

Based on Article 4, 9 and 25 of the Law on Banking Agency of Federation of Bosnia and Herzegovina (Official Gazette of the Federation of BiH No. 9/96, 27/98, 20/00, 45/00 and 58/02) in relation to Article 69 of the Law on Banks (Official Gazette of the Federation of BiH No. 39/98, 32/00, 48/01, 27/02, 41/02 and 58/02), Managing Board of the Banking Agency of Federation of Bosnia and Herzegovina declares

INTERNAL BANK RATING CRITERIA BY THE BANKING AGENCY OF THE FEDERATION OF BOSNIA AND HERZEGOVINA

Article 1

This regulation determines the criteria for unified internal evaluation system (hereinafter: Unified Internal Evaluation System for Banks “UIESB”) regulated by the Banking Agency of Federation of Bosnia and Herzegovina (hereinafter: FBA) based on generally accepted international principles for bank supervision, Law on Banks and FBA regulations.

Over special techniques and evaluations of UIESB, FBA determines rating (hereinafter: the rating) for soundness of banking organizations in unified, that is, uniform way.

General subjects of consideration in bank ratings within the UIESB are financial, management and governance factors of banks, as well as the factors of fulfillment of all the requests prescribed. The FBA’s aim is to ensure to have ratings for all the banks in unified and overall way, and to focus its examination activities on those banks burdened with financial and operating weaknesses, that is, banks whose business operations are taking deteriorating trends. At the same time, the UIESB, as useful means for easier identification of problem banks, that is, banks whose financial condition is getting worse, serves to the FBA as an instrument to monitor general trends for soundness and safety of whole banking system, which gives the possibility for effective implementation of its main mission in developing, maintaining and protecting stability and public trust in the banking system.

Rating procedure determines a composite rating (unified rating) for each banking institution which should be based on an individual rating of six main components of bank’s financial and operating condition. Main components of financial and operating condition, along with individual ratings determined out of which a composite rating should be based on, are the following:

1. Bank’s Capital Adequacy;
2. Bank’s Assets Quality;
3. Bank’s Management and Governance Quality;
4. Bank’s Quality and Level of Profitability;
5. Bank’s Liquidity Adequacy;
6. Bank’s Sensitivity to Market Risk.

Composite rating and ratings of individual (main) components should be determined in numerical order from 1 (one) to 5 (five). Rating 1 represents the highest level, that is, the best quality and very successful performance and risk management, and, at the

same time, the lowest level of supervisory concern, while a rating 5 should be the lowest level, that is, critically bad and unsuccessful performance and risk management, and, at the same time, an extreme supervisory concern which requires an extreme solution.

Composite rating should be in close correlation with the ratings determined for individual components of bank's condition. Each individual rating should be based on a quality and quantity analysis of factors related to a relative component and its interrelations with other components. While determining a composite rating, some individual components can be given more significant importance than others, that depends on a specific profile and specific situations, that is, condition in a specific bank, meaning that a composite rating can be under more significant influence than others or any individual factor which have a special influence to overall condition and level of bank's soundness will have a decisive role. Because of that reason, a composite rating cannot and must not represent only simple arithmetic average of all the ratings for individual components.

Capabilities of bank bodies to successfully answer to all the changes anticipated, and to prepare for effective risk management which can happen due to the changed conditions for business operations or for the initiation of new activities in bank and initiation of new banking products, represent one of especially significant factors in evaluating profile of total risk for certain bank and subject to serious supervisory concern. Based on the reasons mentioned, a component quality of bank's management and governing bodies in determining bank's composite rating should be given a special importance.

Article 2

Composite Rating

Bank should get a composite rating (C-Rating) in accordance to the following criteria:

- C-Rating 1:** If, in any regard, bank is sound and very safe, and if majority of its individual components have rating 1, and no components with rating worse than 2, exceptionally quality and level of profitability worse than 3. Any possible kind of weaknesses can be only of minor character, that is, can be minor, but bank's Supervisory Board and Management should be capable to eliminate those weaknesses in a prompt routine manner. Also, it should be obvious that bank complies with all the applicable laws and sub-legal regulations, and that it is capable to successfully resist vagaries of business conditions, that is, it is resistant to all external influences. And finally, bank should have an extremely high degree of business practice reliability and management over all risks, and not to give any reasons for supervisory concern; FBA's relation towards bank can be informal;
- C-Rating 2:** If, in its basis, bank is sound and safe and neither one of its individual components has rating worse then 3. It can have only modest weaknesses, and Supervisory Board and Management should be capable and sincerely ready to eliminate them in a urgent routine

manner. Bank should be reliable and capable to stand all negative fluctuation of business conditions and, at the same time, have consistent compliance with all the laws applicable and sub-legal regulations, and not to have any serious reasons for supervisory concern. Business practices and risk management should be solid, without any reason for supervisory concern. FBA's relation towards bank can be informal or limited formal.

C-Rating 3: If there are reasons for supervisory concern in one or more individual rating components, that is, if a combination of modest weaknesses is discovered in a bank. The quality of business practices and risk management should be under the level, which is considered satisfactory. However, although it is obvious that there are some problems, the concern for bank should not be too high or too bad, and bank's (only one) individual component from this rating should get rating 4. In general, bank is not capable enough to resist unstable business conditions; it is more vulnerable to some negative external influences than the banks with composite ratings 1 and 2, and Supervisory Board and Management may not be capable to eliminate the weaknesses in an adequate period. With all the above mentioned, such bank may not comply with all the laws applicable and sub-legal regulations. It is subject to supervisory concern and it is not possible to avoid supervision more strict than usual, and provisional measures should be included in informal and formal form. Bank's failure should not be expected, considering its general capability and general financial condition; FBA's relationship with bank should be primarily formal.

C-Rating 4: If bank is in the area of unsafe and unsafe financial condition. It has serious financial and managing deficiencies caused by unsatisfactory performance. Problems range from serious to critical weaknesses and deficiencies. Business management is unacceptable. Bank's Supervisory Board and Management do not recognize and solve those problems and weaknesses. There is a possibility of significant violation in the applicable laws and sub-legal regulations. In general, bank is not capable to resist the fluctuation of business conditions. High supervisory concern should be given to such bank, meaning that, in most cases, formal provisional measures should be applied in order to solve the situation. Bank with this type of a composite rating would represent a significant danger for deposit insurance institutions. If problems and weaknesses do not get eliminated in an urgent and successful manner, then Bank's failure is unavoidable; FBA's engagement should be obligatory constant and exclusively formal; Bank is listed on special FBA's list for continuous and reinforced supervision.

C-Rating 5: If bank is in a bad financial condition, and shows an extremely bad performance, usually reflects the worst business practices and represents the highest degree of supervisory concern. Scope and gravity of a problem exceeds capabilities or sincere readiness of bank

bodies to eliminate bank's critical condition in an urgent and successful manner. For bank's survival, it is necessary to get an urgent and strong financial and other external help. Bank should get a full and continuous supervision. It represents a definite danger for the deposit insurance institution. Bank's failure cannot be avoided and FBA should consider the lowest cost procedure for its elimination from the market.

Article 3

This rating criteria of an individual component should include the following three sections:

- a) introduction;
- b) review of main evaluation components; and
- c) short description of numbered ratings.

Some of the evaluation factors are shown in more than one component in order to emphasize certain relation or interrelation of different components.

Article 4

Bank's Capital Adequacy

Rating criteria for bank's capital adequacy should include the following:

- a) Introduction: Bank should provide and maintain capital adequate to the level of its current and potential risk exposure, also its bodies should be qualified to recognize, measure, monitor and keep under control such bank's exposure. While assessing capital adequacy, one should consider the influence of loan, market, and other risks to the bank's financial condition. Risk type and level, which are related to the operations the bank is dealing with, should determine the amount of capital that such bank requires, sometimes over a required minimum level, in order to eliminate potential adverse consequences those risks can cause.
- b) Evaluation components: Capital adequacy should be rated based on evaluation of the following bank's components:
 - Capital level and quality and total financial condition;
 - Character and volume of business risk;
 - Qualifications of bank bodies to identify, measure, monitor and control risk, and to recognize the immediate need for additional capital;
 - Character, trend and volume of problem assets, as well as adequacy of reserves for loan losses, and other losses;
 - Balance sheet structure, including character and volume of intangible assets, market risk (primarily related to securities and foreign exchange items), risk concentration, as well as risk related to nontraditional activities;
 - Risk exposure in off-balance sheet activities;

- Quality and level of earnings, as well as reasonableness in payments of dividends;
- Growth prospects and plans, as well as previous experience in growth management;
- Access to capital markets and other sources of capital;
- Adherence to adequate laws, regulations and supervisory guidelines, including plans to maintain capital adequacy or eliminate deficiencies.

c) Numbered ratings:

(1) Rating 1 (one) shows a high capital level which is slightly higher than adequate to support the risk profile which the bank carries; that is, when the bank (as a rule) has, at the same time, fulfilled all the following conditions:

- a) amount of equity capital over 150% of the minimum amount prescribed by the Law;
- b) amount of net capital over 150% of the minimum amount prescribed by the Law;
- c) bank's capital adequacy ratio (net capital) at least for 50% higher than the minimum prescribed by the Law;
- d) general reserves for loan losses and special reserves for loan losses established in accordance with provisions of the Decision on Minimum Standards for Managing Bank's Credit Risk and Assets Classification;
- e) risk concentration within the limitations outlined in the Decision on Minimum Standards for Managing Bank's Risk Concentration;
- f) high quality level of all evaluation factors.

(2) Rating 2 (two) shows a satisfactory level of capital in relation to bank's risk exposure, as well as a good quality practice in managing its risk; that is, when the bank (as a rule) has, at the same time, fulfilled all the following conditions:

- a) amount of equity capital over 125% of the minimum amount prescribed by the Law;
- b) amount of net capital over 125% of the minimum amount prescribed by the Law;
- c) bank's capital adequacy ratio (net capital) of at least 20% higher than the minimum prescribed by the Law;
- d) general reserves for loan losses and special reserves for loan losses established in accordance with the provisions of the Decision on Minimum Standards for Managing Bank's Credit Risk and Assets Classification;
- e) risk concentration within the limitations outlined in the Decision on Minimum Standards for Bank's Risk Concentration Management;
- f) moderate quality level of all evaluation factors.

3) Rating 3 (three) shows capital on the edge of satisfactory level, which does not fully support (cover) bank's risk profile. This rating requires a capital increase, even if the bank's capital

level is higher than minimum prescribed by the Law; that is, even if the bank has, at the same time, fulfilled all of the following conditions:

- a) amount of equity capital over the minimum prescribed by the Law;
- b) amount of net capital over the minimum prescribed by the Law;
- c) bank's capital adequacy ratio (net capital) at least at the minimum prescribed by the Law;
- d) general reserves for loan losses and special reserves for loan losses (as a rule) established in accordance with provisions of the Decision on Minimum Standards for Managing Bank's Credit Risk and Assets Classification (Official Gazette of the Federation BiH No. _____);
- e) risk concentration which should not exceed the limitations prescribed by the Decision on Minimum Standards for Managing Bank's Risk Concentration (Official Gazette of the Federation BiH No. _____);
- f) acceptable level of all other evaluation factors.

4) Rating 4 (four) shows a deficient level of bank's capital. In relation to its risk exposure, further maintenance of the bank's business operations is undermined. Financial support by current shareholders and/or other external sources is needed; that is, if the bank has fulfilled some or all of the following conditions:

- a) amount of equity capital over 50% and lower than the minimum prescribed by the Law;
- b) amount of net capital over 50% and lower than the minimum prescribed by the Law;
- c) bank's capital adequacy ratio (net capital) below 12%, but over 6%;
- d) general reserves for loan losses and special reserves for loan losses established in the amount less than prescribed by the Decision on the Minimum Standards for Managing Bank's Credit Risk and Asset Classification;
- e) risk concentration exceeds the limitations prescribed by the Decision on Minimum Standards for Managing Bank's Risk Concentration;
- f) other evaluation factors are weak.

5) Rating 5 (five) shows critical (dangerous) deficiency in capital and further maintenance of the bank's business operations is undermined. It is necessary to get additional financial support from bank's shareholders or other external sources, that is, if bank has fulfilled some or all of the following conditions:

- a) amount of equity capital below 50% of the minimum prescribed by the Law;
- b) amount of net capital below 50% of the minimum prescribed by the Law;

- c) bank's capital adequacy ratio (net capital) below 6%;
- d) general reserves for loan losses and special reserves for loan losses established in the amount less than prescribed by the Decision on Minimum Standards for Managing Bank's Credit Risk and Asset Classification;
- e) risk concentration exceeds the limitations prescribed by the Decision on Minimum Standards for Managing Bank's Risk Concentration;
- f) other evaluation factors are poor.

Article 5

Bank's Assets Quality

Criteria for rating the bank's assets quality include the following:

- a) Introduction: Asset quality rating should reflect quantity (level/scope) of existing and potential collection risk (hereinafter: credit risk) related to loan and investment portfolio, real estate, other assets, and off-balance sheet operations. Ability of bank bodies to identify, measure, monitor and maintain risk has a significant influence in this area. For the purpose of evaluation of asset quality, it is absolutely necessary to evaluate adequacy of reserves for loans and all other losses and to measure/evaluate the bank's exposure to risk from default in payments from customers, whether they are entities issuing securities or other financial instruments (held by the bank within its assets) or they are debtors based on issued loans or bearers of any kind of risk for the bank. All other risk that might have an effect on a fair value of some assets (for example, operating risk, market risk, strategy risk, reputation risk, risk from law and regulations violations and all other risks) have to be taken into consideration during the evaluation process.

- b) Evaluation components: Assets quality is rated in accordance with an evaluation made for the following elements within a bank:
 - adequacy, that is, soundness of policies, procedures and actual practice related to operations, that is items in the loan portfolio;
 - adequacy, that is soundness of procedures and actual practice of the bank in the area of providing security instruments for collection payments (collateral).
 - soundness of the bank's practice, that is, procedures, for risk identification;
 - scope, structure, trends and seriousness of delinquent assets in the portfolio: loans, securities, lease activities, investments and off-balance sheet operations (hereinafter: loan portfolio) for which the bank has suspended interest accruals, that is income accruals and/or has performed their restructuring, that is, loans, securities, and leases for which

it is known that debtors are not current with performing the obligations and/or that debtors are violating laws and regulations;

- adequacy of reserves for loan and all other losses related to evaluation of assets quality;
- the bank's exposure to off-balance sheet risk;
- scope, diversification and quality of loan portfolio;
- scope of the bank's activities and exposures to risk resulting from operations with trading assets;
- identifying assets risk concentrations;
- ability of bank management to successfully handle (manage) the bank's assets including timely identification and collection of problem items;
- adequacy, that is, soundness of internal controls for the loan portfolio;
- compliance with related laws and regulations;

c) Numbered ratings:

1) Rating 1 (one) represents high quality assets and a good portfolio with no significant (higher) risk exposures, that is, if the bank fulfills the following conditions:

- a) special loan losses outlined in the Decision on Minimum Standards for Managing Credit Risk and Classification of Bank's Assets do not exceed 3% of the total assets amount from article 2 of this Decision;
- b) general reserves for loan losses and special reserves for loan losses established in accordance with the provisions of the decision mentioned in item a);
- c) as a rule, risk concentrations are lower than the limitations determined in the Decision on Minimum Standards for Managing Bank's Risk Concentrations;
- d) high quality level of all evaluation factors.

2) Rating 2 represents a satisfactory level of assets quality and practice of managing loan portfolio, which is the situation when the bank (as a rule) has fulfilled all of the below listed conditions at once:

- a) Special loan losses from Decision on Minimum Standards for Managing Credit Risk and Classification of Banks' Assets do not exceed 5% of the total asset amount from Article 2 of the same decision;
- b) General and special reserves for loan losses established in accordance with provisions of the decision mentioned in item a);
- c) Risk concentrations that are within limitations set forth in the Decision on Minimum Standards for Managing Banks' Risk Concentration;
- d) Sound quality level of all evaluation factors;

3) Rating 3 (three) represents asset quality and/or practice of managing loan portfolio that is below satisfactory level. Trends

can be stable or they can show a moderate deterioration in asset quality or growth in bank's risk exposure. Generally, urgent activities and implementation of efficient practice are required to improve loan portfolio and risk management. This rating is determined for bank's assets if the bank (as a rule) has fulfilled all of the below listed conditions:

- a) Special loan losses from Decision on Minimum Standards for Managing Credit Risk and Classification of Banks' Assets do not exceed 8% of the amount of total assets from Article 2 of the same decision;
- b) General reserves for loan losses and special reserves for loan losses established (as a rule) in accordance with provisions in the decision mentioned in item a);
- c) As a rule, risk concentration are found within limitations from Decision on Minimum Standards for Managing Banks' Risk Concentrations;
- d) Acceptable quality level of all evaluation factors;

4) Rating 4 (four) represents poor assets quality and/or practice of loan portfolio management. Level, that is, the scope of risk and delinquent assets is significant, with lack of controls, so the bank is exposed to potential losses which are above an acceptable level and which, if not closely reviewed and eliminated, can impair the bank's existence. This rating is determined for bank's assets if the bank is in one of the following situations:

- a) Special loan losses from Decision on Minimum Standards for Managing Credit Risk and classification of Bank's Assets are higher than 8% and lower than 15% of the total assets amount from Article 2 of the same decision;
- b) General reserves for loan losses and special reserves for loan losses that have an amount that is less than the amount determined in the decision mentioned, item a);
- c) Risk concentrations exceed limitations set forth in the Decision on Minimum Standards for Managing Risk Concentrations;
- d) Special reserves for loan losses, for which there are potential reserves for loan losses established, can cause the bank's net capital to fall below 50% of the minimum prescribed by the Law;
- e) Poor quality level of other evaluation factors;

5) Rating 5 (five) represents performance that is critically deficient, that is, bad assets quality of bank and/or performance of loan portfolio management which threatens the viability of the institution. This rating is to evaluate the assets if one or all the following conditions relate to the bank:

- a) if potential loan losses from the Decision on Minimum Standards for Loan Risk Management and Assets

- Classification are more than 15% of total assets from Article 2 of the same Decision;
- b) General reserves for loan losses and special reserves for loan losses established in the amount less than the level prescribed by the provisions of the decision from previous sub-item a);
 - c) Risk concentration exceeds the limits from the Decision on Minimum Standards for Risk Management;
 - d) Potential loan losses, for which there are no potential reserves for loan losses established, cause bank's net-capital for fall below 50% of the minimum prescribed by the law;
 - e) Other evaluation factors are bad;

Article 6

Bank's Quality of Management and Governance Bodies

Rating criteria for bank's quality of management and governance bodies includes the following:

- a) Introduction: Rating criteria for management and governance bodies should maintain the capabilities of its Supervisory Board and Management to identify, measure, monitor and control risks which bank meets in its performance; to ensure that its performance is safe, sound, reliable and successful, and also to comply with the applicable laws and regulations. Depending on the nature and type of bank's activities, bank's Supervisory Board and Management practices should include the following risks: loan risk, concentration risk, market risk, operating or business risk, reputation risk, strategy risk, compliance with adequate laws and regulations, liquidity risk, foreign exchange risk and others. Good practices of bank's Supervisory Board and Management should be included in the following: a) an active (real) monitoring over bank's managing and business performance; b) ensure a competent (professional and experienced) staff in a bank; c) appointment of adequate (sound) business policies in a bank; d) establishment of sound procedures for the implementation of the above policies; e) permanent and effective functioning of internal control system at all the levels and business areas in a bank; and f) in a successful monitoring of risk and good quality Supervisory Board and Management information system. This rating should evaluate the readiness and capabilities of bank's Supervisory Board and Management in all the areas of bank's performance.

- b) Evaluation components: evaluation
 The quality of bank's management board and management bodies should be rated based on the following bank's components:

- Degree and quality of monitoring and support provided to bank's activities by Supervisory Board and Management, especially bank's executive directors;
- Capabilities of bank's Supervisory Board and Management to plan, that is to anticipate changes in business conditions and react in adequate way to those changes, as well as to recognize and act in adequate way with all the risks resulting from newly established conditions, as well as to introduce some new activities and/or new "products" to bank's business performance;
- Adequacy and compliance with the internal policies adopted for significant activities and risks which bank is exposed to, as well as to their control;
- Accuracy, timeliness and effectiveness of bank's Supervisory Board and Management information system and system for risk monitoring;
- Adequacy of internal control and internal audit system for: a stimulation of more effective activities, reliably prescribed financial reporting, assets protection and compliance with law, regulations and internal policies;
- Compliance with laws and regulations;
- Acceptance of recommendations made by auditors and FBA;
- Education qualifications of bank's Supervisory Board members and Management, as well as assurance that bank has the officers, that is, persons who will, in the future, replace their positions in the bank;
- Degree to which the Supervisory Board members and Management of the bank are exposed to, but they are also subordinate to a dominant influence or concentrated power;
- Reasonable and acceptable policy for salaries and benefits, as well as an avoidance of activities for its own benefit and/or its business activities out of bank;
- Reliable degree of readiness to support legitimate needs of the community for banking services;
- Overall quality of bank and level of risk which bank is exposed to.

c) Numbered ratings:

1) Rating 1 (one) shows very reliable and successful management and governance in the bank by Supervisory Board and Management of the bank, as well as very good practices in managing risks in bank's performance. All significant risks should be identified, measured, monitored and controlled in a safe and clear manner. Management and Supervisory Board shows enough capabilities to settle all existing and potential problems and risks in an urgent and successful manner.

2) Rating 2 (two) shows a satisfactory level of practices in managing and governing the bank, as well as managing risks by Supervisory Board and Management of the bank. There can be only minor weaknesses, which cannot have a material influence to safety and reliability of bank's performance and have already been detected and are already in the process of settlement. In general, significant risks and problems should be successfully identified, measured, monitored and controlled;

3) Rating 3 (three) shows practices which are required to be improved in managing and governing bank by the Supervisory Board and Management. Taking into account the nature of activities, that is, bank's performance, they are less than satisfactory. Capabilities of members of Management and Supervisory Board are insufficient for the type, size and/or condition of the bank. Problems and risks in bank's performance are not identified, measured, and not adequately monitored and are not successfully kept under control.

4) Rating 4 (four) shows poor practices in management and governance of the bank by Supervisory Board and Management of the bank. For the activities, that is, business of the bank, practices in risk management are weak, and gravity of problems and level of risk exposure in bank is excessive. Problems and significant risks are not identified, measured, and inadequately monitored and are not successfully kept under control, they are undermining the future viability of the bank, and do require an urgent action by the Supervisory Board and Management of the bank in order to protect and enhance the financial condition of the bank. At the same time, it is necessary and demanding to have an urgent replacement and/or improvement, that is, better quality of bank's Management and/or Supervisory Board.

5) Rating 5 (five) shows critically bad practices in governance and management of the bank by its Supervisory Board and Management. Bank's Supervisory Board and Management show lack of capability to eliminate problems and implement adequate practices in risk management. Problems and significant risks are not identified or adequately monitored and are not controlled, so that is why the future viability of the bank is extremely complex, expensive and questionable. Replacement of Supervisory Board and Management of the bank is urgent.

Determination of ratings for the quality of bank's managing and governing bodies should be implemented by the criteria defined for each individual rating. However, in order to, at maximum, eliminate potential weaknesses in quality rating elements, in the procedure of determining individual component, in certain way the following quality elements of accrual, depending on specifics of the condition determined, should be included:

1. average arithmetic mean with one decimal of all previously determined individual ratings for:
 - a) bank's capital adequacy;
 - b) bank's assets quality;
 - c) bank's quality and level of profitability;
 - d) bank's liquidity position adequacy;
 - e) bank's sensitivity to market risks.

2. rating made out of accrual from previous item 1 of this paragraph should be adjusted for the following ratios applied:
 - a) (+0.1) when it is obvious that bank's Management did not have an adequate replacement (successors) for the most important positions, in case those positions get vacant;
 - b) (+0.2) when the practice repeats that bank submits required reports to FBA as inaccurate or with delay;
 - c) (+0.2) when bank's net income is lower then average for all banks;
 - d) (+0.2) when internal loan control in a bank is not functioning in an adequate manner;
 - e) (+0.3) when reserves established for general loan risk and potential loan losses are not maintained on a required level;
 - f) (-0.1) when it is obvious that bank's Management has an adequate replacement (successor) for its most important positions, in case those positions become vacant;
 - g) (-0.1) when bank's net income is higher then average for all banks;
 - h) (-0.1) when internal loan control in a bank is functioning in an adequate manner;
 - i) (-0.2) when reserves established for general loan risk and potential loan losses are maintained at required level;

1. Final rating for the quality of bank's managing and governing bodies was made based on evaluation from previous two items from this paragraph, and it can only be for one digit higher from the digit in front of the decimal mentioned in the previous item 1 of this paragraph.

Article 7

Bank's Quality and Level of Profitability

Rating criteria for bank's quality and level of profitability includes the following:

- a) Introduction: Bank's rating criteria for quality and level of profitability should be reflected not only in the quantity of earnings (profit), but also in the factors which can influence its maintenance and/or quality. The quantity, as well as quality of earnings can be affected by the following: a) excessive loan risk and/or inadequate loan risk management, which can lean to loan losses for which it is necessary to establish the reserve; b) high level of market risk which can cause an unjustified exposure of bank's earnings to unstable interest rates; c) an unjustified

confidence in “exceptional” advantages, short term events which will not happen again or more favorable treatment for tax obligations; d) incompetence to anticipate or control business expenses or expenses for funds collection; e) bad set up or bad implementation of business strategy; and f) bad management or uncontrolled exposure to other risks.

b) Evaluation on components:

Bank’s quality and level of profitability should be rated based

the evaluation of the following elements in a bank:

- Level of bank’s profit, including its trend and stability;
- Capability to accrue adequate capital, that is, growth of bank’s capital from retained income;
- Quality and type of bank’s sources of income;
- Volume, that is, level of expenses in relation to activities of a bank;
- Adequacy of financial planning, projection procedures and information system in general;
- Bank’s exposure to loan risk and adequacy of reserves for loan and other losses;
- Bank’s exposure to market risks, as price risk: a) interest rate risk; and b) foreign exchange risk;
- Degree of bank’s compliance with adequate laws and regulations.

c) Numbered ratings:

1) Rating 1 (one) shows bank’s earnings which are very good with an increasing trend and which are sufficient to cover: a) expenses arising from its performance; b) needs for acquiring more than just adequate capital; and c) satisfactory level of dividends to shareholders, taking into account all existing risk and other factors influencing quality and quantity of bank’s earnings (profit). According to the above mentioned, as a rule the following indicators should be fulfilled:

- a) return on assets (ROA) should be higher than 2.5%;
- b) income should be stable and gained from the activities which are permanently repeating;
- c) income should be gained mainly from interest bearing activities; and
- d) interest rate margin should be positive.

2) Rating 2 (two) shows earnings which are satisfactory with at least a minimum growth trend. However, bank’s earnings, which are maintained at the same level, can be evaluated by this rating only if it still fulfills the requirements from items a), b) and c) mentioned in the description of previous Rating 1. According to the above mentioned, as a rule, the following indicators should be fulfilled:

- a) return on assets should be higher than 1.5%;

- b) income should be stable and gained from the activities which are permanently repeating, and partially from short term activities;
- c) income should be gained mainly from interest bearing activities; and
- d) interest rate margin should be positive.

3) Rating 3 (three) shows earnings which are not satisfactory, that is, the earnings which cover only one request from item a) and partially the request from item b) mentioned in the description of Rating 1, and which should be improved, that is, increased in order to, at least, ensure the request from item b) from the description of Rating 1. According to the above mentioned, as a rule, the following indicators should be fulfilled:

- a) return on assets should be higher than 0.5%;
- b) income is not stable during the year;
- c) income is gained mainly from fees;
- d) interest rate margin is positive;

4) Rating 4 (four) shows earnings which are sufficient to cover only the request from item a) mentioned in the description of Rating 1. Bank with this type of earnings can usually be recognized by a capricious of a significant negative trend, small size of earnings, non-retained size of earnings, periodical losses and/or significant decreases of earnings in relation to previous year. According to the above mentioned, the following indicators should be fulfilled:

- a) return on assets should be higher than 0%;
- b) income is not stable during the year and it is gained mainly from short term activities;
- c) interest rate margin is not positive.

5) Rating 5 (five) shows earnings which are critically insufficient. Bank with this type of rating for earnings is not able to fulfill the request from item a) mentioned in the description of Rating 1, and that is how bank makes losses which represent an obvious deterioration of its capital and a real threat to its survival. According to the above mentioned, the following indicators should be fulfilled:

- a) return on assets is negative (loss);
- b) interest rate margin is negative;

Article 8

Bank's Adequacy of Liquidity Position

Rating criteria for bank's adequacy of liquidity position includes the following:

- a) Introduction Banks should consider the following in determining ratings for adequacy of liquidity position and liquidity risk: 1) Comparison for: a) current and expected future sources of liquidity to b) current and expected future needs for liquid funds, as well as 2) Adequacy in practices in managing fund sources. In general, practices in managing funds sources should ensure bank's capability to maintain the level of liquid funds which should be sufficient to: a) fulfill all financial obligations on timely manner; and b) fulfill all justified needs of the community for loans. At the same time, those practices should also demonstrate the capability of a bank to successfully manage unplanned (unexpected) changes in fund sources, as well as to react in adequate way to market changes which influence the possibility to liquidate (cover to cash funds) assets (some of its items) with minimum, that is, minor losses. Additionally, practices for fund management should enable that liquid funds are not reflected by high expenses and/or through unjustified dependence on the sources which might not be available at the moment of financial pressure or bad changes in market conditions.
- b) Evaluation components: Adequacy of bank's liquidity position should be rated based on the following evaluation components:
- adequacy of bank's liquidity sources for current and future needs, as well as bank's capabilities to fulfill its liquidity needs without adverse consequences for its normal operations and business conditions;
 - availability of assets (corresponding assets items) convertible to cash funds, without any delay and excessive (unacceptable) losses;
 - access to money market and other cash fund sources;
 - degree of diversification of fund sources and balance sheet and off-balance sheet items (different agreements for purchasing – securing cash funds for some future moment);
 - degree of dependence on short term unstable fund sources, including short term borrowings and agent deposits;
 - trend and stability of deposits;
 - capabilities – possibilities to sell securities and certain “baskets” of assets items;
 - capabilities of Supervisory Board and Management to identify, measure, monitor and control bank's liquidity positions in an orderly (accurate and timely) manner, including the effectiveness of strategy for fund sources

management, liquidity policy, Supervisory Board and Management information system and contingency planning;

- compliance with adequate laws and regulations;

c) Numbered ratings:

1) Rating 1 (one) shows a very reliable liquidity position and good practices in managing fund sources in relation to bank's risks and other significant components (good plan). Bank has a reliable access to liquidity fund sources sufficient to fulfill all current and anticipated future liquidity needs. Bank's access to external fund sources is under favorable conditions. At the same time, as a rule, bank should fulfill the following requirements:

- a) loans/deposits relationship should be less than 70%;
- b) bank should have standby arrangements (contracts) in order to, in an urgent manner, get liquid funds if necessary;
- c) bank should have a good maturity date position and safe repayment schedule for assets items which can support its expected needs for liquidity funds;
- d) bank's liabilities should be mainly of a banking nature and stable, without any individual large and unexpected liabilities;

2) Rating 2 (two) shows a satisfactory level of liquidity and risk. While comparing with existing risk exposure, there can be some minor weaknesses in quality indicators or practices related to funds sources management (a reliable plan). At the same time, as a rule, bank should fulfill the following requirements:

- a) loans/deposits relationship should not exceed 75%;
- b) bank should have standby arrangements (contracts) in order to, in an urgent manner, get liquid funds if necessary;
- c) bank should have an acceptable maturity date position and safe repayment schedule for assets items which can support its expected needs for liquid funds;
- d) bank's liabilities should be mainly of a banking nature and stable, with a modest amount of borrowings taken;

3) Rating 3 (three) shows bank's level of liquidity and risk or practices for fund sources management which are hardly acceptable and necessary to improve. Bank does not have a direct access to fund sources in reasonable (acceptable) deadlines and in relation to existing risk exposure, it has obvious significant weaknesses in fund sources management. At the same time, as a rule, bank should fulfill the following requirements:

- a) loans/deposits relationship should not exceed 80%;
- b) bank's access to liquid funds is not documented (the contract is not signed) in case of an urgent need for liquid funds;

- c) bank should have a maturity date position and an orderly repayment schedule for assets items which requires a limited support;
- d) bank's liabilities have a moderate level of instability due to the type and maturity date, bringing possibilities for unexpected outflows;

4) Rating 4 (four) shows the level of liquid funds which is unsatisfactory and risky for bank's current and anticipated liabilities, as well as inadequate practices in fund sources management. For the fulfillment of its needs, bank is not capable enough to provide liquid funds from regular sources. At the same time, as a rule, the following facts are obvious:

- a) loans/deposits relationship should not exceed 85%;
- b) bank does not have any agreement for access to liquidity borrowings and the existing one is very difficult to be maintained;
- c) bank has maturity date position and an orderly and possible repayment schedule for assets items, which is weak and undermined;
- d) bank's liabilities are not stable and borrowings and loans where repayment request can be expected soon or has already been requested, amount to 10% to 15% of the amount of bank's total liabilities;

5) Rating 5 (five) shows bank's liquidity position and risk exposure, which is of critical gravity, which has seriously undermined bank's viability. For the fulfillment of already matured liabilities and other liquidity needs, bank urgently, that is, currently needs external financial help. At the same time, the following factors are obvious:

- a) loans/deposits relationship should not exceed 85%;
- b) bank does not have any access to the borrowings necessary for liquidity;
- c) situation for maturity date and/or possibilities of an urgent repayment schedule for assets items is seriously undermined;
- d) bank's liabilities are in the position of requests for repayment, which bank cannot fulfill.

Article 9

Bank's Sensitivity to Market Risks

Rating criteria for bank's sensitivity to market risks includes the following:

- a) Introduction: While rating bank's sensitivity to market risks, there should be degree considered up to which the changes of interest rate, exchange rate, prices of goods and capital can influence the value of bank's assets, level of earnings (profit), liabilities and

capital. Capabilities of bank's Supervisory Board and Management to identify, measure, monitor, and control bank's exposure to market risk represents a component which needs to be considered in a serious manner. Market risk includes price risks: interest rate risk, exchange rate risk, and price risk for asset items for trading and investment. In the evaluation of market risks, sensitivity of the following areas should be seriously considered: bank's assets, liabilities, off-balance sheet liabilities, and earnings to the changes in interest rates. This sensitivity (weakness) should be measured by potential changes in earnings or an economic value of bank's capital in different economic scenarios (anticipated situations in an economic environment). If applicable to the bank, the consideration should include the following: a) price risk related to the portfolio of trading assets and portfolio of investment items, and b) periodical revaluation of foreign currency items denominated in KM.

b) Evaluation components:

Adequacy of bank's sensitivity to market risks should be rated based on the evaluation of following components:

- Sensitivity of net-earnings (profit) and an economic value of bank's capital to the changes in interest rate under different scenarios and adverse economic conditions;
- Volume, structure and changes (instability) of foreign currency included in balance sheet and off-balance sheet items of bank;
- Current and potential instability of earnings or value of capital due to market changes in prices of trading assets items, investment items, and other financial instruments in bank's portfolio;
- Capabilities of Supervisory Board and Management to identify, measure, monitor, and control bank's exposure to risk in interest rates, exchange rates, and risks in other prices.

c) Numbered ratings:

1) Rating 1 (one) shows a minimum, that is, limited exposure of bank to the risks of interest rates, exchange rates, and other prices, and bank has good, that is, strong systems for identification, measurement, monitoring, and control of those risk;

2) Rating 2 (two) shows a modest and controlled exposure of bank to the risks of interest rates, and other prices. Systems for managing those risks should be satisfactory and provide assurance to maintain those risks at an acceptable level;

3) Rating 3 (three) shows that at least one component of market risk needs some improvement. This can be bank's exposure to: a) increased level of interest rate sensitivity; b) more significant exchange rate risk; or c) significant risk of a repeated determination of prices, resulting in earnings and capital in

position of modest degree of instability. System for market risk management should reflect weakness, and it would be necessary to improve them.

4) Rating 4 (four) shows bank's exposure to market risks which have damaged (decreased) earnings, and can also undermine bank's solvency. Excessive exposure to the changes in other prices should be evaluated with this rating;

5) Rating 5 (five) shows an extreme exposure of bank to market risks, resulting in very adverse effects to earnings and capital, seriously questioning future viability of bank.

Article 10

A bank rating determined in accordance to these criteria represents a business secret of FBA and the subject bank, and it will be exclusively used for their internal needs.

The FBA may request from banks to determine their own rating in accordance to these criteria, and to inform the FBA in proper form that will be attached to their request to FBA.

In the case of a newly established bank in where still are not created conditions for evaluation of all the rating criteria, the evaluation covers just the elements at disposition, which can be rated, with special emphasis that a newly established bank is in question.

Article 11

As of the effective date of this Criteria, Criteria for Internal Rating of Banks by the Banking Agency of the Federation of BiH ("Official Gazette of the Federation BiH" No. 54/00) cease to exist.

Article 12

This Decision comes into effect on the day of its declaration and will be published in the "Official Gazette of the Federation BiH".

No. 01-1-1190-17/02
Sarajevo, 12/19/2002

PRESIDENT OF THE
MANAGEMENT BOARD
M.A. Eldar Arnautovic