determination of expected losses arising from the failure to meet contractual obligations by clients or significant increase in credit risk, all in order to protect the Bank's equity in terms of loss identification and realization. Methodology is based on the requirements set in IFRS 9.

Methodology is based on the rules and historical data, in respect with objective business criteria in the local market (application of a real discount rate in expected cash flow assessment, time needed for realization of collateral in the market, applicable legislation and court practice for its execution, current economic conditions and other relevant factor that affect the solvency of the debtor). It imposes an obligation of the Bank to assess the current state of the economic environment and accordingly incorporate future expectations into allowance for impairment.

Methodology defines:

1) Financial assets type ie. Wether they are purchased or credit impaired assets ;
2) Determination of the stage of financial assests;
3) Determination of materiality for individual exposures;
4) Identification of exposures that are assessed/classified on an individual or group basis;
5) Individual allowance for impairment;
6) Group allowance for impairment.

29. FINANCIAL INSTRUMENTS (Continued)

29.3. Allowance for impairment (applying IFRS 9 – Financial instrument) (Continued)

In addition, the Methodology includes the following:

1) the identification of claims that are classified on an individual or group basis, and the criteria for classification of claims into homogeneous groups with similar characteristics (type of client/segmentation, type of the loan product, instrument for securing claims, regularity in settling liabilities, sector and geographical structure);
2) established methods and techniques for classification on an individual or group basis, including the method of estimating the expected time of payment and the percentage of the value of the collateral instrument from which the payment will be made (take into account all the costs of activation and payment) and the factors used in determining time intervals for estimating losses based on data from previous periods;
3) the analyzes, estimates and other procedures used in the calculation of the allowance for impairment or provisions should be precisely explained and adequately documented in writing;
4) providing accurate and up-to-date information that is taken into account when assessing the payment of receivables;
5) clearly defined organizational units within the jurisdiction of which the assessment and conditions under which assessment can be made on the basis of previous experience.

Taking into account the fact that the regulation does not exempt the previous regulatory provisions relating to the classification of exposures and the calculation of provisions in accordance with the classification of exposures, they shall remain in force. At the same time, the Bank is required to calculate provisions in accordance with the classification of exposures and value adjustments according to the internal impairment methodology. The methodological framework for calculating impairment is subject to further development and further improvements in subsequent periods, due to the current harmonization of the ABRS with IFRS, improvements in Bank processes and changes in IFRS itself.
The methodology is based on the final version of the International Financial Reporting Standard 9: "Financial Instruments" adopted by the International Accounting Standards Board (IASB) financial institutions for their financial instruments are required to comply with the requirements of this Standard as of 01.01 .2018.
Standard IFRS 9 provides a series of applications for the recognition and measurement of financial assets, financial liabilities and contracts for the purchase and sale of non-financial items. This Standard replaces International Accounting Standard 39: Financial Instruments: Recognition and Measurement. The intention of the IASB was to complete the replacement of IAS 39 with IFRS 9, but in response to requests for a rapid improvement in the calculation of financial instruments, the replacement project is divided into three areas ("Stages"):

• Area 1 ("Stage 1"): Classification and measurement of financial assets and liabilities - according to which financial assets should be classified on the basis of a business model and characteristics of contractual cash flows.
• Area 2 ("Stage 2"): Methodology Impairment - according to which impairment of financial assets refers to expected credit losses.
• Area 3 ("Stage 3"): General accounting for protection - according to which the observed shortcomings and inconsistencies of the model specified in IAS 39 are being made.

Considering that IFRS 9 replaces the existing IAS 39, the following key differences of IFRS 9 in relation to IAS 39 are:

- Concept of measurement of expected losses - the measurement of the expected loss under IFRS 9 is transferred from the field of recognizing the losses incurred in the area of expected losses, whereby different scenarios must be considered for the expectation of losses.
- Scenarios with weighted probability for calculating the expected loss - means that at all stages of loss expectations it must be incorporated and probability weighted calculation scenarios to a minimum of two, ie, more scenarios with associated likelihood. Consequently, for each exposure there is some (and even marginally small) likelihood of loss.
- Necessary adequate modeling of risk parameter (EAD - exposure, PD - probability of default, LGD - loss given default, CCF - credit conversion factor) - IFRS 9 requires more precise parameters for calculating expected losses taking into account of PIT (point-in-time) parameters, in contrast to the currently defined in IAS 39 (TTC - through the cycle).
- Necessary modeling of macroeconomic expectations - when determining the risk parameters, it is necessary to consider how the movement of macroeconomic variables influences the movement of the Bank's risk parameters.

29. FINANCIAL INSTRUMENTS (Continued)

29.3. Allowance for impairment (applying IFRS 9 – Financial instrument) (Continued)

• Criteria for transition into phases – IFRS 9, given that in phase 2 in the part of revenues portfolio, the stage in which exposures with increased credit risk are classified from the moment of approval to the moment of reporting, it is necessary that the Bank defines the criteria on the basis of which it will recognize exposures with increased credit risk in all segments of the impairment of financial instruments.
• Calculation of interest income on non-performing assets - as well as it was according to IAS 39 - the only source of interest income on non-performing assets is the so called - unwinding.
• POCI (purchased or originated credit – impaired) financial assets - a new category of assets is defined for which there is a specific set of rules, ie, assets that already carry a mark of impairment, assets for which there is already an individually expected impairment.
The impairment of IFRS 9 is created for financial assets within the scope of the standard that is classified in the respective business models and Area 1 of the standard.

According to the requirements of IFRS 9, the Bank assesses at a reasonable cost and effort at what point of the economic cycle is currently in relation to its exposures and how macroeconomic developments or future information can affect the expected loss. Macroeconomic indicators can have a different impact on the risk parameters in the calculation of twelve month and lifetime losses, but given that the formula for calculating the value correction is the product's risk factor/parameter, adjusting a single parameter risk (PD) will also adjust the value adjustment for the expected future information.
Under the threshold of material significance ("treshold"), in the Methodology used for calculating the number of days of delay, the amount is greater than:

- 1% of the bank's individual claim from the debtor who is a person or farmer and not less than 20,00 BAM, or
- 2.5% of the bank's individual claim from the debtor who is a legal entity or entrepreneur and not less than 500.00 BAM.

The definition of the default status remains unchanged in relation to IAS 39. A financial asset or group of financial assets is impaired and impairment losses are incurred if and only if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a "loss event") and that event of loss (or events) have an impact on the estimated future cash flows of a financial asset or group of financial assets that can be reliably estimated.

The Bank first assesses whether there is objective evidence of impairment individually for financial assets that are individually significant, both individually or collectively for financial assets that are not financially significant. Individual marginal exposures would be assessed individually when defining a specific client/transaction risk (eg industry concentration, default status, rating category, type of loan, ability of the buyer to carry risk, etc.). Objective evidence that a financial asset or group of assets is impaired includes visible information that brings to the attention of the Bank in connection with the loss event described below:

- The debtor is in delay for more than 90 days in a material amount. In this case, the material amount implies the Bank's claims from the client as defined by this Methodology;
- The Bank finds it unlikely that the debtor will fully settle its obligation to it, regardless of the possibility of collection based on the activation of the insurance instrument, in particular, considering the following elements:
- partial or complete write-off of receivables;
- restructuring of receivables as a result of deterioration in the financial condition of the debtor, with a reduction in principal, interest or compensation, or an extension of the repayment deadline;
- liquidation or bankruptcy of the debtor.

The Bank determines the status of non-fulfillment of obligations at the client level for all exposures. Based on the default status and the individual significance of the exposure, the Bank distinguishes between different approaches to measurement of impairment (single or collective assessment). For all substantially significant clients that are found to have objective evidence of impairment, i.e. that they are in the default status, default or are classified as POCI assets, the Bank will carry out an individual impairment assessment.

29. FINANCIAL INSTRUMENTS (Continued)

29.3. Allowance for impairment (applying IFRS 9 – Financial instrument) (Continued)

Accordingly, in the process of determining impairment in accordance with IFRS 9, the Bank distinguishes two approaches:

- Individual (individual) impairment - This type of impairment is calculated on the above exposures, which are at the same time individually material (their exposure exceeds an individually defined significant limit) and have evidence of impairment of receivables,
- Portfolio (group) value adjustment - This type of impairment is calculated on all exposures of the Bank for which there is no evidence of impairment of receivables.
- On each last day of the month, the Bank will determine both types of value adjustments. The methodology defines criteria for allocation by areas ("Stage") for legal and natural persons.

The calculation of the allowance for impairment of losses and the provision for impairment of losses on individual material exposures where an impairment event is identified is carried out through an individual allowance for impairment. An individual value correction implies the assessment of expected credit losses implies an analysis of the expected future cash flows in several different collection scenarios with the specific probabilities of each scenario and the calculation of their present value. Individual allowance for impairment is calculated as the difference between the total balance of the client's exposure to the loan (due principal, outstanding principal, interest) and collects the net present value of the estimated future cash flows (from regular repayment and from the activated security instruments) of that loan. For each transaction, the individual future cash flows will be individually determined, in particular for the principal and in particular for interest. Calculation of the value adjustment through a portfolio value adjustment is performed for the following types of exposures: for exposures that are not materially significant in Phase 3 and for all exposures in the areas ("Stage") 1 and 2.

All placements of clients classified according to the criteria for group dilution are further grouped into appropriate homogeneous groups (HG). The main criteria of the grouping are segments, with the largest segment of MSME further divided into groups of credit products: MSME-Credit for working capital, MSME-Credit for material assets and investments, MSME-Non-purpose loan for eneterpreneurs, MSME-Transfer credit and MSME- The others. Due to the specific nature of the credit product "Overdraft", the exposures belonging to this product are separated into a special homogeneous group at the level of the Bank's portfolio (regardless of the segment). For defined homogeneous groups, a value correction will be made through the application. For each homogeneous group, the movement, ie the migration of exposures from the rating groups into a certain status according to the days of delay, will be monitored as shown in the table below. Migration from rating groups to a certain status ie the second rating group will be monitored taking the mean (weighted) value of the cross-section at the end of the individual quarters, going backwards through the data history for a defined period (minimum of three years). Therefore, individual migrations will first be determined at the defined breakdown dates (quarterly), in order to monitor the movement of exposures / lots (by rating groups) that were active for one year to the day of cross-section. Then, for each credit rating group, the resulting amounts migrated at all the cross-sectional times will be aggregated and divided by a pool of total exposures on all the cross-sectional dates.

The measurement of impairment on a group basis requires the estimation of parameters on a statistical basis with adjustments for future information. The PD and LGD risk parameters will be calculated for each homogeneous group at a lifelong level, i.e. the maximum maturity of a particular homogeneous group using historical data and adjusting for the expected future losses. The methodology defines the types of collateral and the collateral-related parameters used for the calculation of value adjustments on an individual and portfolio basis. The difference between the carrying amount of the exposures and the recognized amount of collateral (the estimated value corrected by the stated percentages in the table) is the uncovered amount that forms the basis for the portfolio calculation of the impairment. By applying the defined parameters by individual types of collateral from the table, for the purpose of calculating the individual allowance for individual material material exposures secured by these types of collaterals, the expected cash flow is reduced by discounting to the present value. Procedures and methods that describe in more detail the activities related to security means (classification of collateral instruments, relevant valuation methods, certified appraisers and others) are prescribed in the Policy of Acceptable Security Instruments.

After preparation and analysis of the calculation according to IFRS 9 Methodology as of December 31, 2017, a correction was made for the revaluation adjustment of the impairment provision as of December 31, 2017 due to the application of IFRS 9 - Financial instruments with the effect of increasing the value adjustment of BAM 1,347,560 against the undistributed profit due to the application of IFRS 9 and the amount of earlier revenue reserves in applying IAS 39.

29. FINANCIAL INSTRUMENTS (Continued)

29.4. Financial Risks

In its operations, the Bank is particularly exposed to following risks:

- Credit risk, including residual risk, the risk of a decrease in the value of the receivables, the risk of settlement / delivery, as well as the risk of the counterparty;
- Concentration risk, which specifically includes exposure to one person or a group of related parties;
- Liquidity risk;
- Market risk (interest rate risk, foreign exchange risk and others);
- Operational Risk;
- Investment Risk;
- Strategic Risk;
- Risk of compliance of bank's operations
- Risk of money laundering and financing terrorism.

29.5. Credit Risk

The Bank assumes credit risk which relates to potential negative effects on the financial result of the Bank contingent on the failure of debtors to meet their liabilities towards the Bank. Credit risk is the most significant risk for the Bank's business operations, and the Bank manages its risk exposure being aware of its importance. The credit risk exposure occurs primarily based on crediting activities i.e. in loan origination activity. Credit risk is also present in off-balance sheet instruments such as guarantees and undrawn lines of credit.
Credit risk represents the risk of negative effects on the Bank's financial result and capital as a result of the customer's inability to settle its matured liabilities to the Bank. Credit risk entails:

- default risk– the risk of loss that may arise if a debtor fails to settle liabilities toward the Bank;
- downgrade risk – the risk of loss that may arise if a risk level of a debtor is downgraded (deterioration of in the customer credit rating) on the line items of assets that are recorded in the credit portfolio;
- Risk of change in the value of assets - the risk of loss that may arise on items of assets that are recorded in the credit portfolio in the event of a decline in their market value compared to the price at which assets were acquired;
- Counterparty exposure risks - risks that can arise from the Bank's exposure toward a single individual, a group of related parties or entities.

The Bank manages credit risk by implementing the crediting strategy focused on entrepreneurs and SME and risk dispersion.

The Bank manages credit risk by approving standardized credit products in accordance with its crediting policy. Those products and their basic characteristics in terms of amount, maturity, interest rate, fee and obligatory collateral are defined in the bank's Credit Product Catalogue. The Risk Management Department is involved in definition of credit products and their evaluation from the aspect of risk. Decision-making levels defined by the Rules of Procedure for Credit Committees, are competent for decision making in instances of standard loan approval under standard terms, whereas any departure from the defined standards requires higher level decision making.

The Bank's Credit Manual clearly defines the manner of processing credit products, documentation required for certain market segments, steps of the crediting process and organizational units and individual operators responsible for the implementation thereof. The aforesaid document prescribes all the forms used in loan processing and monitoring and also the manner and forms for analyses of the credit worthiness of borrowers depending on the segment they belong to (COR and PUB, SME and Retail segments).

The Bank approves loans in accordance with the defined procedure for loan approval based on the assessed credit worthiness of the borrowers and collaterals. The analysis of the borrower creditworthiness must be presented in the document named "Assessment, "which includes the loan proposal as the basis for making a decision on loan approval. Such decisions are made based on the defined limits for individual exposures and total exposures per single entity or a group of related entities. There five levels of authority within the Bank for loan approval, the highest of which is the Bank's Supervisory Board and the lowest personal responsibility of the Branch Manager. Processing of loan requests for SME and Retail segments is decentralized and performed by the Bank's branches. Processing of loan requests from the receipt of up to the loan disbursement is performed through the application module adjusted to the requirements of the Front Office.

29. FINANCIAL INSTRUMENTS (Continued)

29.5. Credit Risk (Continued)

The Instructions for Collection and Management of Non-Performing Loans (NPL) define the manner of monitoring the existing loans and competences and responsibilities for performing collection activities. The aforesaid Instructions define the daily and monthly monitoring of collection within certain steps of NPL management are performed.

In order to ensure quality, systematic and orderly management of loan portfolio in default, the Bank's internal procedures prescribe the following two documents: "Irregular Repayment File" and "Collection Strategies." The "Irregular Repayment File" represents a report providing a summary of activities already undertaken and performed in respect of loans with repayment over 30 days past due and is maintained until the loan repayment is settled in full. Loan Officers are obligated to maintain the irregular repayment files and chronologically record all activities undertaken in order to collect the receivables. The maintenance of this form is supported by the software within the module used by the Front Office. "Collection Strategies „is a report presenting a dynamic overview of activities that will be undertaken in order to collect receivables, i.e. the agreed upon collection strategy.

Impairment Losses and Provisioning Policy

The Bank estimates the risk of potential losses due to deterioration of the borrower credit rating. Credit risk represents the risk of the borrowers' inability to discharge their liabilities when due, whether there be little probability of borrowers settling the liabilities from their primary sources or the repayment be over 90 days past due.

Impaired loans are those loans where objective evidence of impairment has been determined. Objective evidence of impairment includes events causing measurable decrease in the estimated future cash flows.

Individually impaired assets are those assets which were assessed for impairment on an individual level and for which the assessed impairment losses have been recognized. The amount of impairment loss is determined as the difference between the carrying value and the present value of the future cash flows.

The calculated amount of the impairment of balance sheet assets is charged to expenses and credited to the impairment allowance of those assets, while the calculated amount of the probable loss per off-balance sheet assets is charged to expenses and credited to the provisions for potential losses per off-balance sheet items.

Group-level or portfolio-level assessment for impairment is performed for loans that are not individually significant.

For the purpose of this type of impairment assessment, loans are classified into groups homogeneous from the credit risk aspect in accordance with the bank's internal methodology for calculation of the impairment allowance.

Expected future cash flows for homogeneous loan groups are determined based on the available historical data, mostly data on default in liability settlement, and cash flows that will certainly result from collateral foreclosure are also taken into account.

Collaterals

In accordance with the standard principles of crediting operations, the Bank requires collaterals for loan securitization to cover the risk of the borrower inability to meet the contractual obligations.
The Bank most commonly uses the following collaterals as security:

- Bills of exchange,
- Collection of authorisations,
- statement of distrain (injunction),
- co-debtor,
- warrantor,
- mortgages assigned over property,
- pledge liens assigned over movables
- pledge liens assigned over securities,
- deposits/savings deposits,
- insurance policies,
- guarantees of the RS Guarantee Fund.

The Bank reserves the right to demand any other type of collateral it deems necessary.

29. FINANCIAL RISK MANAGEMENT (continued)

29.5. Credit risk (continued)

Non Performing Loans

Non-performing loans (NPLs) are loans with repayment over 90 days past due and materially significant default. According to the categorization, those are category C, D and E loans. Loans from category B and less than 90 days past due ate not considered to be NPL but are assets for special watch.

The Bank classifies the customers in accordance with its internal methodology for calculating impairment allowance according to the number of days in arrears and in accordance with the BARS Decision on the Minimum Standards for Credit Risk Management and Asset Classification. Pursuant to the aforecited BARS Decision, all borrowers are classified into 5 categories: A, B, C, D and E.

NPL management for SME and Retail customers is centralized within the Division for Loan Restructuring. The Division was formed in April 2013 in order to ensure higher quality NPL management for SME and Retail segment borrowers.

This Division is competent for rescheduling and restructuring all loans but the opinion expressed by the Risk Management Department is mandatory. When this Division has attempted and failed at all possibilities of collection, it proposes making a decision on instigation of legal proceedings to the Bank's Loan Management Committee/Credit Committee.

Instructions for Collection and management of NPLs explicitly prescribes the activities of assumption, monitoring and collection of NPLs for all market segments. A loan is assumed by the Division for Loan Restructuring when the following conditions are met:

1. Loans that are 90 and over 90 days past due with liability matured in excess of one repayment installment;
2. Borrowers that failed to settle their liabilities to the Bank within 30 days from the maturity of the entire account overdraft or revolving loan amount;
3. Credit card facilities with repayment of 90 and over 90 days past due;
4. All types of guarantees called on where the Bank made the required payments and liabilities matured were not settled within 30 days from the Bank's payment date.

The borrowers meeting the above listed criteria are transferred to the Division for Loan Restructuring if it is possible to enable further regular debt servicing by the borrower through loan rescheduling or restructuring. If there are no possibilities for resuming debt servicing on the part of the borrower, such a borrower is not transferred to the Loan Restructuring Division but to the Legal Department instead, where legal proceedings are instigated.

Borrowers are transferred from the Front Office to the Loan Restructuring Division upon Front Office creating a monthly list of borrowers where, on the last day of the previous month, conditions were met for this transfer. The list needs to include all the loan facilities of each borrower, and those of its related parties, even if they are not in the categories triggering the transfer (related through ownership and family relations), yet they affect the creditworthiness and possibility of loan repayment. The Front Office may propose delay in transferring a borrower to the Loan Restructuring Division for up to 30 days if there is an arrangement with the borrower that within these 30 days the payment will be made or repayment liabilities rescheduled. If within 30 days such a borrower fails to make the due payment or have the Bank reschedule the liabilities, the borrower will be transferred to the Loan Restructuring Division. Decisions on the delay of transfer of borrowers to the Loan Restructuring Division is made by the Loan Management Committee after considering the Front Office's proposals. The final and with branch offices reconciled list of the loans/borrowers to be transferred to the Loan Restructuring Division is prepared in 3 copies and signed by the Deputy CEO. A copy is submitted to the Loan Restructuring Division, another copy is intended for the Back Office and the third is archived in the Front Office. This final list is delivered electronically to all heads of branch offices.

Based on the aforesaid list, loan files are transferred from branch offices to the Loan Restructuring Division and a Loan Restructuring Officer becomes competent for the loan files received within the system. This activity within the system entails that, at the end of the seventh day in each month, all the loan facilities included in the list are assigned a Backup Officer from the Loan Restructuring Division (within the banking application).

29. FINANCIAL INSTRUMENTS (continued)

29.5. Credit risk (continued)

Non-Performing Loans (continued)

The Loan Restructuring (Backup) Officer must receive the loan file from the Loan Officer within 15 days from the assignment date and act on it as soon as possible. The Backup Officer in charge of a borrower is obligated to maintain records of the activities and measures undertaken in respect of specific loan facilities through update of strategies in the front application. Even if the loans are regularly serviced, the Backup Officer is obligated to perform regular quarterly monitoring of the borrower.

Loan Restructuring Officers have at their disposal all the measures and for addressing the default problems, which entail aggressive collection, current debt rescheduling, current debt restructuring, main debt restructuring by including other co-debtors, etc.

Credit Risk-Related Risks

The Bank issues guarantees to its customers whereupon it has contingent liabilities to make the payment in favor of third parties. In this manner the Bank is exposed to risks similar and related to credit risk, which may be overcome by applying the same control processes and procedures.
Monitoring and collection procedures applied to these exposures are identical to those applied to loans.

Collaterals and Other Forms of Securitization

The Bank demands security instruments for all types of loans. The amount and type of the security instrument demanded depends on the market segment a specific borrower belongs to and the type of credit product approves as well as the assessed credit risk for each individual borrower.

The assessment and fair value of collateral are based on the value thereof upon loan approval. In accordance with its business policy and internal procedures, the Bank determines the required fair value of the collateral as well as the manner and time of its revaluation.

The management monitors the market value of collaterals and demands additional security instruments upon reassessment of the loan impairment allowance adequacy. The Bank takes into account the value of collaterals upon reassessment of the loan impairment allowance adequacy.

(Thousands of BAM)

	As of 31 December 2017	**31 December 2016**
Loans securitized with earmarked deposits	2.779	2.435
Loans securitized with mortgages	111.747	81.686
Loans securitized with other collaterals	150.121	141.040
Total:	**264.647**	**225.161**

29.5.1. Concentration Risk

In order to secure its operations in terms of credit risk exposure and risk of potential losses from loans, other placements and potential off-balance sheet liabilities, the Bank internally defines minimum standards for concentration risk management. That way, the Bank ensures stability of its operations, determines minimum standards of the largest exposure of the bank towards a single person, debtor or or other entity (and the group of related persons), as well as limitations of large exposures.

Pursuant to Article 106 of Law on Banks of Republic of Srpska large exposure of a bank is the exposure of the bank towards a single person or a group of related persons totaling or exceeding 10 percent of the bank eligible capital. The Bank is obligated to adopt policies and procedures for identification and monitoring of individual and total exposure, keep records, monitor and report on exposure in accordance with the Agency's regulations.

The eligible capital is equal to the bank regulatory capital, which consists of regular core capital and additional core capital after regulatory adjustments.

29. FINANCIAL INSTRUMENTS (continued)

29.5. Credit risk (continued)

29.5.1. Concentration Risk (continued)

Exposure toward a natural person or group related persons is forbidden for a bank after applying the credit risk reduction technique to exceed 25 % of it eligible capital, The maximum permissible amount of credit receivables that is not secured by collateral in accordance with the Agency's regulations towards a single person or group of related persons may be up to 5% of the bank eligible capital. The total exposure of the bank towards its controlling and subordinate company and persons related thereto shall be subject to limitations prescribed in this Article.

Interest of a bank in other legal persons is regulated by Article 111 of the Law on Banks of Republic of Srpska.

- It is forbidden for a bank, directly or indirectly, without the prior approval of the Agency to have:an interest in a legal entity or in a subsidiary of that entity person which exceeds 5 % of the bank eligible capital or a total net value of the bank interest in other legal entities and subsidiaries of these legal entities over 20 % of the bank eligible capita.
- The bank interest in a single legal entity from the financial sector, directly or indirectly, may be up to 15 % of its eligible capital.
- The bank interest in a entity which is not a person in the financial sector may not exceed 10 %of its eligible capital, or 49 % of the capital of that entity.
- The total interest of the bank in entities which are not entities in the financial sector may be up to 25 % of the bank eligible capital, and the total interest of the bank in entities in the financial sector may be up to 50 % of its eligible capital.

Risk Concentration per Borrower

As of 31 December 2017 the largest exposure to a single entity borrower, before considering collaterals, amounted to BAM 2,521 thousand or 1 % the total credit risk exposure (31 December 2016 BAM 2,516 thousand).

Credit Risk Concentration per Geographic Area

During 2017, the Bank's loan portfolio was concentrated on the territory of the Republic of Srpska, i.e. the City of Banja Luka, with noticeable increase of the City of Banja Luka's share in the portfolio which amounted to 15,72 % compared to 13,59 % in September 2017 and 14,15% in 2016.

Credit Risk Concentration per Industry Sector

The Bank has a diversified loan portfolio covering various industries: **(Thousands of BAM)**

	31 December 2017	**In %**	**31 December 2016**	**In %**
Construction industry	19.577	7%	17.099	8%
Trade	37.752	14%	32.770	15%
Services, tourism, catering and accommodation industry	11.756	4%	6.738	3%
Agriculture	7.428	3%	8.033	4%
Mining and manufacturing industry	35.859	14%	29.233	13%
Transport, storage, postal services and telecommunications	18.134	7%	16.395	7%
Finance services	3.731	2%	746	0%
Real estate trade	2.240	1%	872	0%
Other (retail customers)	128.325	48%	113.102	50%
Total:	264.802	100%	224.988	100%

As of 31 December 2017 in comparison to 31 December 2016, credit risk concentration increased by 1% in the services, tourism, catering and accommodation industry, mining and manufacturing industry,finance services and real estate trade. In transport, storage, postal services and telecommunications there was no change, while decreases were recorded in construction industry, trade and agriculture by 1%.

29. FINANCIAL INSTRUMENTS (continued)

29.5. Credit Risk (continued)

29.5.1. Concentration Risk (continued)

Credit Risk Concentration per Loan Type

The Bank regularly monitors and diversifies loans approved according to their purpose and type.

(Thousands of BAM)

	31 December 2017	In %	31 December 2016	In %
Loans per transaction accounts	24.794	9%	26.045	12%
Consumer loans	67.147	25%	66.080	29%
Working capital loans	70.339	27%	55.705	25%
Investment loans	89.924	34%	65.464	29%
Housing loans	10.713	4%	8.479	4%
Payments per guarantees called on	572	0%	555	0%
Placements for payments per guarantees called on	1.313	1%	2.660	1%
Total:	264.802	100%	224.988	100%

As of 31 December 2017 in comparison to 31 December 2016, credit risk concentration decreased by 4% in consumer and other loans, increased by 5% in investment loans, and while the other loan types mostly retained the same levels of concentration.

Loan and Off-Balance Sheet Item Quality According to BARS Categories (Portfolio Quality)

Pursuant to the BARS Decision, the Bank classifies loans due from customers according to the number of days past due.

(Thousands of BAM)

		Category				
31 December 2017	**A**	**B**	**C**	**D**	**E**	**Total**
Loans due to customers						
- short- term	36.075	6.061	200	165	20	42.521
- long- term	156.953	43.638	3.609	1.426	1.157	206.783
- matured	947	1.227	508	834	11.410	14.926
guarantees called on	-	17	-	-	555	572
Total loans	193.975	50.943	4.317	2.425	13.135	264.802
- off- balance sheet items	24.564	2.772	70	73	11	27.490
Total:	**218.539**	**53.715**	**4.387**	**2.498**	**13.153**	**292.292**

(Thousands of BAM)

		Category				
31 December 2016	**A**	**B**	**C**	**D**	**E**	**Total**
Loans due to customers						
- short-term	36.143	2.434	256	22	6	38.861
- long-term	144.732	23.805	3.446	955	383	173.321
- matured	1.254	682	587	912	8.816	12.251
guarantees called on	-	-	-	-	555	555
Total loans	182.129	26.921	4.289	1.889	9.760	224.988
- off-balance sheet items	18.869	1.525	5	7	73	20.479
Total:	**200.998**	**28.446**	**4.294**	**1.896**	**9.833**	**245.467**

29. FINANCIAL INSTRUMENTS (continued)

29.5. Credit Risk (continued)

29.5.2. Stress Test

In the course of credit risk assessment, the Bank applied the worst possible scenario of events for its portfolio. The Bank performed the stress test under the following assumptions: 30% BAM devaluation, 30% collateral devaluation, and increase in allowance for impairment for customers with recorded defaults in settling their matured liabilities

(Thousands of BAM)

Portfolio as of 31 December 2017	Total Exposure	Total Exposure Net of Deposits	Discounted Collateral Value	Allowance for Impairment	Amount of Shortfall Reserves	Total Deterioration
Before the test	358.259	355.253	240.058	25.448	-	30.316
After the test	296.261	293.255	268.031	21.426	-	27.076
Difference	**61.998**	**61.998**	**(27.973)**	**4.022**	**-**	**3.240**

(Thousands of BAM)

Portfolio as of 31 December 2016	Total Exposure	Total Exposure Net of Deposits	Discounted Collateral Value	Allowance for Impairment	Amount of Shortfall Reserves	Total Deterioration
After the test	300.445	298.204	170.000	15.663	-	25.508
Before the test	248.409	246.168	185.124	13.727	-	22.672
Difference	**52.036**	**52.036**	**(15.124)**	**1.936**	**-**	**2.836**

29.6. Market Risk

The Bank assumes market risks which represent the risk that the fair value or future cash flows from financial instruments may oscillate due to changes in market values. Market risks occur in open positions exposed to risk based on maturities, interest rates, currencies and capital products exposed to general and special movements and changes related to the degree of market rate and price volatility (such as interest rates, credit margins, foreign exchange rates and prices of capital). The Bank is exposed to foreign exchange (currency) risk and interest rate risk. The market risk control system is implemented through the separation of the risk assuming function (Front Office) from the risk monitoring and management function and backup activities (Back Office).

29.6.1. Foreign Exchange Risk

Foreign exchange risk represents the Bank's exposure to the possible adverse effects of the changes in exchange rates causing the Bank to incur losses in local currency, where the level of foreign exchange risk represents the function of the amount and duration of the Bank's exposure to the possible changes in exchange rates and depends on the amount of Bank's foreign debt, extent of the foreign currency exposure of the balance sheet assets and off-balance sheet items as well as the matching of the currency cash flows of the Bank.

The strategy of the Bank, applied in foreign exchange risk management, is based on the maintenance of foreign currency position within the limits prescribed by the Law on Banks of the Republic of Srpska and Decision on the Minimum Standards for Currency Risk Management in Banks.

For the purpose of controlling and identifying foreign currency exposure, the Bank monitors daily balances and structure of foreign currency cash in the treasury, foreign currency assets and structure per currencies on the accounts with foreign banks, ensures the matching between the foreign currency positions in unstable currencies, includes in contracts currency clause for both balance sheet assets and liabilities and off-balance sheet items, in the form a symmetrical, i.e. two-directional currency clause, in order to protect the value of assets and liabilities irrespective of the rise or decline of the exchange rate of the currency the currency clause refers to against the local currency, so as to achieve currency match between the financial assets and financial liabilities.

29. FINANCIAL INSTRUMENTS (continued)

29.6. Market Risk (continued)

29.6.1. Foreign Exchange Risk (continued)

The Treasury and Transactions Department monitors the foreign currency position on a daily basis and, in collaboration with the Front Office and Bank's Management undertakes adequate aforesaid activities in order to maintain the foreign currency position within the permitted limits.

In planning activities that significantly influence the changes in the structure or maturities of the Bank's financial assets and/or financial liabilities, and thereby Bank's foreign currency position, the Treasury and Transactions Department makes projections of the foreign currency position in order to ensure timely activities for continuous maintenance of the currency matching of financial assets and financial liabilities.

The breakdown of foreign currency balances as of 31 December 2017 net is presented in the table below:

(Thousands of BAM)

	EUR	USD	CHF	GBP	Other	Total FX	BAM	Total
Assets								
Cash and cash funds held with the Central Bank	1.997	56	70	4	146	2.273	41.425	43.698
Loans and receivables due from banks	1329	326	85	23	60	1.823	49	1.872
Loans and receivables due from customers	199.415	-	-	-	-	199.415	44.483	243.898
Property, equipment and intangible assets	-	-	-	-	-	-	6.415	6.415
Interest accrued and other assets	108	-	-	-	-	108	3.828	3.936
	202.849	382	155	27	206	203.619	96.200	299.819
Liabilities								
Deposits due to customers	85.729	63	14	-	20	85.825	130.192	216.017
Borrowings	1.118	-	-	-	-	1.118	17.324	18.442
Subordinated debt	6.845	-	-	-	-	6.845	-	6.845
Other liabilities	2.233	7	-	-	-	2.240	4.354	6.594
Provisions for employee benefits and other contingencies	-	-	-	-	-	-	169	169
	95.825	70	14	-	20	96.028	152.039	248.067
Net foreign currency position	106.924	312	141	27	186	107.591	55.839	51.752

The breakdown of foreign currency balances as of 31 December 2016 net is presented in the table below:

(Thousands of BAM)

	EUR	USD	CHF	GBP	Other	Total FX	BAM	Total
Assets								
Cash and cash funds held with the Central Bank	1.945	80	7.3	3	124	2.225	46.726	48.951
Loans and receivables due from banks	1.618	592	-	-	-	2.210	247	2.457
Loans and receivables due from customers	172.867	-	-	-	-	172.867	38.776	211.643
Property, equipment and intangible assets	-	-	-	-	-	-	6.278	6.278
Interest accrued and other assets	123	-	-	-	-	123	2157	2.280
	176.553	672	73	3	124	177.425	94.184	271.609
Liabilities								
Deposits due to customers	82.520	71	46	-	2	82.639	115.768	198.407
Borrowings	5.309	-	-	-	-	5.309	12.880	18.189
Subordinated debt	6.845	-	-	-	-	6.845	-	6.845
Other liabilities	2.570	7	-	-	-	2.577	4.042	6.619
Provisions for employee benefits and other contingencies	-	-	-	-	-	-	144	144
	97.244	78	46	-	2	97.370	132.834	230.204
Net foreign currency position	**79.309**	**594**	**27**	**3**	**122**	**80.055**	**(38.650)**	**41.405**

Loans extended to customers in BAM with currency clause index to EUR are presented as EUR-denominated loans

29. FINANCIAL INSTRUMENTS (continued)

29.6. Market Risk (continued)

29.6.1. Foreign Exchange Risk (continued)

During 2017, the Bank maintained the open individual foreign currency position within limits permitted for EUR currency up to the maximum of +/- 30% of its core capital and for USD currency up to +/- 20% of its core capital, while the total foreign currency position was within the permitted range.

Foreign Currency Sensitivity Analysis

The Bank is mostly exposed to EUR. Since Convertible Mark (BAM) is pegged to EUR, the Bank is not exposed to risk of fluctuations in the EUR exchange rate.

29.6.2. Interest Rate Risk

The Bank is exposed to multiple risks, which influence its financial position and cash flows through the effects of changes in the amount of interest rate fluctuations on the market. Interest rate risk is the risk from adverse effect on the Bank's financial result and equity contingent on the changes in interest rates.

The basic objective of interest rate risk management is to minimize adverse effects of changes in interest rates.

Interest rates applied to loans depend on the volatility of market interest rates and their trends in the money market as well as on the business policies of the Bank.

Fixed interest rates were applied to the loans with repayment periods of up to 36 months, and variable to the loans with repayment periods of over 36 months. The exceptions are loans approved to corporate customers and public sector customers as well as housing loans where the variable interest rates are applied for all repayment periods. The Bank decide on the variable interest rate equal to 6-month EURIBOR rounded to the next decade above adjusted two times a year, on 30 June and 31 December.

Fixed interest rates are applied to deposits, and interest rates on foreign borrowings are variable and based on 6-month EURIBOR.

The basic principle of interest rate management is matching assets and liabilities per interest rate type (fixed or variable) and maturities or repricing dates.

The Bank's top management and Risk Management Department take care of optimization of the levels of profitability and interest rate risk exposure.

Interest Rate Sensitivity Analysis

The sensitivity analyses below have been determined based on the exposure to interest rates for instruments at the statement of financial position date. For floating rate liabilities, the analysis is prepared assuming the amount of liability outstanding at the statement of financial position date remained the same for the whole year. A 10% increase or decrease is used when reporting interest rate risk internally to key management personnel and represents management's assessment of the reasonably possible change in interest rates.
Had interest rates been 10% higher/lower and all other variables held constant, the Bank's profit for the year ended 31 December 2017 would have decreased/increased by BAM 3,045 thousand (2016: decrease/increase by BAM 1,604 thousand).

The table below shows the review of the annual interest rates applied to most significant financial instruments:

29. FINANCIAL INSTRUMENTS (continued)

29.6. Market Risk (continued)

29.6.2. Interest Rate Risk (continued)

	FX	In BAM
Assets		
Obligatory reserve with the Central Bank	-	0,00%
Assets in excess of obligatory reserves	-	(0,20%)
Foreign currency accounts with foreign banks	0,00%	-
Short-term loans due from customers:		
- corporate customers	-	8,00%-12,50%
- retail customers	-	6,50% -15,50%
Long-term loans due from customers:		
- corporate customers	-	7,00%-12,50% +6M Euribor
- retail customers	8,49%	6,5%-15,5% +6M Euribor
Liabilities		
Demand deposits of corporate customers	0,00%	0,00%-0,20%
Demand deposits of retail customers	0,10%-0,80%	0,10%-0,80%
Short- term deposits:		
- corporate customers	0,50%-1,30%	0,50%-1,30%
- retail customers	0,50%-1,50%	0,50%-1,50%
Long- term deposits:		
- state institutions	-	-
- corporate customers	1,80%-2,20%	1,80%-2,20%
- retail customers	2,05%-2,80%	2,05%-2,80%
Borrowings:		
FSE	6,20%	-
IFC	4,75%+6M Euribor	-
RS Development and Employment Fund	-	1,20%-2,40%
Housing Fund RS	-	1,20%-2,40%
Fund for Development of Eastern Region of RS	-	1,50%-2,40%

Lower interest rates applied to the long-term retail and corporate loans of 3.6%and 4.1%, respectively relate to the loans extended from IDB funds.

The Bank is exposed to various risks which, through the effects of changes in the amounts of market interest rates, influence its financial position and cash flows. The table below shows the review of interest-bearing and non-interest bearing assets and liabilities as of 31 December 2017:

The table below shows the review of the annual interest rates as of 31 December 2017 and as of 31 December 2016 applied to most significant financial instruments:

(Thousands of BAM)
31 December 2017

Monetary assets	**Interest-Bearing**	**Non- Interest-Bearing**	**Total**
Cash and cash funds held with the Central Bank and other banks	13.572	31.998	45.570
Claims for interest, fees and other receivables	63	4.640	4.703
Equipment and intangible assets	-	6.415	6.415
Provisions for contigent losses		(21.671)	(21.671)
Loans and deposits	264.802	-	264.802
Total:	**278.437**	**21.382**	**299.819**
Monetary liabilities:			
Deposits due to banks	193.690	22.327	216.017
Deposits due to customers	18.442	-	18.442
Subordinated debt	6.845	-	6.845
Other liabilities	-	6.594	6.594
Provisions for contingent losses	-	169	169

Total:	**218.977**	**28.090**	**248.067**

29.FINANCIAL INSTRUMENTS (continued)

29.6. Market Risk (continued)

29.6.2. Interest Rate Risk (continued)

(Thousands of BAM)

		31 December 2016	
Monetary assets	**Interest-Bearing**	**Non- Interest-Bearing**	**Total**
Cash and cash funds held with the Central Bank	21.934	29.474	51.408
Loans and receivables due from customers	224.988	-	224.988
Equipment and intangible assets	-	6.278	6.278
Interest accrued and other assets	1.187	1.093	2.280
Total:	**248.109**	**36.845**	**284.954**
Monetary liabilities:			
Deposits due to banks	-	-	-
Deposits due to customers	183.295	15.112	198.407
Borrowings	18.189	-	18.189
Subordinated debt	6.845	-	6.845
Other liabilities	-	6.619	6.619
Provisions for contingent losses	-	144	144
Total:	**208.329**	**21.875**	**230.204**

29.7. Liquidity Risk

The risk which emerges when the Bank is unable to settle all liabilities when due and in full. The basic objective of liquidity management is to ensure that the Bank has resources obtainable at reasonable costs necessary to discharge all liabilities for expected and unexpected fluctuations in the statement of financial position. Additionally, the process of liquidity management in the Bank needs to ensure liquid resources sufficient to finance the development of its loan portfolio.

The Bank's liquidity management strategy is carried out by controlling the maturity matching of assets and sources of assets based on the realistic and precise projections of cash inflows and outflows, both recurring and non-recurring, for different maturity buckets and periods.

The strategy of asset liquidity risk management encompasses:

- Striving to keep within the line items of assets, liquid forms of assets easily exchanged on the market for cash at no loss in case of a liquidity crisis (the Bank's aim is to maintain sufficient available resources to discharge its contingent liabilities at any time);
- Diversification of investments per separate customers, per industries and per loan maturities.

The strategy of liability management in respect to liquidity comprises the following:

- Striving to ensure deposit stability with increasing participation of long-term deposits

- Maximum diversification of resources according to their maturity, stability, origin, market and instruments,
- Particular attention is paid to large deposits,
- Undertaking arrangements with domestic and foreign banks on mutual extension of interbank liquidity loans which makes it possible to invest liquidity surpluses at an adequate interest rate, i.e. in case of insufficient liquidity funds, these resources are available to the Bank at favorable terms.

Primary sources of funds are local deposits acquired by the Bank by applying adequate interest rate policy.

The adoption, comprehensiveness and implementation of the Liquidity Risk Management Program is the responsibility of Bank's Supervisory Board and its Management.

Everyday monitoring of daily liquidity in the Bank is the responsibility of the Treasury and Transactions Department and Liquidity Commission; short-term liquidity is the responsibility of the Liquidity Commission; and long-term liquidity is the responsibility of ALCO (the Asset and Liability Management Committee).

29. FINANCIAL INSTRUMENTS (continued)

29.7. Liquidity risk (continued)

Responsible persons monitor the liquidity position and composition of asset and liability maturities and:

- perform operational management of liquid assets on daily basis,
- compare the positions with projected position so as to determine trends in the liquidity positions and undertake adjustment measures so the liquidity position and maturity gaps would be in compliance with the law and the limits set by the Bank's Supervisory Board.

The table below shows a GAP analysis of assets and liabilities according to respective maturity based on the outstanding period before the agreed due date by matching receivables and payable per maturity periods in accordance with BARS regulations.

(Thousands BAM)

31 December 2017	**Within a month**	**From 1 to 3 months**	**From 3 to 12 months**	**Over 1 year**	**Total**
ASSETS					
Cash and cash funds held with the Central Bank	43.698	-	-	-	43.698
Loans and receivables due from banks	1.872	-	-	-	1.872
Loans and receivables due from customers	9.924	18.690	79.146	136.438	243.898
Equipment and intangible assets				6.415	6.415
Interest accrued and other assets	3.568	320	4	44	3.936
Total Assets	**58.762**	**19.010**	**79.150**	**142.897**	**299.819**
LIABILITIES					
Deposits	53.067	20.419	80.410	62.121	216.017
Borrowings	-	353	2.712	15.377	18.442
Subordinated debt	-	-	-	6.845	6.845
Other liabilities and provisions for contingent losses	1.763	669	2.086	2.245	6.763
Total Liabilities	**54.830**	**21.441**	**85.208**	**86.588**	**248.067**
Liability gap	3.932	(2.431)	(6.058)	56.309	51.752

(Thousands of BAM)

31 December 2016	**Within a month**	**From 1 to 3 months**	**From 3 to 12 months**	**Over 1 year**	**Total**
ASSETS					
Cash and cash funds held with the Central Bank	48.951	-	-	-	48.951
Loans and receivables due from banks	2.457	-	-	-	2.457

Loans and receivables due from customers	20.524	18.961	83.476	126.920	249.881
Equipment and intangible assets	-	-	-	6.278	6.278
Interest accrued and other assets	2.175	35	19	51	2.280
Total Assets	74.107	18.996	83.495	133.249	309.847
LIABILITIES					
Deposits	41.887	16.553	85.995	65.200	209.635
Borrowings	142	2.289	3.574	13.876	19.881
Subordinated debts	-	177	212	8.967	9.356
Other liabilities	1.123	890	2.696	1.910	6.619
Provision for contingent losses	-	-	-	144	144
Total Liabilities	43.152	19.909	92.477	90.097	245.635
Liability gap	30.955	(913)	(8.982)	43.152	64.212

29. FINANCIAL RISKS (continued)

29.8. Operational Risk

Operational risk management is an important part of the Bank's business as it minimizes adverse effects on the income and equity of the Bank. Operational risk management entails the following:

- Forming a network of operational risk custodians and reporters across departments and divisions, who are in charge of taking activities in the area of operational risk management;
- Maintaining records on harmful events occurrences;
- Operational risk identification and assessment within all processes and adoption of measures for risk minimization;
- Regular reporting on damages incurred and detailed review of risks identified per process;
- Monitoring of implementation of the proposed measures for the review of operational risks.

Operational risk is managed based on:

- Monitoring harmful events occurrence in the scope of operational risks;
- Risk identification per process within the Bank;
- Significant risk measurements;
- Continuous monitoring and control of operational risks;
- Forming the minimum amount of adequate capital

Monitoring harmful events occurrence in the scope of operational risks results in the historical review of the scale and type of actually occurred operational risks and is performed in accordance with the Procedure and Instructions for Harmful Event Recording.

Operational risk management is performed through the following activities:

- Identification of the existing sources of operational risks and sources contingent on the introduction of new products, systems and activities;
- Operational risk measurement through accurate and timely risk estimates;
- Continuous control of operational risks ensuring the maintenance thereof up to the level acceptable for the Bank's risk profile, its reduction and minimization;
- Continuous monitoring of operational risks by analyzing amounts, changes and trends of the Bank's exposure thereto;
- Forming the minimum amount of capital for protection against incurring operational risk-based losses (MACOR);
- Clear definition of authority and responsibility lines in the process of operational risk assumption and management;
- Setting up a system to ensure that all Bank's employees become familiar with their respective obligations in the process of operational risk management;
- Setting up a system for regular reporting to the Supervisory Board and Management on functioning of the operational risk management;
- Obligatory regular periodical review and obligation of the Supervisory Board to analyze and assess adequacy of the established system for operational risk management at least annually

29.9. Capital Management

Capital represents a unique economic resource and capital management is one of the most important components of the Bank's prudent, efficient and strategic planning and management. The Bank's capital management policy includes providing and maintaining the quantity and quality of the capital at least at the level of the minimum standards prescribed by the BARS Decision on the Minimum Standards for Capital Management of Banks (the "Decision"), i.e., the minimum amount of the share capital and the minimum amount of the net capital that the Bank is under obligation to maintain cannot be below BAM 15 million. In accordance with the aforecited decision, the Bank's capital is comprised of the core capital (Tier 1), supplementary capital (Tier 2) and net capital is the capital less deductible items.

The Bank's core capital is comprised of share capital paid in cash and other reserves that do not refer to the asset quality assessment less the following deductible items: unabsorbed prior years' losses and intangible assets. The Bank's supplementary capital includes general reserves for absorption of credit losses per Bank's assets within category A – good assets, amount of subordinated debts (maximum 1/2 and 1/3 of the core capital as from December 31, 2015 and 2016, respectively) where the core capital totals at least 9% of the total risk-weighted assets. The deductible item is the amount of shortfall reserves for credit losses per regulatory requirement (which the Bank did not form).

29. FINANCIAL INSTRUMENTS (continued)

29.9. Capital Management (Continued)

The Bank's policies for maintaining the quantity and quality of the capita include the following:

- In respect of the shareholder composition and profile, focus on shareholders from the banking sector and areas of micro crediting, financial investment, corporate shareholders and eventually private individuals;
- Policy of diverse equity instruments, particularly within the core and supplementary capital, and decrease or avoidance of the capital deductibles;
- In respect of the profit distribution, increase in the Bank's total capital in accordance with the effective regulations;
- In respect of the capital adequacy, when the capital adequacy ratio fall below 15%, the Bank undertakes activities to improve capital adequacy by new share issues, increase of supplementary capital by setting as priorities restructuring of bad assets, write-off of liabilities and obtaining subordinated debts.

Procedures for continuous monitoring of the balances are implemented through:

- Maintaining up-to-date accounting records;
- Monitoring capital balances per quantity, quality and structure;
- Monitoring and analyzing balance sheet items and off-balance sheet credit equivalents;
- Reporting on changes in capital and changes that could have material adverse effect on the capital adequacy;
- Proposing necessary measures to be taken in order to ensure the quantity and quality structure of capital; and
- Planning the capital in terms of anticipating the Bank's future needs and requirements for capital.

On 31 December 2017, the plan for capital adequacy maintenance was harmonized with the Decision on the Minimum Standards for Capital Management and Capital Protection of Banks, as well as with the overall action plans, taking into accounts the current condition and expected influences of the anticipated changes in the business operations and environment. The Bank is under obligation to maintain capital adequacy at the minimum of 12% and the management regularly monitors the adequacy indicators and submits a report thereon in the prescribed form to BARS on a quarterly basis.

As of 31 December 2017, the Bank was in full compliance with all the prescribed capital adequacy indicators:

	(Thousands of BAM)	
	As of	
	31 December 2017	**31 December 2016**
Core capital	47.301	38.218
Supplementary capital	10.376	9.798
Deductible items	(6.121)	(8.874)
Bank's net capital	**51.556**	**39.142**
Credit risk-weighted assets and off-balance sheet items	264.383	226.446

Weighted operational risk exposure	24.005	18.558
Total risk-weighted assets, off-balance sheet items and operational risk exposure	288.388	245.004
Capital adequacy ratio	**17,90%**	**16,00%**

30. EVENTS AFTER THE REPORTING PERIOD

Until these financial statements' issue date, there have been no other subsequent events that would require additional disclosures in or adjustments to the Bank's financial statements for the twelve-month period ended 31 December 2017.

31. EXCHANGE RATES

The official exchange rates for major currencies used in the translation of statement of financial position components denominated in foreign currencies into BAM as of 31 December 2017 and 31 December 2016 were as follows:

		In BAM
	31 December 2017	**31 December 2016**
USD	1,6308	1,8554
CHF	1,6714	1,8212
EUR	1,9558	1,9558