

**NKB INVESTMENTS LTD.**

**Capital Requirements Directive – Pillar 3 Market Disclosures**

**April 2009**

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## 1. Overview

The E.U. Capital Requirements Directive (“CRD”) created a revised regulatory framework (commonly known as Basel II) governing how much capital firms are required to maintain. The main purpose of the Basel II revisions was to make the framework more risk sensitive and representative of actual risk management practices. The new framework consists of three Pillars: Pillar One sets out the new minimum capital requirements firms are required to meet; Pillar Two requires firms to assess their capital requirements in light of any specific risks not captured in the Pillar One calculations; and Pillar Three seeks to improve market discipline by requiring firms to publish certain details of their risks, capital and risk management.

In Cyprus, the CRD was implemented through the CySEC Directive for the Capital Requirements of Investment Firms of 2007, and the CySEC Directive for Large Exposures of IFs of 2007 (collectively, “the Directive”). The Company has prepared these disclosures in accordance with the requirements of the Directive.

The Directive provides that an investment firm may omit one or more of the disclosures if it believes that the information is immaterial. Materiality is based on the criterion that the omission or misstatement of information would be likely to change or influence the decision of a reader relying on that information for the purpose of making economic decisions. Where the Company has considered a disclosure to be immaterial, it has stated this in the document.

The Directive also permits investment firms to omit one or more of the required disclosures if it believes that the information is regarded as confidential or proprietary. The Directive defines proprietary as “...if sharing that information with the public would undermine its competitive position. It may include information on products or systems which, if shared with competitors, would render an investment firm’s investments therein less valuable.” Confidential information is defined thus: “Information shall be regarded as confidential if there are obligations to customers or other counterparty relationships binding an investment firm to confidentiality.” Where the Company has omitted information for either of these two reasons, it has stated this in the relevant section and the reasons for this.

## 2. Location and Frequency of Disclosure

The Company intends to make its Pillar Three disclosures annually in a document other than the financial statements. The disclosures will be uploaded on the website of the Company.

These disclosures are based on the position of the Company as at 31<sup>st</sup> December 2008, before the end of the audit for the financial statements, and are the first such disclosures made under the Directive.

The Company has commissioned independent auditors (KPMG, Cyprus) to verify its Pillar Three disclosures. The Company is required by the Directive to provide a copy of the auditor’s verification report to CySEC within four months of the (2008) year-end.

### **3. Scope of Disclosure**

The Company is making the disclosures on an individual (solo) basis.

### **4. Capital Management**

The primary objective of the Company's capital management is to ensure that the Company complies with its regulatory capital requirements per the Directive and that the Company maintains healthy capital ratios in order to support its business and to maximize shareholder value.

The Company manages its capital structure and may make adjustments to it in light of changes in economic conditions and the risk characteristics of its activities. In order to maintain or adjust the capital structure, the Company may adjust or maintain the amount of dividend payment to shareholders or issue additional capital.

The Company did not adjust its capital structure in 2008.

### **5. Risk Management**

#### ***a. Risk Management Framework***

The Board of Directors, which consists of both executive and non-executive members, has responsibility for the overall risk governance of the Company, including aligning business strategy with risk appetite, and ensuring that all key risks are controlled via a robust risk management framework. The following are part of the responsibilities of the Board of Directors in relation to risk management:

- To carry out regular reviews about the Company's risk management policies and procedures as implemented by the management;
- The regular review (at least annually) of written reports concerning compliance, risk management and internal audit policies, procedures and work.

These responsibilities are clearly stated in the Internal Operation Manual of the company.

The Board meets on a regular basis, and receives updates on risk and regulatory capital matters from management. The risk management framework of the Company is incorporated into the Group's risk management framework and is supervised by the Group's Assets and Liabilities Management Committee.

Management is tasked with ensuring that all key risks are effectively and efficiently controlled, and has unrestricted access to the Board to discuss risk, compliance and control issues on an ongoing basis. The Company, pursuant to current CySEC Directives, is also obliged to ensure the Board receives written reports on risk, compliance and internal audit at least annually.

The Company has designed its risk management framework to be proportionate to the scale, nature and complexity of the business, and is comprised of the following components:

- Compliance/Risk Management;
- External Audit (KPMG);
- Internal Audit (outsourced);
- Internal Control (URALSIB Group);
- Line Management;
- Online Credit Risk Limit Monitoring System (URALSIB Group proprietary system).

## ***b. Risk Categorisation***

### *i. Credit Risk*

Credit risk, which is the risk that one party to a financial instrument will cause a financial loss to the other party by failing to discharge an obligation, is the most significant risk borne by the Company. Accordingly, the Company structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one counterparty or group of counterparties, and to industry and geographical segments. Such risks are monitored on a continuing basis and limits are subject to annual review (or more frequently, as market conditions dictate). The credit risk policy and procedures of the Company is documented in a Risk Management Policy Document.

The exposure to any counterparty, including banks and brokers, is further restricted by sub-limits covering “pre-settlement” and/or “delivery” risk, with limits assigned to both types of risk which are set by the Group’s Credit Committee which meets at least once a week. Actual exposures against limits are monitored daily.

Exposure to credit risk is therefore managed through:

- The regular analysis of the financial soundness of clients and counterparties;
- The setting of appropriate credit limits;
- The ongoing monitoring of credit limits;
- The application of credit mitigation techniques where appropriate.

### *ii. Market Risk*

Market risk for the Company is comprised of Interest rate risk and FX Risk as they are presented below.

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates and is measured by the extent to which changes in market interest rates impact margins and net income. As the Company does not engage in proprietary trading it does not have any material interest rate risk. The

Company has implemented controls to ensure no interest rate risk arises from an inadvertent house position, including daily reconciliations and monitoring of statements, new trades and settlements. The Company's assets and liabilities are relatively short term and are not sensitive to interest rate movements, other than cash and cash equivalents and investments available for sale. Consequently the Company does not consider itself to be significantly exposed to interest rate risk or consequential cash flow risk. The Group's interest rate policy is reviewed and approved by the Group's Assets and Liabilities Management Committee.

The Company is exposed to FX risk, which is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. FX risk is monitored by the Company's management and managed by the Group according to Group limits. The Group's Assets and Liabilities Management Committee sets limits on the level of exposure by currencies as well as in total.

### iii. Operational Risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. The Company manages its operational risk through the following:

- Semi-annual internal audits, with auditors reporting directly to the Board;
- On-site inspections from Group internal control;
- A Business Continuity Plan;
- An Outsourcing Policy;
- The circulation of the Company's Operational Risk Policy to all staff.

To ensure an effective operational risk management framework, the Company has documented an Operational Risk Policy Document, which describes the processes and procedures established by NKB Investments Limited in order to identify, monitor and control the operational risks faced in its day-to-day operations, and to ensure these risks are maintained within the Company's risk tolerance.

### iv. Liquidity Risk

The Company is exposed to liquidity risk, which is the risk that an entity will encounter difficulty in meeting obligations associated with its financial liabilities. The Group has designed and implemented a liquidity risk management framework with the objective of ensuring that funds will be available at all times to honor the cash flow obligations as they become due. The Group's Asset and Liability Management Committee sets limits on the minimum proportion of maturing funds available to cover such cash outflows, and uses a dedicated system to generate cash-flow reports to monitor and control Liquidity risk on an ongoing basis. The company manages its liquidity always in accordance with the Company's policy and regulatory requirements.

## 6. Capital Resources

The own funds of the Company are comprised entirely by Tier 1 capital. As at the 31<sup>st</sup> of December 2008, the level of own funds was at USD 45.6 million. Table 1 below shows a breakdown of the own funds as at 31/12/08. There were no capital deductions and the Capital Adequacy Ratio at that time was 125.45%.

Table 1: Analysis of Capital (Own Funds)	(USD, 000)
Ordinary Share Capital	438
Share Premium	4.669
Retained Earnings	40.514
<b>TOTAL</b>	<b>45.621</b>

*Note: Pre-audited profit of USD 1.490k for the year ended 31 December 2008 is not included in the above calculation.*

## 7. Credit, Market and Operational Risk Capital Requirements

The capital requirements for the three risks covered by Pillar 1 of the Directive are as follows:

Table 2: Risk (USD, 000)	Pillar 1 Capital Requirement
Credit Risk	1.647
Market Risk (FX Risk)	553
Operational Risk	709
<b>Total Capital Requirement</b>	<b>2.909</b>

Following we will analyze the exposures and calculation of capital requirements for each risk

### **a. Credit Risk**

The Company has adopted the Standardised Approach for the assessment of capital requirements for credit risk, and has elected to use Fitch Ratings as the External Credit Assessment Institution (“ECAI”) for all classes of exposure. The Company has used the credit step mapping tables provided in the Directive to map credit assessment from the ECAI to risk weightings.

The Company makes use of legally enforceable on-balance sheet netting agreements for credit risk mitigation (“CRM”) purposes with a small number of counterparties in order to manage credit exposures more effectively and thereby minimise aggregate credit risk.

There were no material impaired or past due exposures as at the 31<sup>st</sup> of December 2008 and no provisions were made up to that date.

<b>Standardised Credit Risk Exposure Class</b>	<b>Exposure Pre-CRM (USD, 000)</b>	<b>B/S Exposure Post-CRM (USD, 000)</b>	<b>8% of Risk Weighted Exposure (USD, 000)</b>
Central Governments and Central Banks	1.167	1.167	0
Institutions	116.822	79.991	1.397
Corporates	3.074	3.038	243
Other Items	87	36.954	7
<b>TOTAL</b>	<b>121.150</b>	<b>121.150</b>	<b>1.647</b>

The exposure classes under which the assets of the company have been allocated under the standardised approach are as shown in **Table 3** above. There were no exposures to other the other risk classes available under the Standardised Approach. The exposures above are presented pre and after credit risk mitigation techniques have been applied.

In the tables below we lay out the breakdown of the credit risk exposures by country, by credit quality step and by exposure class.

<b>Region</b>	<b>Exposure Pre-CRM (USD, 000)</b>	<b>B/S Exposure Post-CRM (USD, 000)</b>
Cyprus	5.056	5.056
EU	70.761	70.761
USA	8.415	8.415
Russian Federation	33.714	33.714
Rest of the world	3.203	3.203
<b>TOTAL</b>	<b>121.150</b>	<b>121.150</b>

<b>Table 5: Pre and Post CRM Exposures by Credit Quality Step for each asset class</b>			
<b>Exposure Classes</b>	<b>Credit Quality Step</b>	<b>Pre-CRM Exposure (USD, 000)</b>	<b>Post-CRM Exposure (USD, 000)</b>
Central Governments	0%	1.167	1.167
Institutions	20%	83.108	78.155
	100%	33.714	1.836
Corporates	100%	3.074	3.038
Other Items	0%	0	36.867
	100%	87	87
<b>TOTAL</b>		<b>121.150</b>	<b>121.150</b>

<b>Table 6: Average Exposure before CRM by exposure class</b>	
<b>Exposure Class</b>	<b>(USD, 000)</b>
Central Governments and Central Banks	584
Institutions	184.451
Corporates	6.010
Other Items	850
<b>TOTAL</b>	<b>191.895</b>

<b>Table 7: Average Exposure before CRM by industry</b>	
<b>Exposure Class</b>	<b>(USD, 000)</b>
Governments	584
Financial Services	184.451
Other Non Financial	6.860
<b>TOTAL</b>	<b>191.895</b>

There were no material credit exposures more than one month due (residual maturity).

## ***b. Operational Risk***

Given the relatively small size and scale of operations, the Company considers the Basic Indicator Approach the most appropriate method to assess its ongoing operational risk capital requirements. An operational risk capital charge of USD 709k has been calculated using this method. In the following table we analyse the calculation of the capital requirements for Operational Risk with the Basic Indicator Approach.

<b>Table 8: Operational Risk Capital Requirements – Basic Indicator Approach</b>			
<b>(USD)</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
Operating Income	<b>5.470</b>	<b>5.296</b>	<b>3.414</b>
Average of 3 years	<b>4.727</b>		
<b>Capital Requirement</b>	<b>709</b>		

## ***c. Market Risk***

The Company has a market risk capital charge of USD 553k, relating entirely to FX Position Risk.