# ProCredit Bank AD Skopje

# Risk Management Framework

# ProCredit Bank AD Skopje Risk Management Framework Contents

This document follows the requirements of the Banking Law ("Official Gazette of the Republic of Macedonia" No. 67/07, 90/09, 67/10, 26/13, 15/15, 153/15, 190/16, 7/19 and 101/19), the Decision on the methodology for risk management ("Official Gazette of the Republic of North Macedonia No. 113/19 and 69/20), and the Strategy Business policy and Development plan for ProCredit Bank North Macedonia 2020-2024, as well as the Risk Management Policy of ProCredit Holding. This document is part of the internal regulatory framework for corporate governance and risk management of ProCredit Bank AD Skopje.

## Introduction- Bank's strategic orientation

ProCredit Bank AD Skopje ("ProCredit Bank", "the Bank") is a development-oriented bank which offers a full range of banking services to its clients. The Bank's goals and objectives are closely related to, and indeed are derived from, the goals and objectives of the group's parent company, ProCredit Holding AG & Co. KGaA, which is based in Frankfurt am Main, Germany.

ProCredit bank defines itself as a responsible "Hausbank" for very small, small and medium enterprises. In particular it aims to be the "Hausbank" of choice for the very small, small and medium sized businesses and to provide responsible, secure and simple banking services to the private clients in the environment in which it works. To be the "Hausbank" of choice, the Bank specializes in providing professional, flexible integrated banking services for the very small, small and medium sized businesses, their owners and targeted group of private individuals who have the capacity to save and who prefer to do their banking through electronic channels. "Responsibility" is hereby derived from a commitment to achieving a development impact, a commitment to bank's customers and a commitment to the well-managed, sustainable development of the institution. It influences the definition of the target group of customers which the bank aims to serve, and, above all, the way in which the bank serves them. The emphasis on "Hausbank" is based on bank's commitment to access, trust and partnership: the need to provide services over the long term.

The aim of the Bank is to achieve this by continuing to recruit and train the staff in best possible way in order to be able to work with our clients in a responsible and efficient way, and by continuing to build well-structured institutions based upon a culture of professional discipline, communication and trust.

ProCredit Bank has modernized the way of doing banking and atomized most of the services provided to the clients. On each location, ProCredit Bank offers 24/7 Zones with several types of automated teller machines which enable cash deposits and withdrawals for clients. It does not process any kind of cash transactions in service point and aims to provide direct on-line banking service, in most secure and convenient way for clients.

The lending methodology used by the ProCredit banks was developed by ProCredit Holding. Over the years, it has gained a profound understanding of both the problems encountered by very small, small and medium businesses and the opportunities available to them, and as a result, the credit technology has been designed to reflect the realities of this target group's operating environment. Thanks to this credit technology, which combines a detailed analysis of all credit risks with a high degree of efficiency, the ProCredit banks are able to build and maintain mutually beneficial business relationships with their clients. ProCredit Bank does not actively promote consumer lending, and in serving its credit clients it places great emphasis on performing a careful evaluation of each borrower's debt capacity and on building lasting relationships.

The "Hausbank" concept also has important implications in terms of the way in which ProCredit Bank deals with its employees and how their role is defined. The corporate values of the ProCredit group serve to make the principles of honest communication, transparency and professionalism an integral part of day-to-day business operations. Accordingly, ProCredit Bank sees a sound, comprehensive approach to the recruitment and training of staff as the key to success. This means that there is a need not only for intensive training in technical and managerial skills, but also for a continuous exchange of personnel among various ProCredit institutions in order to take full advantage of the opportunities for staff development that are created by their status as members of a truly international group.

ProCredit Bank AD Skopje will strive to maintain the excellent quality of its customer service and its broad range of banking services, as well as to provide socially responsible services with the aim of contributing to the economic development of the country. The Bank's focus is on very small, small and medium-sized enterprises because such businesses constitute the most important segment of the Macedonian economy; they create the largest number of jobs and make a vital contribution to the development of the economy by providing a great many essential goods and services.

Finally, it should be noted that while ProCredit Bank's shareholders expect a sustainable return on their investment, their goal is not short-term profit maximisation.

The aim of this document is to provide an overall view of the risk management framework of ProCredit Bank AD Skopje, promote sound Risk Culture and to define bank's Risk appetite. This document is to be seen in conjunction with the separate bank Policies governing specific risks as well as the Remuneration Policy, Code of conduct and Code of Corporate governance. Furthermore the document's principles will be complemented with Procedures and Risk Manuals on the various risks.

Overall responsibility for the bank's risk management framework lies with ProCredit Bank's Management. This document is approved by Bank's Management and Supervisory Board. The document is to be reviewed at least annually, or in case of significant changes in the overall risk management system of the bank and amended accordingly.

# I Risk Culture of ProCredit Banka AD Skopje

The approach taken by ProCredit Bank AD Skopje to risk management, internal control and the internal audit function, is in line with the Bank's risk profile. The Bank's positioning on the market as a responsible "Hausbank" is a reflection of its overall business philosophy, which in turn ensures that it consistently applies a responsible and conservative risk management approach based on detailed knowledge of its market and its clients.

The general risk management principles applied by ProCredit Bank are as follows:

- ProCredit Bank offers basic banking services on transparent and fair terms and conditions. Both its services and its business processes are characterised by a low degree of complexity and a sufficient level of monitoring and internal control. Accordingly, they are in turn characterised by a limited level of risk. Trading in financial instruments is not one of the Bank's principal activities, and the Bank does not engage in speculative trading at all.
- ProCredit Bank fosters risk awareness on all employees, and all staff are responsible for ensuring that a working environment is created and maintained in which due consideration is given to risk-related issues. This includes the principle that staff are never to base decisions on assumptions regarding unclear issues, but rather are to ask more knowledgeable colleagues for information and advice and to clarify all points about which they are uncertain. Whenever new risks are identified which may be regarded as significant, staff must inform the Management and the Risk Management Unit, with whom appropriate measures for risk reduction are to be agreed.
- The Bank makes a considerable investment in basic and advanced professional training for the staff in order to ensure the highest possible level of professionalism in the delivery of services.
- Ethical behaviour on the part of all managers and employees and the creation of a working environment that is characterised by trust and openness are important prerequisites for risk avoidance.
- Supervisory Board adopts Code of Conduct[1] as a mean of communicating ProCredit's clear ethical principles to employees and of bringing them to conduct themselves in accordance with these values, to recognise any misconduct or inappropriate behaviour on the part of others, and to take the appropriate measures to counter such behaviour. Each employee must fully understand and adhere to the principles defined in the Code of conduct and engage in the ongoing dialogue about its application. The corporate values provide the framework for bank's business ethics:

    i. Personal integrity and commitment: Complete honesty is required of all employees at all times, and any breaches of this principle are swiftly and rigorously dealt with.

    ii. High professional standards: Employees take personal responsibility for the quality of their work and always strive to grow as professionals.

[1] See document "Our responsibility – Our Code of Conduct", June 2020.

iii. Social responsibility: As a development-oriented banking group, the intention is to act for the benefit of society at large, not only passively (by avoiding socially harmful acts) but actively (by engaging in actions with a positive impact on the welfare of society and the environment).

iv. A culture of open communication: The communication is open, fair and constructive among everyone in the bank. Conflicts at work are dealt in a professional manner, people working together to find solutions.

v. Transparency: The information provided to customers, to the general public and to each other is transparent.

- Whistleblowing as an important aspect of accountability and transparency is a mechanism that enables the bank staff to voice concerns in a responsible and effective manner. When an employee discovers information which he or she believes to show serious malpractice or wrongdoing within the organization, then this information shall be disclosed internally without fear of reprisal, and there shall be arrangements to enable this to be done independently of line management (although in relatively minor instances the line manager would be the appropriate person to be informed). No members of staff should feel at a disadvantage in raising legitimate concerns.

- Incompatible tasks are performed by separate departments; when necessary, processes must be carried out in compliance with the “four - eyes principle”, or dual control should be implemented.

- The bank takes adequate precautions against money laundering and other fraudulent activities. All relevant customer transactions have to be conducted following a “know-your customer” principle, which prescribes that business can only be executed with customers whose business and background we sufficiently understand.

## 1. Training

ProCredit bank’s culture is based on its ethical principles and encourages proactive participation and professionalism. The implementation of the business strategy requires staff who establish long term relationships with customers and provide them with innovative and efficient service in a friendly manner.

In order to achieve this, training is organized at many different levels of the group and involves a large number of key people and resources. Training programs can be provided either at the bank level, in the academies or at the group level. This training continuum provides a strong base for the participants’ solid individual development, for knowing the key staff members and future managers of the group and for creating strong bonds between colleagues and the group.

In regards to establishing bank’s risk culture, the following trainings take key role in employees training process:

### *Code of Conduct*[2]

The Code of Conduct is an integral part of the employment contract and is a legally binding document for all employees of the bank. In conjunction with the annual signed affirmation of the Code of Conduct, the bank organizes an annual training for all employees based on recommendations of Group Human Recourses department as to the approach, curriculum or methodology applied. The expectation is that all employees need to comply with the Code of Conduct not only because it is a binding document but, more importantly, because it reflects the group's values, mission and vision.

### *Risk awareness training*

The bank conducts a risk awareness training program for all employees every two years. The contents of the training program is defined by the bank's risk manager, but shall consider the following standard elements:

- Brief overview of risk management activities in the bank, with a special focus on operational risk;
- Definition of operational risk, including some examples of different sources/types for a better understanding;
- Discussion of specific Risk event database (RED) entries as examples to illustrate the usefulness of the process;
- A summary on the code of conduct (unless provided in other training programs);
- Basics of process controls;
- Basics of the bank's insurance coverage, if appropriate for the audience;
- Update on fraud prevention as defined in the Group Fraud Prevention Policy;
- Reminder of every employee's requirement to escalate if in doubt about a process;
- Communication and escalation process for operational risks in the bank and the group;
- Reminder of every employee's responsibility to escalate their concerns (whistleblowing) and the available channels for this purpose;
- Brief overview of the principles of information security and business continuity (unless provided in a separate training programme).

In addition, at group level trainings are established for all staff in order to further understand the principles of the institution. This includes the following trainings:

- The Onboarding Programme;
- English courses;
- Glossary (the common dictionary of ProCredit terminology);
- Ethics;
- General Green Training;
- Position-specific training:
  - Business Client Adviser (BCA) training
  - One year Staff exchange programme at ProCredit Holding
  - Credit Risk Officer training
- AML Training;

[2] See document "Our responsibility – Our Code of Conduct", June 2020.

- Information security awareness training;
- Academies- purpose of the academies is for students to develop their understanding of ProCredit identity, business model and strategy and the challenges of banking and management. In the humanities curriculum, they undertake an in-depth analysis of both the natural and social sciences. The Group organizes the following academies:
  - Bankers' Academy- 14 weeks course
  - Management Academy-3 years course

## 2. Risk organization

The organizational layout for risk management consists of clear organizational structure and efficient internal control system. The bank establishes an organizational structure that ensures clearly defined competences between the persons and organizational departments/units performing risk-taking activities on the one hand and the persons and organizational departments/units performing risk-management activities on the other. For credit exposures to business clients which in line with internal classification are upper small and medium credit exposures a segregation between front-office and back-office functions up to and including the management level is implemented.

The bank appoints a member of the Management Board responsible for monitoring the performance of the risk management function. The appointed member is independent in monitoring the performance of the risk management function and is not directly responsible for activities that constitute risk-taking. This appointed member has access to all the information needed to perform its duties effectively.

The bank has established Risk Management Unit and Credit Risk Department responsible for the risk management in the bank. The bank ensures independence and proper organization of this risk management functions, which enables their involvement in making risk management decisions, access to the bank's employees and bodies and obtain all information necessary for the effective fulfilment of their responsibilities.

All processes and areas of operations including the risk management system are assessed by the Internal Audit Department on a regular basis.

In regards to risk management, following bodies in the bank have the following competences:

### 2. 1 Supervisory Board

The obligations and responsibilities of the members of both Supervisory Board and the Managing Board are set forth in detail in the Banking Law, Decision on corporate governance and Code of corporate governance of the Bank.
The Supervisory Board has the ultimate responsibility to create conditions for good operation and management of the bank and its stability.
The Supervisory Board:

- adopts the bank's business policy and to monitors its implementation;

- is actively involved in the supervision of the bank’s operations, keeps pace with the significant changes in its operations and its environment and acts on time to protect the bank’s long-term goals;
- adopts and monitors the implementation of other policies and internal regulations within its competence;
- together with the Managing Board, establishes and promotes corporate culture and values in the bank;
- makes a self-assessment and an assessment of the members of the Risk Management Committee, the Auditing Committee and the Board of Directors, pursuant to the policy on the method of selection, monitoring of the operations and dismissal of the members of the Supervisory Board, the Risk Management Committee, the Auditing Committee and the Board of Directors;
- defines the rights and responsibilities of the legally prescribed committees and the Board of Directors, as well as defines the cooperation with the bank’s Board of Directors;
- together with the Board of Directors, determines the acceptable level of risk, taking into consideration the market competition, the regulatory requirements, the bank's long-term goals, the risk exposure and the risk-taking capacity, which means compliance of the acceptable level of risk with the business policy, the financial plan, the process of determination of the internal capital and the remuneration system;
- establishes and monitors the implementation of the risk management system, including the operation of the Risk Management Committee, taking into consideration the requirements of the National Bank’s regulation on risk management ;
- establishes and monitors the implementation of the internal audit and to monitor the operation of the Auditing Committee.
- monitors the bank’s financial operation and the manner in which the financial reporting is being made;
- monitors the remuneration system in the bank and makes an assessment if it is in compliance with the remuneration policy, the risk culture and the bank’s risk-taking capacity;
- monitors the implementation of the bank’s internal regulations for protected whistleblowing;
- reviews transactions with the entities connected to the bank.

The Supervisory Board supervises the work of the members of the Managing Board and monitors the work of the persons in charge of the control functions. In cases when these persons fail to adhere to the corporate culture and values, the acceptable level of risk and the risk culture, the Supervisory Board is obliged to undertake appropriate measures, including the request for their dismissal.

Supervisory Board appoints one member of the Managing Board who is responsible for monitoring the work of the organizational unit in charge of implementing and/or coordinating the activities and processes related to the risk management system (hereinafter: member of the Managing Board responsible for monitoring the risk management).

The bank's Supervisory Board monitors the implementation of the internal regulations and processes for free protected whistleblowing by the employees of the bank, pursuant to law. The internal regulations and processes cover all types of reporting's, especially the reporting to the National Bank, define the entire procedure for protected whistleblowing, in the Fraud prevention Policy, that is not part of the regular system of reporting in the bank, which among other things includes determination of:

- the person/authority to who/which it reports;
- the manner of determining the validity of the protected whistleblowing;
- the manner of eliminating the ground for the protected whistleblowing, if it is determined that the whistleblowing was justified.
- the manner of protecting whistleblowers in the bank against any punishments or threats against them or their post.

The internal regulations for whistle blowing are available to all employees of the bank.
The Supervisory Board is obliged, at least once quarterly, to review the report on transactions with the entities related to the bank, as well as on the amount of approved loans and other forms of exposure to the persons with special rights and responsibilities in the bank.

## 2. 2 Managing Board

With regards to the overall organization of Risk Management, Managing Board is responsible for the proper conduct of the bank's activities in compliance with the regulations. It is responsible for risk management and monitoring. It is responsible for the achievement and maintenance of proper level of own funds. Management takes care of proper functioning of the internal control system in all areas of banking operations. It provides ground for smooth operating of the Internal Audit Department making sure it has access to all documentation and staff in the bank. Management is responsible for the implementation and regular update of policies and procedures in the bank. It develops a Code of conduct of the bank which is afterword approved by the Supervisory Board.

## 2. 3 Risk Management

Risk Management function is maintained according to local regulations. Risk Management has the mandate to constantly identify, analyze and advise on risks following the principles set in this document. Risk management is implemented and developed, in operational terms, by autonomous Risk Management unit and Credit Risk department which are not involved in any way with the bank's customer service operations (credit staff) or trading operations. The Risk Management function has direct responsibility for the risk environment and the execution of all risk management tasks.
Risk Management is put in a position to always be aware of the general risk situation of the bank and monitor the usage of exposure limits. To ensure that this requirement can be met, all transactions must be entered immediately in the respective system(s), and Risk Management must have access to the necessary information at all times.
The responsibility for risk management lies with the Managing Board Member, responsible for Risk Management (Chief Risk Officer).

## 2. 4 Internal Audit Function

The Internal Audit Department is an independent organisational unit which is not subordinate to the Managing Board and is not involved in the operational activities of the Bank. As is reflected in the current organizational structure of ProCredit Bank AD Skopje and the established lines of authority and communication within the Bank, the Internal Audit Department reports directly to the Audit Committee.

The internal audit function is an independent, autonomous area of activity within the Bank, designed to increase the quality of the Bank's entire range of operations. It assists the Bank in achieving its goals by carrying out systematic, prudent assessments of operations so as to improve the efficiency of risk management, the internal control functions and the overall process of corporate governance.

The main objective of the Internal Audit Department is to provide reasonable assurance that the existing control mechanisms have been appropriately designed and that they are functioning properly, and to monitor the operating processes within the Bank to ensure that they are being carried out in such a way as to support the institution's goals and enable it to meet its commitments.

In order to enable it to determine whether the established rules and procedures within the various departments are sound, effective and efficient, the Internal Audit Department is using a comprehensive audit approach known as the "risk-based approach to the planning and implementation of audit activities".

The principal goals and activities of the Internal Audit Department shall be as follows:

- Assessment of the efficiency and effectiveness of the internal control systems;
- Assessment of the extent to which the internal policies and procedures have been implemented;
- Monitoring of compliance with the applicable legal regulations, the Bank's code of corporate governance and its code of conduct;
- Review of outsourcing activities to assess the extent to which they are being carried out in compliance with the established policies and procedures;
- Monitoring to assess the way in which the Bank's policies and procedures relating to measurement, monitoring, control and mitigation of all types of banking risks (credit, liquidity, currency, market, interest, concentration, operational, reputation, etc.) are being implemented;
- Evaluation of the accuracy and reliability of the accounting records and the financial statements;
- Assessment of the systems, policies and procedures that are employed in order to prevent money laundering;
- Provision of advisory assistance within the department's area of responsibility and expertise to support all aspects of the bank's operations.

# 3. Risk Management Process

The central Risk Management Process is set up around the weekly Risk Management Committees and the quarterly Audit Committees. These committees have been set up to ensure regular monitoring and documentation of the risk profile of the bank. The Risk Management Committee addresses all risks. Sub-committees are as well set up to specifically address certain risks (Market Risks, Credit Risks, Operational Risks or other risks).
The following sections describe how the risk management process is actually implemented.

## 3.1 Identification of Risks

As a preliminary step in order to be able to identify the bank's risk profile, all processes within the bank must be clearly documented in work procedures, for example. Such documentation must be reviewed on an annual basis or whenever significant changes to the processes are implemented. This does include interfaces to outsourced processes. Aim of the identification process is to achieve a timely, complete and adequately documented risk map of the bank. The following activities are executed to identify risks:

### 3.1.1 Control Assessments

As part of the annual review of policies, procedures and job descriptions, all departments execute an assessment on their processes to determine if risks implied in the processes are adequately controlled. With the update and implementation of these documents, the respective department heads confirm that the implemented level of controls is adequate.
Any gaps identified and the appropriate measure to close the control gap should be discussed with Risk Management and/ or other relevant units/departments. In cases where additional controls would be disproportionate, risks may be accepted by the responsible Management. Such decisions are documented.
The Control Assessment covers at least the critical processes, but can be widened towards a control-focused analysis of all processes.

### 3.1.2 Internal Audits and External Audits

Audit planning within Internal Audit is based on an assessment of risks and exposures that may affect the bank, which is done annually in order to reflect the most current strategies and direction of the bank. It is the aim of Internal Audit that the risk assessment and the plan developed from this assessment reflect the overall objectives of the bank as well as management's concerns. In this way, the risk-based audit plan ensures that audit activities are effectively focused on those areas where the risks or materiality of exposure is greatest.
External Audits is conducted as per legal requirements.
Identified gaps of any audit are shared with Management, and with Risk Management as and where deemed necessary by Internal Audit. Management is responsible for the timely closure of all identified gaps.

### 3.1.3 Risk Events

Significant Risk Events must be recorded in a database (Risk Event Database – RED) and reported to Management. All employees are required to report Risk Events to Risk Management for proper execution of the Risk Identification process. In cases of substantial events or changes in the risk situation, Management is informed instantly and measures are initiated to limit such risks or losses.

### 3.1.4 Ad hoc identification

All ProCredit staff is required to raise any suspicion about processes or transactions to Management and / or Risk Management to clarify if there is a control weakness or risk, which needs to be addressed. The general rule for all staff is to never assume that things are in good order, but to always clarify in case of doubt.

### 3.1.5 New Risk Approval Process

Any new activities or major changes in existing processes must be run through an NRA process, including (if relevant and appropriate), but not limited to approval from Risk, Legal, Compliance and AML, Accounting and the relevant business departments. New products/ processes/ instruments etc. must be tested before going live, as appropriate. Operational Risk Committee and Managing Board ultimately decides upon the implementation of a new process (this responsibility can be delegated). In case the bank's risk profile is substantially impacted with the new products / processes / instruments etc. (material risks) they are approved by the Supervisory Board.

### 3.1.6 Risk Reports and Risk Committees

Risk Reports are compiled on at least quarterly basis and Audit Committee reports on a quarterly basis as a minimum standard of risk reporting. These reports summarize findings based on a review and analysis of key indicators provided by the various departments in the bank.
In addition, Risk Reports are reviewed by Group Risk Management and consolidated to generate the ProCredit Group's risk map.

## 3.2 Evaluation of Risks and Risk Limits

Any risks identified are brought to the attention of Management and Risk Management for analysis and proposals for action. This is done by way of requirement to all staff to escalate to Risk or by direct participation in the risk identifying activities (e. g. NRA, Control Assessment).
Each risk is identified and limits are set as defined in the Risk appetite Statement.

## 3.3 Risk Control

Control processes are implemented within the bank at every level of operations. The level of control depends on the level of risk implied in the process. Control processes must be adjusted in a timely manner to reflect changes in the operating environment. All processes must be designed in such a way as to ensure that fraudulent activities cannot be successfully carried out or, at the very least, that any such activities will be identified in a timely manner. Furthermore, management is responsible for creating and fostering a culture of open communication, mutual respect and trust which should prevent or lead to the early detection of fraud (see below: Communication of Risks). Two main control principles are implemented as and where appropriate:

1. Four-eyes-principle or dual control. This principle is also implemented in IT systems where possible (e. g. to ensure approval of an activity is done by another person).
2. Segregation of duties is applied in the following way:
   - Trading is strictly separated from the back office up to the manager level;
   - Responsibility for accounting and all kinds of risk control (especially market and credit risks) is segregated from the corresponding business functions, which are considered the “risk takers”;
   - Essential legal risks are handled by the legal, compliance and AML organizational unit.

## 3.4 Reporting system

ProCredit Bank AD Skopje has established a well-functioning and adequate information system. This system integrates several subsystems that are organized and serve for basic banking activities related to business and services oriented to risk, finance and control, human resources management, etc. The structure of the system and processes are defined and organized to provide a solid basis for timely, appropriate and effective decision-making and management of the bank. Also, the system is built on the principles of controlled and strictly defined access to different types of information, division of duties and dual control in certain operations.

On the basis of data in the information system, reports are generated on a regular basis.

The risk reports fulfill the following conditions:

- they are transparent - contain clear, understandable and accurate data related to risks;
- they are complete - ensure enough data on all material risks and to enable comprehensive analysis and assessment of the bank's exposure to risks;
- they are useful - contain the most important data related to risks;
- reports are comparable with previous reports and
- enable monitoring of the implementation of the risk appetite statement, including monitoring of individual qualitative and quantitative indicators, their thresholds, internal limits, exceeding of threshold and internal limits, as well as monitoring of approved exceptions;

The information from the system is processed and sent to senior management and middle management in a timely manner which enables timely monitoring, verification, control and decision-making regarding taking and managing risks.

## 3.5 Communication of Risks

### 3.5.1 General Risk Management Committee

General Risk Management Committee is held on at least weekly basis, where the Risk Management unit reports on risk, based on the defined limits and early warning triggers. The responsibilities of the committee are defined in the Procedure on General Risk Management Committee.

Sub-committees are also set up in order to specifically address certain risks (Market Risks, Credit Risks, Operational Risks or other risks).

### 3.5.2 Audit Committee

On a quarterly basis, an Audit Committee is held. In this committee, Management reports on the bank’s situation to the Audit Committee (including an overall summary of relevant risks discussed by the Risk Management Committee). Also, Internal Audit reports on their findings.

### 3.5.3 Requirement to escalate

Within its internal acts, the bank establishes procedures for taking actions in case of exceeding limits, which define: reporting lines, scope and reporting time frame, possible actions to be undertaken to eliminate the limit breaches and the organizational units and committees responsible for their undertaking.

### 3.5.4 Quarterly update to Supervisory Board

The bank’s Management gives a quarterly update to the Supervisory Board, in which an overall summary of relevant risks discussed by the Risk Management Committee is included.

## 3.6 Documentation of Risks

All relevant documents regarding business processes and control processes are recorded adequately and archived as required by law.
All essential Risk Events must be documented in the corresponding database.
Internal Audit documents all findings in the respective audit reports.

## 4. Remuneration policy[3]

The Bank has defined the principles according to which remuneration will be determined for the members of the Managing Board, persons with special rights and responsibilities and the other employees of the Bank. The principles established for determining remuneration are in line with the overall business policy and long-term strategy and risk management framework of the Bank. The Bank has transparent salary structure with fixed salaries and is consciously refraining from contractually agreed bonuses as means of incentivizing the staff. Variable remuneration element can be granted when a member of staff has performed exceptionally well during the course of a financial year or has made a key contribution to the team or group.
ProCredit has a standardized salary system which is applied throughout the group and includes: salary levels for certain positions, the maximum allowed ratio between the lowest and the highest salary level and the training requirements for each position. In individual cases, an institution may provide non-monetary remuneration elements such as visits to other ProCredit banks or participation in additional training. The management board of the bank report annually to its respective Supervisory board about the remuneration structure.
Open and responsible communication is a central part of staff management in ProCredit Bank. The remuneration structure is presented to all staff in transparent manner. Remuneration and promotion are primarily linked to individual performance appraisals. Managers conduct annual staff talks and give regular feedback to their employees. In addition, every employee has an annual staff conversation with a member of the management team.

The persons with special rights and responsibilities are to be awarded based on the following criteria:

- fulfilment of the business plan in the area for which the person with special rights and responsibilities is responsible;
- absence of any high-risk findings in the person’s area of responsibility in the audit performed by the Internal Audit Department;
- management and motivation of the employees of the area for which the employee is responsible, in a manner which creates a healthy working environment;
- promotion of teamwork among the employees of the respective organisational unit;
- due and timely completion of the duties delegated to him/her by the management of the Bank;
- improvement of the operating efficiency of the organisational unit, etc.

Rewards for persons with special rights and responsibilities may take the form of monetary reward, such as salary increase or payment that will be used with a purpose for investment in shares in ProCredit staff Invest GMBH, or of non-monetary compensation such as:

- the opportunity to attend the ProCredit Management and/or Bankers Academy in Fürth, Germany;
- the opportunity to attend trainings, workshops and seminars
- the opportunity to exchange experience in other sister banks
- serving as a lecturer at the ProCredit Management and Bankers Academy

[3] Refer to “Remuneration policy” for more details on this section

- serving as a lecturer/moderator in the local trainings and seminars (ProCredit Onboarding process, specialized technical trainings, etc.)

In addition, for the individuals responsible for the control functions within the bank, such as compliance, audit and risk, the Supervisory board will take the decision related to the salary change.

The members of the Managing Board are to be awarded based on the following criteria:
- the scope of competencies of the Board member in question
- the individual's success in performing the function of member of the Managing Board
- the implementation of the Bank's strategy and annual plan of activities, and
- the overall performance of the Bank

Remuneration of members of the Managing Board may take the form of a monetary reward, such as salary increase or payment that will be used with a purpose for investment in shares in ProCredit staff Invest GMBH, or of non-monetary compensation such as:
- serving as a lecturer at the ProCredit Management and Bankers Academy
- attending external trainings, workshops and seminars

The Bank's Supervisory Board shall have the right to decide whether the members of the Managing Board will be rewarded. The decision to reward members of the Managing Board shall be initiated and taken by the Supervisory Board

To independent members of the Supervisory board, the Bank can pay fixed compensation for their performance of their duties. To the other members of the Supervisory board, the Bank can reimburse travel expenses occurred from the meetings of the Supervisory board members.

## II Risk appetite statement of ProCredit Bank AD Skopje

Ensuring the long-term stability of the ProCredit group and its individual institutions is an objective which has maximum priority in the Group's framework of corporate management. The risk appetite statement of ProCredit Bank AD Skopje shall ensure that the Bank only assumes the amount of risk in order to achieve its long-term goals as well as the types of risks it is willing to take within its risk capacity. The following steps are therefore taken:

- determination of maximum permissible risk levels (limits),
- establishment of processes for the ongoing monitoring of the set limits and
- management and planning of the risk profile and the available capital.

The overarching goal of the Risk appetite statement is to ensure capital adequacy at all times and ensure that risks are appropriately covered by sufficient capital, ensuring the continuity of business activity. This means that risks have to be quantified in order to understand their impact on the bank's capital. The Bank regards its capital as adequate when it can be assumed with high degree of certainty that the capital is sufficient to adequately cover all the risks that have been incurred in the course of its business operations even under extreme circumstances.

The Bank shall comply at all times with all prudential regulation limits required to be maintained by the laws of the Republic of North Macedonia (in particular the Banking Law). In addition, limits are set in Group's policies adopted by ProCredit Bank AD Skopje as well. The limits cover aspects of risk management that are not regulatory defined and that the ProCredit Group/ ProCredit Bank believe should be limited.

In order to prevent the bank from incurring excessive risks, complementary to the defined limits, reporting triggers are also set. Reporting triggers may be exceeded, but if this occurs the situation must be explained, with mitigation measures (if applicable/available) being decided upon the General risk management committee. Limit breaches should be avoided by all means.

Within its internal acts, the bank establishes procedures for taking actions in case of exceeding limits, which define: reporting lines, scope and reporting time frame, possible actions to be undertaken to eliminate the limit breaches and the organizational units and committees responsible for their undertaking.

The implementation of this Risk appetite statement is supported by appropriate process descriptions for the respective organizational units in order to ensure that the objectives of the statement are being met in full at every level. The process descriptions are to specify the organizational structure and the allocation of decision-making authority, and are to be complemented by terms of reference for all committees and by appropriate job description.

In line with ProCredit Group risk management framework, ProCredit AD Skopje limits the level of risk taking in accordance with the defined risk appetite on Group level and on set of approved maximum permissible risk levels for a given risk. The setting and continuous monitoring of limits is intended to ensure that the bank's development is in accordance with the business and risk strategy, to prevent developments which put solvency at risk and to make certain information available on the basis of which the responsible managers can act, allowing them to initiate any necessary corrective measures in a timely manner.

In line with Group Policy on ICAAP, Bank's Managing Board must ensure that the available capital resources are deployed economically and that business development perspectives are taken into consideration. On the one hand, over capitalization should be avoided; on the other hand, an appropriate amount and structure of suitable capital instruments should be ensured.

The Group's ICAAP consists of a normative and an economic perspective, reflecting both the goal of continuing the bank's operations on an ongoing basis and the goal of protecting creditors in an economic perspective:

- The normative perspective aims to ensure that institutions can meet all regulatory and external obligations and resulting internal requirements on an ongoing basis.
- The economic perspective mainly serves to safeguard the institution's economic substance in the long term.

Normative and economic perspectives are closely interwoven, but offer different angles on an institution's internal capital adequacy. The interaction of both perspectives is a necessary condition for aligned management.

In order to ensure internal capital adequacy in the economic perspective at all times, only a maximum of 60% of the risk-taking potential is made available as resources available to cover risks (RAtCR). For each material risk, an individual reporting trigger is set.

In the economic perspective, the risk-taking potential is defined as the total amount of capital instruments available to cover risks arising from business operations. ProCredit differentiates between the total risk-taking potential (RTP) and the resources available to cover risk (RAtCR). The differentiation between RAtCR and RTP is intended to cover risks that are not (yet) explicitly included in the calculations at bank level and to serve as a "security buffer".

The RAtCR is defined at 60% of RTP.

The RAtCR are distributed among the different risk categories and is as follows:

| Risk category | Economic perspective |
|---|---|
| | % of risk-taking potential |
| Credit risk<br>(customer credit risk + counterparty risk) | 38 |
| Foreign currency risk | 2 |
| Interest rate risk | 10 |
| Operational risk | 10 |
| Total | 60 |

For the total position a limit is set and for the individual material risks reporting triggers are set.

Stress tests are performed to analyze the effects that extreme market developments have in order to detect and assess risks to the institution's solvency. The results of the stress tests are to be critically analyzed in order to arrive at a clear statement about whether action needs to be taken.

## 1. Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP)

The process of determining the necessary internal capital and internal liquidity are an integral part of the risk management framework and are carried out and reported to the National Bank of the Republic of North Macedonia at least once per year or in case of significant changes in the overall risk profile.

The bank establishes ICAAP and ILAAP that provide:

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

Internal capital is an assessment of the amount of current and future capital requirements for covering individual risks the bank is or can be exposed in its operations.

Internal liquidity is an assessment of the amount of liquidity that enables the bank to fulfill its obligations within their maturity and cover the liquidity needs, in normal or emergency conditions.

In establishing internal capital and internal liquidity, the bank should take into consideration the stress tests results.

For the purposes of ICAAP, stress testing should encompass all identified material risks and cover the same time period covered by ICAAP.

For the purposes of ILAAP, stress testing should encompass different time periods, including one day, different sources of funds important for the bank's liquidity, including use of funds from the National Bank, encompass the material currencies and markets, as well as the possibility for using funds within the group.

In line with its business mission, business strategy, risk profile and the market in which the Bank operates, at least annually, the Bank conducts a risk inventory with the aim of identifying all risks to which is or may be exposed in its operations. For all included risks, the materiality of their impact is assessed. Based on the assessment, these risks are incorporated into the ICAAP and ILAAP.

The Bank has defined the following risks as material, which are then included in the ICAAP:

- Credit risk;
- Counterparty risk;
- Currency risk;
- Interest rate risk;
- Liquidity risk;
- Operational risk;

- Reputational risk;
- Macroeconomic risk;

The following risks are identified by the bank, however based on the assessment are defined as non-material:

- Strategic risk;
- Regulatory risk;
- Concentration risk;
- Country risk.

The Bank has defined the following liquidity risks as material, which are then included in the ILAAP:

- Risk of deposit outflow;
- Long term funding risk;
- Risk of short term funding on the money market;
- Concentration risk;
- Risk of decreased inflows from the loan portfolio.

The following liquidity risks are identified by the bank, however based on the assessment are defined as non-material:

- Transfer liquidity risk
- Increased usage of off-balance exposures;
- Market liquidity risk.

In its policies the bank, limits the level risk on which it is exposed during its operations. The levels of risk define in qualitative and quantitative form the maximum tolerable risk that the bank is inclined to take on the basis of its risk appetite and in line with its business strategy. In quantitative form, this means setting limits and early warning triggers, which are regularly monitored and evaluated. On the other hand, certain internal policies are set that also limit the level of risk the bank takes.

**Credit risk**

The management of credit risk is defined in the Group Credit risk management policy and Collateral valuation policy.

ProCredit group has developed robust processes for its lending operations under which it is able to successfully manage the specific credit risks in its countries of operation. The following principles characterize the ProCredit bank's approach to managing credit risk:

- Selection of the right profile of clients - Clear ownership structure; Management structure that insure adequate management and development of the business; Transparent in cooperation with the bank and other institutions, Business activity in line with Banks requirements and risk strategy (no involvement in speculative activities, no AML issues and there is low political and legal risk), and Sustainable business model and financial performance in accordance with credit exposure.

- "Hausbank" principle - Usage of services that the Banks provides; having an exposure and turnover with the bank; appropriate usage of the credit facilities; building clear and long-term vision of cooperation and long-term relationship with the client
- Responsible credit risk assessment and approval process– analysis of financial development of each company individually; decisions based on the payment capacity of the company; offering adequate credit facility structure and product; not over indebting the companies; regular monitoring
- Staff competence – bank's staff is well trained for credit risk assessment; the Bank is investing in high quality selection process and ongoing training programs for all employees;

Asset Quality Indicators (AQI) that structure the loan portfolio according to the categories "performing (with/without) early warning signs", "underperforming" and "defaulted portfolio" are developed. The assessment of the loan portfolio quality according to this structure allows timely and objective identification of credit risk.

A credit exposure should typically not exceed 10% of bank's regulatory capital. A large credit exposure must not exceed 25% of the bank's total regulatory capital, nor must the sum of all large credit exposures of a bank exceed 150% of its total regulatory capital.

The Bank establishes appropriate provisions against potential losses at a level consistent with sound financial and accounting practices and in the light of loan collection performance.

**Counterparty risk**

The management of counterparty risk is defined in the Group Counterparty risk management policy (incl. Issuer risk).

The counterparty and issuer risk of the ProCredit bank mainly arises from keeping highly liquid assets for the purpose of mitigating liquidity risk, i.e. as a reserve for times of potential stress, and not with the primary aim to make a profit. The main risk results from principal risk which is mitigated by keeping placed/invested amounts low, using derivatives to a minor degree and investing only into relatively low risk securities.

The aim is to invest liquidity safely and to diversify exposures as far as possible, wherefore no deal is allowed without a limit. The bank's ALCO/RMC sets its counterparty limits based on the needs of treasury front office/trading and the risk assessment made by risk management. Limits above the competence thresholds set in the Policy must be approved by Group ALCO/RMC.

Based on the policy the bank sets limits for all counterparties that is exposed to, mainly first-class foreign and domestic banks in which highly liquid assets are kept. Additionally, bank sets a limit of EUR 120 million (with reporting trigger set at EUR 115 million) towards the county of North Macedonia, EUR 9 million for investments in State bills issued by the Government of North Macedonia and EUR 5 million for investments in Eurobond issued by the Government of North Macedonia.

**Currency risk**

The management of currency risk is defined in the Group Foreign currency risk management policy.

As a matter of principle, ProCredit bank do not engage in proprietary trading[4] and do not enter any speculative positions on foreign exchange markets for the purpose of generating potential additional income. Therefore, ProCredit bank is strictly non-trading book[5] credit institution in the sense of the German banking act. The bank aims to close currency positions and ensures that an open currency position remains within the conservative limits at all times. Derivatives can only be used for hedging purposes to close positions of the bank as well as for liquidity purposes (in addition to being a service provided to clients).

In order to manage currency risk, limits and reporting triggers are specified. The key currency risk indicator (i.e. the total OCP) is restricted by a limit and thereby maintains the currency risk of each bank at an acceptable level. An overview of the key currency risk and early warning indicators is given in the below table.

| **% of CRR total capital** | **OCP per currency** | **Total OCP** |
|---|---|---|
| Reporting trigger for the internal early warning indicator | ± 5% | 7.5% |
| Limit | | 10% |

### Interest rate risk

The management of interest rate risk is defined in the Group Interest rate risk management policy.

The bank does not aim to earn profits through speculation in the interest rate market. Rather, it seeks to ensure that its interest rate structure is sufficiently balanced across all maturities by staying within the limits defined in the Policy. The bank achieves this by matching repricing profiles between assets and liabilities. If the asset-liability structure cannot be sufficiently matched to remain within Policy limits, interest rate derivatives (if available) can be used for hedging purposes only. The bank minimizes risk concentrations.

The policy sets limits for the bank exposure in each interest rate risk relevant currency considering the related interest rates volatility. To monitor interest rate changes, the bank employs a repricing gap analysis and captures the impact on the economic value (long term perspective) and the impact on earnings (short term perspective) deriving from a one-time shock (parallel shift of the yield curve) high enough to cover different scenarios of yield curve shifts, this is done for all interest rate risk relevant currencies. Only by assessing both indicators simultaneously is possible to determine the full scope of the interest rate risk exposure.

The following limits and early warning triggers for the key interest rate risk indicators shall be met by the bank.

[4] Proprietary trade occurs when a bank trades currencies, currency derivatives or other financial instruments with the bank's own resources for the purpose of generating a profit for itself.
[5] Following the definition of the Group Treasury Policy, the term trading book is defined such that any financial instrument has to be assigned to the trading book if its transaction purpose is to generate a short term trading profit.

- Non-netted, total economic value impact: An upper limit of 15% and trigger of above 10%, of the bank's CRR capital is set.
- Non-netted, total 12 months interest earnings impact: An upper limit of 10% and trigger of above 5%, of the bank's CRR capital is set.

**Liquidity risk**

The management of liquidity risk is defined in the Group Liquidity risk management policy.

ProCredit bank, in line with the Group Risk Strategy and Liquidity risk management Policy, adopt prudent liquidity risk practices and keep the level of liquid assets adequately high.

The key principles/tasks of liquidity risk management are the following:

- Ensure appropriate levels of liquidity at all times;
- Monitor liquidity and funding on an ongoing basis to ensure that the approved business targets are met in a manner that does not compromise the risk profile of an individual institution or the group;
- Manage the PCH core liquidity reserve;
- Optimize payment flows within the group;
- Analyze all potential future in- and outflows and measure their effect on liquidity risk, including those arising out of collateralized derivative transactions (e.g. margin calls);
- Co-ordinate significant group fund raising activities, including bond issues on the international capital market, as well as funding activities with international financial institutions and international banks.

The following key liquidity risk indicators shall be met by the bank at all times:

- Sufficient liquidity indicator (SLI): at least 1 at all times on total currency level, as well as on total hard currency level and local currency level.
- Survival period: at least 90 days on total currency level, as well as on total hard currency level and local currency level.
- Interbank market indicator: Total amount of interbank liabilities is not higher than the minimum of: 4% of total liabilities of the bank; EUR 20m.
- Overnight funding indicator: Total amount of overnight funding is not higher than the minimum of: 3% of total liabilities; EUR 15m.

The following reporting triggers shall apply for the bank:

- A risk exists that a limit will be breached, i.e.
    - Total sufficient liquidity indicator on total or per currency is below 1.2;
    - Interbank market indicator of more than 3% or interbank liabilities of more than EUR 15m, and no measures taken to reduce the level;
    - Overnight funding indicator of more than 2% or overnight funding of more than EUR 10m and no measures taken to reduce the level;
    - Survival period estimated based on Stress scenario 3 (extended market stress) assumptions is below 90 days on total currency level, or on total hard currency level or local currency level.
- LCR below 100%.

- A liquidity position in each of time buckets above 31 days less than zero.
- A deposit concentration indicator higher than the level of the defined deposit outflow assumptions used in Risk scenario for the deposits of non-financial institutional customers.

### Operational risk

The management of operational and reputational risk is defined in the Group Operational risk management policy. In addition, for further managing of the operational risk, the bank approves Group Fraud prevention policy, Group Outsourcing policy, Group Information security policy and Group Business continuity policy.

The framework for the management of operational risks combines the following general principles and instruments, which are implemented in the bank.

- The ProCredit group has defined a corporate culture based on openness and trust. The group's corporate values are emphasized in the group's training efforts, which go beyond providing technical and managerial skills.
- The governance framework of the group and each bank ensures that appropriate organizational measures are taken to manage the banks. This includes various measures, from the establishment of Audit Committees and Supervisory Boards to the documentation of processes and job descriptions.
- Policies and procedures that clearly document all main processes in the bank help identify and manage operational risk.
- Bank conducts operational and fraud risk assessments to establish a full operational risk profile of the institution.
- The bank ensures through a New Risk Approval (NRA) that new risks are assessed and all necessary preparations and tests are completed before the implementation or use of new or significantly changed business processes, products, instruments, IT systems or changes in organizational structure.
- Key Risk Indicators (KRI) are to be prepared at least quarterly and discussed in the (Operational) Risk Management Committee.
- The bank utilizes Risk Event Database (RED) to ensure that operational risk events are handled appropriately.
- The bank conducts scenario analysis which are used as an input factor for risk quantification.

### Macroeconomic risk

Macroeconomic risk, as the likelihood of adverse effects on the bank's financial result, capital or liquidity as a result of changes in macroeconomic and business conditions, changes in customer habits and technological developments to which the bank will not be able to adjust, is closely monitored by the Bank since the bank believes that their impact can have significant impact on overall operations of the bank and the realization of its business strategy.

Indicators such as gross domestic product, inflation, industrial production index, public debt development, unemployment rate, banking sector loan and deposit base development, Fitch outlook and political situation in the country are regularly monitored by relevant departments/units in the Bank and the developments are also monitored by General risk management committee and Supervisory board.

**Strategic risk**

The management of strategic risk is defined in the Strategic risk management policy.

The Bank has established risk mitigation factors in order to reduce and manage the strategic risk arising from its operations. Such factors include: qualified Supervisory and Managing Board, quality personnel and their ongoing training, an effective risk management system, adequate access to information, adequate business planning process and timely and efficient introduction of new products, banking system or services.

The Supervisory Board and Managing Board of the Bank closely monitor the strategic risk and its impact to the realization of the strategy and business plan in order to ensure that the level of strategic risk exposure is acceptable.

**Regulatory risk**

Regulatory risk, as the risk of regulatory changes that can affect bank's financial results, own funds and/ or liquidity, is closely monitored by the Bank.

On regular bases responsible departments in the Bank follow the changes in the regulation and draft regulation published by National Bank of Republic of North Macedonia. These changes are in timely manner discussed on the Compliance risk committee where based on analysis and projections further decisions are taken in order to minimize the possible risks and to timely apply the changes.

**Concentration risk**

The management of concentration risk is defined in the Concentration risk management policy. The policy is in line with the Group Credit risk management policy.

Within the policy following indicators are prescribed with the purpose of managing concentration risk:

- A credit exposure should typically not exceed 10% of the individual bank's regulatory capital.
- A large credit exposure must not exceed 25% of the bank's total regulatory capital, nor must the sum of all large credit exposures of a bank exceed 150% of its total regulatory capital.
- The share of the 10 largest exposures shall not exceed 85% of Bank's own funds and 12% of Bank's gross loan portfolio
- The share of the 20 largest exposures shall not exceed 150% of Bank's own funds and 20% of Bank's gross loan portfolio
- Bank's EUR loan portfolio shall not exceed 70% of total gross loan portfolio
- The bank limits the concentration of the loan portfolio by activity:
    - Agriculture limit of 20% of total business gross loan portfolio
    - Construction limit of 20% of total business gross loan portfolio

  - Transport limit of 20% of total business gross loan portfolio
- Loans to business clients with contractual maturity of over 120 months (i.e. over 120 installments for loans with monthly repayment schedule) shall not exceed 15% of total business gross loan portfolio (reporting trigger is set at 10%)
- Approved business overdraft and credit line exposure shall not exceed 35% of approved business loan portfolio
- Loan portfolio covered only by promissory note, guarantor and/or co-debtor with exposure over EUR 10.000 shall not exceed 15% of total loan portfolio (early warning trigger is set at 10%).

Additionally the bank monitors the concentration of loan portfolio by exposure type (very small, small, medium and private) and the loan portfolio for which the credit risk is transferred to another institution.

**Country risk**

The management of country risk is defined in the Country risk management policy.

In line with its business strategy, the bank is focused on financing clients located in North Macedonia. Excess highly liquid assets in line with the Group Counterparty risk management policy are placed in first-class foreign in countries with low risk profile.

The Fitch Country Ceiling and International Default Rating (IDR) is used to monitor the risk of transfer and convertibility restrictions. Additionally, a set of early warning indicators are used.

Typical indicators include:

- Fitch outlook;
- Economist Intelligence Unit (EIU) assessment of the transfer and convertibility risk;
- Development of public debt levels and percentages;
- FX reserves, months of import coverage;
- Sharp local currency depreciations;
- Sudden regulatory interventions in the banking sector;
- War or warlike situation.

These events typically affect the repayment capacity of the sovereign and thus also transfer and convertibility risk.