

VABA d.d. banka Varaždin

Annual report for the year
ended 31 December 2012

This version of the report is a translation from the original, which was prepared in the Croatian language. All possible care has been taken to ensure that the translation is an accurate representation of the original. However, in all matters of interpretation of information, views or opinions, the original language version of our report takes precedence over this translation.

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Introduction

The annual report comprises a summary of operation and key financial indicators, a description of operation and the audited financial statements including Independent auditor's report for the year ended 31 December 2012.

Legal status

The Annual Report includes the Bank's financial statements prepared in accordance with accounting regulations applicable to banks in the Republic of Croatia and audited in accordance with International Standards on Auditing.

The Annual report was prepared by the Management of the Bank in compliance with the Accounting Law and the Companies Act, which prescribe reporting to shareholders at the General Assembly meeting.

Abbreviations

In the Annual Report of Vaba d.d. banka Varaždin is referred to as the "Bank" or "Vaba", Croatian National Bank is referred to as the "CNB", the Republic of Croatia as the "Government" and the Croatian Bank for Reconstruction and Development, is referred to as "CBRD".

Exchange Rate

The following CNB exchange rates were used for translation of foreign currencies into Croatian kuna:

31 December 2011	1 EUR = HRK 7.530420	1 USD = HRK 5.819940
31 December 2012	1 EUR = HRK 7.545624	1 USD = HRK 5.726794

Summary of operation and key financial indicators

	2011 (HRK '000)	2012 (HRK '000)
Net interest income	48,444	31,005
Net fee and commission income	4,464	4,511
Operating income	9,805	5,465
Profit before impairment losses	9,561	(8,073)
Profit/(loss) for the year	(13,456)	(12,699)
Total assets	1,236,257	1,204,271
Loans and advances to customers	792,731	722,828

Macroeconomic developments in the Republic of Croatia for the year ended 31 December 2012

After continuous growth of GDP from 2000 to 2008, the growth slowed down in 2008, 2009 saw the first negative GDP growth since 1999, continuing with the negative trends. Based on the Central Bureau of Statistics (CBS) data, GDP fell by 6.0% in 2009, 1.2% in 2010, while it stagnated in 2011.

Though at the beginning of 2012 it appeared that the tourist season and its influence on GDP movement will decrease cumulative annual GDP negative growth, it didn't materialise. Based on the initial CBS estimate, third quarter negative growth amounted to 1.9%, increasing cumulative negative growth rate from 1.7% after the first 2 quarters to 1.8% for the first three quarters.

First Eurostat estimates showed a slight increase in negative GDP growth in the third quarter in the European Union, from -0.3% in the second quarter to -0.4%, so that the total negative GDP growth for the first three quarters amounted to -0.2%. These movements are mainly result of movements in the EU member countries affected by debt crisis. The debt crisis has similar effects as in Croatia, with austerity on all levels leading to drops in wages and employment, negatively affecting total demand.

Together with the effects of VAT increase in March, new increases in prices of electricity and gas increased the annual inflation rate to 4.8%, the highest level since the beginning of 2009.

Consequently, the rate of registered unemployment increased from 18.3% in September to 19.6% in October, the sharpest rise since the beginning of the crisis. Considering the age structure of the unemployed, we can conclude that the crisis struck all age groups (somewhat bigger level of unemployment is recorded within the 25 to 34 years of age group, making 25% of the total number).

Long term crisis of the Croatian economy in the uncertain environment of the global financial markets marks weak foreign capital inflow in the last few years. During the first half of the year direct foreign investments amounted to mere 154.4 million euro, the lowest number since 1995. It marks 74% less than in the same period of the last year and 13 times less than in 2008. In relation to the GDP, foreign direct investments in the last four quarters amounted to only 1.4%. From this modest investment, the majority (80% or 124 million euro) relates to financial services sector, mainly relating to ownership relations of the Austrian banking groups and the capital increase of Kentbank d.d. from Turkish Eksen Holding (*Süzer Group*) which took ownership over Banka Brod d.d. in 2011.

During the last few months of 2012 value of unpaid liabilities totalled around HRK 44 billion; at the end of October it amounted to HRK 44.54 billion, HRK 43.5 million less than the previous month, but also HRK 4.4 billion more than a year before. At the same time, number of blocked entities amounts to around 73 thousand, 1.2 thousand less than the month before, but 4.2 thousand more than the same month the previous year.

Monthly decrease in value of unpaid liabilities in October was only registered with the companies (*by HRK 279 million*) while craftsmen increased their unpaid liabilities by HRK 101 million. The highest absolute monthly decrease was recorded with trading companies (*by HRK 379.3 million*). The highest increase was recorded with construction companies (*by HRK 229 million*), after five months of slight decrease. Construction industry remains the sector with the highest annual increase of unpaid liabilities of HRK 1.5 billion.

THE BANKING SYSTEM IN 2012

In these unfavourable conditions, the banking system in Croatia notes lower rates of profitability, increase in non-performing loans and increase in impairment allowances.

Total number of banks at the end of 2012 included 6 big, 3 medium and 22 small banks (2011: 6 big, 3 medium and 23 small banks). In November 2012 Međimurska banka d.d. was merged with Privredna banka d.d., while the name change included Kent banka d.d (earlier Banka Brod d.d.) at the end of 2012 and Sberbank d.d. (earlier Volksbank d.d.) at the beginning of 2013. Due to decrease of the number of banks, but also due to below-average growth of the rest of the peer group banks, the market share of small banks decreased, while big banks increased its already leading share, largely thanks to support from their foreign parent banks.

Due to this, the banking system in Croatia remains highly differentiated, with small number of profitable and strongly capitalised big banks in the leading role.

Based on the unaudited data as at 31 December 2012, total pre-tax income of banks and saving banks was 18.67% lower than in the same period of 2011, while the losses incurred increased significantly.

As at 31 December 2012, 12 banks had a total of HRK 472.7 million of losses (as at 31 December 2011 8 banks had a total of HRK 107.6 million of losses). Neither of the banks which incurred losses (with the exception of Sberbank d.d.) had more than 0.49% of the banking sector share (assets up to HRK 1.9 billion).

Distinctive bank differentiation together with negative macroeconomic movements continues in 2013 to put pressure on and to challenge small banks to find model of sustainable and profitable business in accordance with regulatory requirements, identical to all categories of banks in Croatia.

Description of the Bank's operation

Vaba d.d. banka Varaždin is registered as a limited company with the Commercial Court in Varaždin, headquartered in Varaždin, Alana kralja Zvonimira 1, for the following purposes:

- ✦ Receipt of all types of deposits or other redeemable funds and lending from those funds, for its own account,
- ✦ Receipt of all types of deposits or other redeemable funds,
- ✦ Providing all types of loans, including consumer loans and mortgage loans if allowed by separate laws, financing of commercial business, including export financing based on forfeighting,
- ✦ Factoring,
- ✦ Finance lease,
- ✦ Issuing of bank guarantees or other guarantees,
- ✦ Trading for its own account or on behalf of its customers of:
 - money market instruments,
 - transferrable securities,
 - foreign currencies, including money exchange,
 - financial futures and options,
 - currency and interest instruments,
- ✦ Payment operations within the country (in accordance with the Law on payment operations)
- ✦ Services tied with lending, such as gathering of data, analysis and issuing information on credit ability of sole traders and enterprises,
- ✦ Issuing of other payment instruments and managing them in accordance with separate laws, if these services are not considered to be payment operations in accordance with separate laws,
- ✦ Safe rentals,
- ✦ Mediation in financial affairs,
- ✦ Investments and other services and activities in accordance with separate laws regulating capital markets, as follows:
 - trading for its own account,
 - services of offerings, i.e. sale of financial instruments without purchase obligation,
 - safekeeping and administration of financial instruments on behalf of clients, including custodian and similar services, such as money and securities management,
- ✦ Representation in the sale of insurance policies in accordance with legislation regulating insurance.

As of 31 December 2012, the Bank operates through two financial centres (Varaždin and Zagreb), and 11 branches (Varaždin, Ludbreg, Ivanec, Novi Marof, Čakovec, Zagreb, Slavonski Brod, Nova Gradiška, Pula).

MISSION

An individual approach to each client and our high quality and professional services, based on the competence of our employees, we create value added for our customers. This contributes to the growth of our organization and improves the quality of the life of our community. We appreciate the personal contribution of each of our employees, whose creativity and knowledge are our greatest value.

VISION

Our vision is to continuously exceed expectations and be the first to innovate and create new values. We want to be a leader in creating high quality financial solutions for our customers and be the best in the area of development and prosperity for all of our employees.

Retail operation

Retail banking is carried out through 11 branches (Varaždin, Ludbreg, Ivanec, Novi Marof, Čakovec, Zagreb, Slavonski Brod, Nova Gradiška, Pula) and 11 ATMs. From 1 June 2012 the Bank enabled its clients fee-free withdrawing of funds from MBNET network of ATMs.

With the cooperation of the Varaždin County and the Municipality of Radoboj from the Krapinsko zagorska County, the Bank continues lending to students from the Varaždin County, where a great interest of students and their parents was noted.

During 2012 the Bank continuously improved deposit and loan products for the customers, keeping in line with the customers' needs and market trends. The highlight was given to additional protection and informing of the customers and to protection of personal data.

At the end of 2012 in Varaždin the project of introducing of central heating system in residential buildings was started, with the Bank, following the needs of the market it operates in, together with its partners – contractors and others, expanding its credit offering with additional credit line – for the introduction of central heating systems.

As a partner bank, Vaba participated in numerous exhibitions and events in the areas where it conducts its operation, such as the Međimurje's "MESAP", XVI National entrepreneurship and economy counselling by the Ministry of entrepreneurship and crafts and Business fair in Ivanec.

Business operations with craftsmen and small entrepreneurs

Business operations with sole traders and entrepreneurs represent a significant segment of the Bank's operations.

Considering that the European Investment Fund (EIF) at the end of 2010 recognised Vaba d.d. banka Varaždin as its partner in achieving common mission, on 17 December 2010 the Bank and EIF signed Loan agreement with the objective of easier access of funds to Croatian micro entrepreneurs, starting with its implementation at the beginning of 2011. A new product, Entrepreneur's loan by the Bank in cooperation with the EIF, was offered to new and existing clients. At the end of 2012 an annex to the contract was signed, extending the offering to micro entrepreneurs.

To date, cooperation of the Bank and local government has created a strong lever for the development of regional and local banking industry and has led to an active involvement of the Bank in development projects of local communities in which it operates. In that sense, the Bank participated in the projects with the Varaždin County (local development projects-micro lending for the years 2007, 2008 and 2009), with the City of Varaždin (lending to soletraders and small entrepreneurs of the City of Varaždin), the City of Ivanec (micro lending to soletraders and small entrepreneurs of the City of Ivanec, lending of investments in the business zone, lending to soletraders and small entrepreneurs that invest in the area of the City of Ivanec) and the the City of Ludbreg ("Entrepreneur 3" programme) and the City of Lepoglava ("Entrepreneur").

To reduce the costs of investment loans to its users in the City of Varaždin, the Bank has signed agreement with the City to subsidy part of the interest to entrepreneurs and craftsmen.

Through already successful realisation of the projects mentioned above, extremely successful cooperation with the Guarantee agency of the Varaždin County and the Development agency "Sjever-Dan" was established.

Corporate banking

The Bank's strategy in corporate banking in 2011 was focusing on further strengthening of primary business activities and creation of quality client base, targeting mainly clients in the region, primarily from Varaždin Međimurje, Krapinsko-zagorska and Bjelovarsko-bilogorska Counties, mid-size, production and export oriented.

One of important objectives for 2012 was orientation to usage of subsidised, specialised lines by the Croatian Bank for Reconstruction and Development for development of small and medium enterprises, inclusion in measures for economic recovery through programmes and models of the Government (models A, A+), involvement in auctions and inclusion of the local and national guarantee agencies. This especially relates to support of export activities of the region as a help with the recovery from the crisis and to quality lending and growth support to the clients primarily operating in production activities.

Activities were mainly focused on keeping the existing, quality part of the portfolio and, when possible, increasing the portfolio through acquisition of new clients and increase of exposure towards existing targeted clients, as well as maximum collection of receivables and restructuring of part of the portfolio.

Considering the disturbances in the Bank's operations evident at the end of 2011, consequences of which were still felt in 2012, especially in the first half of the year, when significant outflow of deposits in the period and significant repayments of first-class clients caused modest opportunity for sales activity. All activities were focused on keeping the existing clients, continuing relationship with them and serving as advisors, all as a stake in the coming period, i.e. after the capital increase expected during the year and marking the atmosphere through 2012.

In the north-western region as the main operating market segment, gradual recovery of economic activity is expected, with gradual recovery from the crisis, further foreign investments and new business zones, which are target segments of the Corporate banking division.

The Bank was actively involved in production processes of its clients and was engaged in supporting faster cash flows and liquidity maintenance, especially through maintaining of orientation of activities towards supporting development and technical plans of exporting and production based companies. In accordance with the difficult economic environment, special consideration was given to maintenance of the loan portfolio quality and to helping quality clients whose operations were endangered by the recession and high level of illiquidity of the system.

Strategy was also oriented to maximum increase in service quality, above all combining comprehensive supply, speed and availability and maximum dedication to the client.

Basic objectives of the Corporate banking division remain expanding of the client base, portfolio diversification and quality monitoring of the clients in all aspects of their operations through development of products and integral client monitoring system, enabling more effective managing of individual clients as well as the client base.

Following market conditions and opportunities, the Bank, through the Corporate banking division, joined the EU funds programmes, further opening possibilities for SME segment to join the measures for which tenders will be held during the following few years and with the joining the EU.

Treasury activities

In its main revenue segment – foreign currency exchange differences and securities trading, the Treasury performed well this year too. Foreign currency differences segment exceeded last year's results, while securities trading noted decrease in realised profits.

Situation in the foreign currency trading segment was quite stable, with no big market shocks. Only the year's end brought a significant weakening of the kuna as well as expectations that the CNB could react not only through foreign currency interventions, but also by using other measures with the objective of defending the FX exchange rate. Looking at the rate's movement, the year's end noted maximum level of the rate for the year (around 7.55). Not even the better tourist season couldn't compensate for lower investments inflow and, as an interesting factor affecting the kuna weakening, during April a negative EUR/HRK forward trading interest differential appeared. Stable trading was marked by still low margin in corporate trading, enhancing the importance of the foreign exchange differences trading realised results.

Market of fixed income securities was interesting, but marked by mainly negative news for the issuers (corporate as well as sovereign). PIGS countries situation escalated in the second half of the year, with general impression being worsened by negative macroeconomic forecasts and numerous rating downgrades, not only in Europe. Even the USA lost its decades undisputed AAA ratings. At the beginning of the year growth outlook and various indicators seemed relatively good so ECB even increased its basic interest rate (April and July). Unfortunately, the last quarter was marked by returning of the interest rate to the levels at the beginning of the year (1%) and by aforementioned ratings downgrades. All this resulted in very bad situation for most securities, including those issued by the Republic of Croatia, with significant yield increase.

Foreign payment transactions migration project resulted in significant improvements in IT support to the Treasury. As a result, transactions processing in the back office and their recording in the Bank's records have become significantly faster while operating risks have been decreased.

System of internal control and internal audit

The internal control system represents processes and procedures established to adequately control and monitor the risks incurred in operations, monitor the effectiveness of the Bank's operations, the reliability of financial reporting, information and compliance with regulations. The Bank has, in accordance with the Credit Institutions Act and the Decision on the internal controls system, established internal controls system comprising:

1. adequate organisational system
2. organisational culture
3. adequate control activities and segregation of duties
4. adequate internal controls integrated in the business processes and activities of the Bank
5. adequate administrative and accounting procedures
6. activities in the area of control function of the Bank

The Bank has regulated and established adequate control activities and the segregation of duties, adequate internal controls and adequate administrative and accounting procedures performed in the course of the Bank's regular activities.

Based on the legal requirements, the Bank has established three control functions independent of the business processes and activities in which risks arise, i.e. which it monitors. These are:

1. risk control function
2. compliance monitoring function
3. internal audit function

Risk control function ensures the Bank's compliance with strategies and policies of risk management, through risk analysis, reporting to the Board and others on the risks and involvement in creating, application and monitoring of methods and models for risk management.

Compliance monitoring function ensures the Bank operates in accordance with the relevant legislation, standards and internal acts. Activities of the compliance monitoring function include recognising and assessment of the compliance risk the Bank is, or could be, exposed to, advising the Board and other responsible persons on the application of relevant legislation, standards and rules, assessment of legislative changes to the Bank's operations, checking of compliance of new products and procedures with the applicable legislation and with the legislation changes, and advising on the preparation of the compliance related educational programmes.

Internal audit function, as a part of the internal supervision, tests and values adequacy and effectiveness of the internal controls system, rates adequacy and effectiveness of risk management procedures and risk

assessment methodology, rates the effectiveness of compliance monitoring function, rates the reporting system to the Board and the Management, rates the correctness and reliability of the accounting evidence system and of the financial statements, rates strategies and procedures of assessment of internal capital adequacy ratios, audits the IT system, checks reliability of the reporting system and timing and accuracy of reports as required by the Credit Institutions Act, rates the safety of the assets, rates the system of gathering and the accuracy of the information being publicly announced and performs all other activities needed for reaching the objectives of the internal audit.

Each control function prepares reports in accordance with its respective activities and which are based on the operational plans in accordance with the Credit Institutions Act and the Decisions based on the Act.

Development plan

In accordance with the mission and vision of the Bank, during 2013 operations will be focused on further development of the quality of products and services, functionality improvement of business processes and compliance with new regulatory requirements.

The above should contribute to increased quality of the Bank's business operations to the satisfaction of customers, regulator, employees and shareholders of the Bank.

STRATEGIC OBJECTIVES

- ✦ Become one of the leading banks in operations with small and medium enterprises and with local authorities and public companies in Varaždinska and Međimurska counties,
- ✦ Ensure adequate capital in accordance with the business strategy and risks undertaken,
- ✦ Ensure stabile finance sources,
- ✦ Rationalization of operations and further effectiveness increase,
- ✦ Diversification of risks and assets and liabilities management in accordance to best practice,
- ✦ Achieve sustainable return on share equity (long term objective).

On 31 January 2013 the increase of the share capital in the amount of HRK 50,000 thousand was approved. The increase was done by Alternative upravljanje d.o.o. with cash payment, acquiring 66.92% of the Bank's shares.

This should contribute to increase in the quality of the Bank's services, satisfying the Bank's clients, the regulator, employees and the shareholders.

Operations in 2012

As at 31 December 2012, the Bank had total assets of HRK 1.20 billion (31.12.2011: HRK 1.24 billion), of which total loans amounted to HRK 723 million (31.12.2011: HRK 792 million).

As at 31 December 2012, total clients' deposits amounted to HRK 863 million, the same as the previous year.

As at 31 December 2012, the Bank's equity amounted to HRK 127 million (31.12.2011: HRK 129 million).

The Bank generated HRK 73 million interest revenue in 2012, with the interest expenses amounting to HRK 42 million. Consequently, net interest income amounted to HRK 31 million, lower than the previous year.

Net interest and fees income in 2012 amounted to HRK 4.5 million, the same as the previous year. Revenues amounted to HRK 6.2 million and expenses amounted to HRK 1.7 million.

Operations in 2012 were significantly influenced by macroeconomic situation, foremost reflecting in slowing down of economic activities, investments decrease, worsening of balance of payments and low liquidity of the real sector.

General administrative expenses and depreciation and other expenses are lower than the previous year for HRK 4.1 million (8%) and amount to HRK 49 million.

As a consequence of the aforementioned, net operating loss before impairment allowances amounted to HRK 8 million. Impairment allowances amounted to HRK 4.6 million (2011: HRK 23 million), resulting in net loss for the year of HRK 12.7 million (2011: HRK 13.5).

The Bank continues to try reducing general administrative expenses, combining with the capital increase done at the beginning of 2013 to create positive effects on the Banks operations.

Risk management

The most significant financial risks the Bank is exposed to are credit risk, liquidity risk, market risk and operational risk. Market risk includes foreign exchange risk, interest rate risk and risk of market price changes in value of equity and debt financial instruments.

Integrated system of risk management is built and continuously improved at the Bank's level by introducing policies and procedures for assessment, control and managing of risks and by establishing limits to risks exposures in line with the regulations and the Bank's risk profile.

Credit risk

The Bank is exposed to credit risk through activities including trading, granting of loans, investing and in cases where it acts for and on behalf of clients or third parties or when it issues guarantees. Risk of default present in financial instruments transactions with some counterparties is constantly monitored. With the aim of managing credit risk, the Bank tries to do business with clients with good credit ratings and to obtain good collateral to ensure the recoverability of receivables from two independent sources (cash flow and collateral).

Credit risk is managed in accordance with the Bank's policies. Credit exposure to the portfolio or separate groups is constantly questioned in accordance with the given limits. Usage of limits is communicated to the Bank's bodies responsible for their approval. Credit board approves all significant increases of credit exposures and makes all decisions regarding the credit risk.

Liquidity risk

Liquidity risk occurs in financing activities of the Bank and the management of positions. The bank has access to different financing sources. Funds are collected through large number of instruments including different type of deposits, loans and other liabilities, including deposits, loans and shareholders' equity. The Bank continuously works on defining procedures and business processes for effective monitoring of liquidity risk by establishing and overlooking financing changes, with the aim of achieving business objectives in line with the Bank's overall business strategy. The Bank adjusts its business activities relating to liquidity risk, in line with the regulation and internal policies for maintaining liquidity reserves, balancing of assets and liabilities, controlling limits and liquidity indicators and planning for unforeseen events. Treasury daily manages liquidity reserves and ensures fulfilment of the clients' needs.

Market risk

The Bank manages foreign exchange risk of a foreign currency on the financial position and cash flows. Foreign exchange risk is monitored on the balance sheet level, in accordance to the regulation on open foreign exchange position on a daily basis.

Interest rate risk represents sensitivity of the Bank's financial position on the interest rates movements. The Banks operations are under influence of the interest rate changes to an extent in which interest bearing assets and liabilities mature or their interest rates change in different timing or amounts.

Operational risk

Operational risk is present in all segments of the Bank's operations, requiring quality knowledge over and continuous monitoring of all business processes. Organizational model of the process of managing of operational risk is conceptualized on both centralized and decentralized function of managing operational risk and is performed in accordance with the regulations and Basel guidelines and internal acts (policies, procedures and methodology on managing of operational risk).

IT safety managing in the context of IT operational risk managing includes several periodical activities with the aim of reducing the Bank's IT operational risk, embedding control mechanisms, improving business processes and complying with the regulations with the aim of reducing potential damage to the Bank's IT system arising from the vulnerability.

With the aim of operational risk managing, the Bank has secured adequate IT system management and IT system risk management, externalization risks management, compliance risk management, business continuity management and has secured adequate anti money laundering and financing of terrorism system.

Policies of financial risks management are described in detail in the Notes to the financial statements for 2012.

Statement on the application of the Code of Corporate Governance

During December 2009, the Bank's Management and Supervisory Board have adopted the Code of Corporate Governance of Vaba d.d. banka Varaždin, which established high standards and methods of quality corporate governance (further: the Code). The Code is published on the Bank's official web site.

In every matter that is not regulated by the Code, the Bank applies Code of Corporate Governance made by the Zagreb Stock Exchange and the Croatian Financial Services Supervisory Agency "CFSSA", to the extent applicable to the Bank.

In accordance with the Companies Act, Article 272p, the Management Board announces that the Bank has voluntarily applied the recommendations of both Codes during 2011, with exception to certain sections (as explained in details within annual questionnaire in the Code delivered along with the annual report to the Zagreb Stock Exchange for the publication).

The Management Board governs the Bank and its assets. Accordingly, the Board is obliged and authorised to take any necessary actions and decisions required for successful management of the Bank, all within the valid framework of the Companies Act and the Credit Institutions Act.

In accordance with the Bank's Articles of Association, the Management Board consists of three members at most, and the Supervisory Board decides on the number of members of the Management Board. Currently, the Management Board consists of two members.

The Supervisory Board appoints members and the president of the Management Board for the period of a maximum of 5 years, with the possibility of reappointment, upon CNB's approval.

The Supervisory Board can recall its decision on appointment in the case of existence of relevant reason in accordance with effective regulation.

Members of the Management Board who have preformed their duty during 2012 were as follows:

- ✦ Josip Šeremet, Vice-president* (until 19 January 2012)
- ✦ Stanko Kežman, President (from 6 February 2012)
- ✦ Natalija Jambrečić, Member

** Mr Šeremet has been appointed a deputy Chairman in the capacity of the Supervisory Board member, one off, to a 3-month term, until the appointment of the permanent Chairman of the Management Board (Article 43, 13p of the Credit Institutions Act).*

The Supervisory Board was on 31 December 2012 composed of six members on a 4 year mandate, which can be re-elected. In accordance with the Companies Act, Article 256, Section 2, a right to appoint 2 (two) members of the Supervisory Board has a shareholder Validus, as long as it is an owner of at least 24% of the Bank's shares.

A member of the Supervisory Board can be appointed only if an individual has knowledge and experience in banking or economics or scientific research, which would guarantee proper and duly performance of his duties. In addition, a member of the Supervisory Board cannot be an individual in contrary to the conditions specified by the Law.

The privileges of the Supervisory Board are set out in the Bank's Articles of Association in accordance with the applicable regulations within Companies Act and Credit Institutions Act.

Members of the Supervisory board of the Bank for the year 2012 were as follows:

- ✦ Vladimir Košćec, Chairman
- ✦ Anisur Rehman Khan (until 13.6.2012)
- ✦ Zaltan Kuljiš
- ✦ Zdenko Franić
- ✦ Josip Šeremet (until 6.2.2012)
- ✦ Ivana Jagačić (from 06.02.2012.)
- ✦ Marinko Benić
- ✦ Tomáš Hlaváč (from 13.06.2012.)

Information on the composition and activities of the Management and the Supervisory Board and their sub-committees is provided within the Annual Questionnaire within the Code of Corporate Governance.

The procedure for making amendments to the Articles of Association is defined in Article 65 of the Articles of Association. In accordance with law and this Articles of Association, amendments to Articles of Association can be processed at the General Assembly, whereas Supervisory Board is entitled to amend Articles of Association in order to adapt or to refine content of the Articles of Association.

Proposals for amendments and additions to the Articles of Association can be made by the Supervisory Board, the Management Board and the Bank's shareholders.

The Management Board is entitled to issue new shares of the Bank as a part of the section on so called approved issued capital. Issue of new shares is subject to approval by the Bank's Supervisory Board, and can be made during the period of 5 years, commencing from the date of entry of amendments into the Court register, in accordance with the Decision of the General Assembly of 6 March 2009. The Management Board can make decisions to increase Bank's share capital by making cash contribution and by issuing new shares, but total increase of share capital cannot exceed half of the nominal amount of the Bank's share capital at the date of decision on amendment of the Articles of Association. Management Board, upon approval of the Supervisory Board, is entitled to exclude shareholders' priority. Furthermore, management Board upon approval of the Supervisory Board decides on rights arising from ownership of shares and condition of their issue.

Main shareholders of the Bank with a share capital exceeding 2% of total share capital as at 31 December 2012 were as follows:

	Number of shares	Ownership share %
VALIDUS D.D. in bankruptcy	513,477	29.09%
BALKAN FINANCIAL SECTOR EQUITY FUND C.V.	292,000	16.54%
PLURIS D.D. in bankruptcy	158,694	8.99%
GARA SECUNDUS D.O.O.	76,000	4.31%
FINESA CONCEPTUS D.O.O.	62,276	3.53%
INTERFINANCE D.O.O.	62,226	3.53%
KALEM JOZO	62,226	3.53%
CROATIA OSIGURANJE D.D.	50,470	2.86%
NIKOMAT D.O.O.	43,346	2.46%
PODVEZANEC ĐURO	39,935	2.26%
CITY OF VARAŽDIN	38,501	2.18%

Policies of risk management are described in detail within the Notes to the financial statements for 2012.

In December 2009, the Supervisory Board founded the Audit Committee which consisted of three members of Supervisory Board (with at least one independent member), and of one member which is not a member of the Supervisory Board, neither employee of the Bank, but has experience in accounting and audit.

The Audit Committee, which on 31 December 2012 consisted of Marinko BeniĆ (president of the Audit Committee), Vladimir Košćec (member of the Audit Committee), Tomáš Hlaváč (member of the Audit Committee) and Marija Maltar (member of the Audit Committee), assists the Supervisory Board performing the function of business supervision, and especially of the following tasks:

- Monitors the reliability (credibility) of the financial information and reports (examines the relevance and consistence of the accounting methods),
- at least once a year revises the internal control system and the risk management system,
- provides the efficiency of the internal audit by suggesting the selection, appointment, removal or re-appointment of the Head of the Internal Audit, concerning also available budget and by assessing actions taken by the Management following the findings and recommendations of the internal audit
- makes recommendations to the Supervisory Board regarding the selection, appointment, re-appointment or replacement of external auditors and concerning also the terms of external auditors' engagement,

- oversees the independence and objectivity of external auditors, particularly regarding the rotation of auditors and fees paid by the Bank for audit services and takes care of other regulatory requirements (assessment of the extent and the level of other fees paid by the Bank to the auditor),
- considers the efficiency of external audit process and the actions undertaken by the senior management following the external auditor's recommendations following the audit

At least twice a year the Audit Committee reports to the Supervisory Board about its work, which is at least on the issuance of the half year and the Annual report of the Bank.

Beside the Audit Committee, the Supervisory Board in the performing function of supervision, follows and assess the work of the internal audit and makes recommendations to improve the quality of its work, and makes the recommendations for the use of available resources, with the purpose of establishing the quality system of internal controls which will timely identify the risks that the Bank is exposed to, with the aim of effective risk management.

After the increase of the share capital by Alternative upravljanje d.o.o., the ownership structure (shareholders with share over 1%) was:

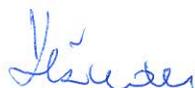
	Ownership share %
ALTERNATIVE UPRAVLJANJE D.O.O.	66.9226%
VALIDUS D.D. in bankruptcy	9.6217%
BALKAN FINANCIAL SECTOR EQUITY FUND C.V.	5.4716%
PLURIS D.D. in bankruptcy	2.9737%
FINESA CONCEPTUS D.O.O.	1.4967%
GARA SECUNDUS D.O.O.	1.4241%
KALEM JOZO	1.1660%
OTHER SHAREHOLDERS	10.9236%

With respect to the increase of the share capital, in March 2013 new Supervisory Board was formed consisting of:

- ✚ Julius Strapek, Chairman
- ✚ Tomislav Marinac
- ✚ Zoran Zemlić
- ✚ Irena Adžić-Jagodić
- ✚ Mario Baburić
- ✚ Vladimir Košćec
- ✚ Tomáš Hlaváč

Also, with the appointment of new Supervisory Board, new Audit committee was formed consisting of:

- ▼ Irena Adžić-Jagodić
- ▼ Mario Baburić
- ▼ Tomáš Hlaváč



Stanko Kežman, president of the Management Board



Natalija Jambrečić, member of the Management Board

Responsibilities of the Management and Supervisory Boards for the preparation and approval of the annual financial statements

The Management Board of the Bank is required to prepare financial statements for each financial year which give a true and fair view of the financial position of the Bank and of the results of their operations and cash flows, in accordance with applicable accounting standards, and is responsible for maintaining proper accounting records to enable the preparation of such financial statements at any time. It has a general responsibility for taking such steps as are reasonably available to it to safeguard the assets of the Bank and to prevent and detect fraud and other irregularities.

The Management Board is responsible for selecting suitable accounting policies to conform with applicable accounting standards and then apply them consistently; making judgements and estimates that are reasonable and prudent; and preparing the financial statements on a going concern basis unless it is inappropriate to presume that the Bank will continue in business.

The Management Board is responsible for the submission to the Supervisory Board of its annual report on the Bank together with the annual financial statements for acceptance. If the Supervisory Board approves the annual financial statements they are deemed confirmed by the Management Board and Supervisory Board.

The financial statements set out on pages 18 to 75 were authorised by the Management Board on 22 April 2013 for issue to the Supervisory Board and are signed below to signify this.

For and on behalf of Vaba d.d. banka Varaždin:



Stanko Kežman, president of the Management Board



Natalija Jambrečić, member of the Management Board

This version of the report is a translation from the original, which was prepared in the Croatian language. All possible care has been taken to ensure that the translation is an accurate representation of the original. However, in all matters of interpretation of information, views or opinions, the original language version of our report takes precedence over this translation.



Independent Auditors' Report

To the Management Board and Shareholders of VABA d.d. banka Varaždin

We have audited the accompanying financial statements of VABA d.d. banka Varaždin (herein below the Bank), which comprise of the balance sheet as at 31 December 2012, the income statement, the statement of comprehensive income, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes as presented on pages 18 to 75.

Management's Responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting regulations applicable to banks in Croatia. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Bank's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Basis for Qualified Opinion

1. As at 31 December 2012 loans and advances to customers, as presented in the note 8, include gross amount of HRK 60,114 thousand for which impairment allowances in the amount of HRK 10.339 thousand were recognised. The Bank's Management considers this allowance to be adequate as at 31 December 2012. However, in our opinion, additional impairment allowances in the amount of HRK 9,989 thousand should be recognised for these loans.
2. Other assets presented in the note 11 as at 31 December 2012 include receivables in the amount of HRK 9,214 thousand relating to a receivable of the Bank and the legal case the Bank raised because of other's side cancellation of the signed agreement. Based on audit procedures performed, we are not able to confirm the recoverability of the receivable.
3. Intangible assets presented in the note 10 as at 31 December 2012 include goodwill in the amount of HRK 2,300 thousand arisen from a transaction in 2008 for which the Bank expected to achieve value above the value of the net assets acquired. We are not able to confirm the recoverability of goodwill.

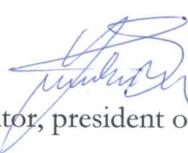
Qualified Opinion

In our opinion, except for the effects on the financial statements of the matters described in preceding paragraph, the financial statements presented on pages 18 to 75 give a true and fair view of the financial position of the Bank as at 31 December 2012 and the results of its operations and cash flows for the year then ended in accordance with statutory accounting regulations applicable to banks in Croatia.

Emphasis of matter

We draw attention to the note 17.9 presenting the Bank's capital adequacy as at 31 December 2012 (not considering the Auditor's qualifications) being close to the regulatory limit of 12%. Hence the Bank, at the beginning of 2013, increased its share capital in the amount of HRK 50 million by Alternative upravljanje d.o.o., raising its capital adequacy ratio to 16% after the increase of the share capital.


Grant Thornton revizija d.o.o.
Ivana Lučića 2A, Zagreb
Zagreb, 22 April 2013

Ivica Smiljan 
Certified auditor, president of the Board

GRANT THORNTON
revizija d.o.o.
ZAGREB

This version of our report is a translation from the original, which was prepared in the Croatian language. All possible care has been taken to ensure that the translation is an accurate representation of the original. However, in all matters of interpretation of information, views or opinions, the original language version of our report takes precedence over this translation.

Balance sheet as at 31 December 2012

	Notes	31 December 2011 (HRK '000)	31 December 2012 (HRK '000)
ASSETS			
Cash and deposits with Croatian National Bank	4	131,491	144,353
Placements with and loans to other banks	5	19,424	43,159
Financial assets available for sale	6	221,734	200,146
Financial assets held to maturity	7	13,430	16,248
Loans and advances to customers	8	792,731	722,828
Property and equipment	9	27,116	30,536
Intangible assets	10	17,100	16,971
Other assets	11	13,232	30,029
TOTAL ASSETS		1,236,257	1,204,271
LIABILITIES			
Deposits from customers	12	863,431	863,182
Borrowings	13	230,259	197,982
Hybrid instruments	14	3,012	3,018
Provisions for liabilities and charges	15	729	889
Other liabilities	16	9,496	12,255
TOTAL LIABILITIES		1,106,926	1,077,328
EQUITY			
Share capital	17.1	176,464	176,523
Share premium	17.2	27,440	27,440
Other reserves	17.3	2,611	2,552
Fair value reserve	17.4	(4,701)	5,610
Accumulated losses	17.5	(72,484)	(85,183)
TOTAL EQUITY		129,331	126,943
TOTAL LIABILITIES AND EQUITY		1,236,257	1,204,271

The significant accounting policies and other notes on pages 23 to 75 form an integral part of these financial statements.

Income statement for the year ended 31 December 2012

	Notes	2011 (HRK '000)	2012 (HRK '000)
Interest and similar income	18	97,833	73,106
Interest expense and similar charges	19	(49,389)	(42,101)
Net interest income		48,444	31,005
Fee and commission income	20	6,645	6,215
Fee and commission expense	21	(2,182)	(1,704)
Net fee and commission income		4,464	4,511
Gains less losses from financial assets available for sale	22	1,057	88
Gains less losses arising from foreign currencies	23	6,348	3,415
Other operating income	24	2,400	1,966
Dealing and other income/(expense)		9,805	5,419
OPERATING INCOME		62,713	40,934
General and administrative expenses	25	(47,909)	(44,176)
Depreciation and amortisation		(5,134)	(4,670)
Provisions for liabilities and charges		(109)	(161)
Operating expenses		(53,152)	(49,007)
OPERATING RESULT BEFORE IMPAIRMENT OF ASSETS		9,561	(8,073)
Identified impairment losses		(24,312)	(4,881)
Identified impairment losses on group basis		1,295	255
Impairment losses	26	(23,017)	(4,626)
PROFIT/(LOSS) BEFORE TAX		(13,456)	(12,699)
Income tax expense	27	-	-
PROFIT/(LOSS) FOR THE YEAR		(13,456)	(12,699)

The significant accounting policies and other notes on pages 23 to 75 form an integral part of these financial statements.

Statement of comprehensive income for the year ended 31 December 2012

	2011 (HRK '000)	2012 (HRK '000)
PROFIT/(LOSS) FOR THE YEAR	(13,456)	(12,699)
Net unrealised losses from financial assets available for sale	(4,026)	10,311
Other comprehensive income	(4,026)	10,311
Total comprehensive income	(17,482)	(2,388)

The significant accounting policies and other notes on pages 23 to 75 form an integral part of these financial statements.

Statement of changes in equity

HRK '000	Share capital	Share premium	Other reserves	Fair value reserve	Accumulated losses	Total
Balance at 1 January 2011	176,523	27,464	2,611	(674)	(59,028)	146,896
<i>Transactions with the owners</i>						
Share capital decrease for own shares	(59)	(24)	-	-	-	(83)
Total transactions with the owners	(59)	(24)	-	-	-	(83)
Loss for the year	-	-	-	-	(13,456)	(13,456)
Net unrealised losses from financial assets available for sale	-	-	-	(4,026)	-	(4,026)
Total comprehensive income	-	-	-	(4,026)	(13,456)	(17,482)
Balance at 31 December 2011	176,464	27,440	2,611	(4,700)	(72,484)	129,331
<i>Transactions with the owners</i>						
Share capital decrease for own shares	59	-	(59)	-	-	-
Total transactions with the owners	59	-	(59)	-	-	-
Loss for the year	-	-	-	-	(12,699)	(12,699)
Net unrealised gains/losses from financial assets available for sale	-	-	-	10,311	-	10,311
Total comprehensive income	-	-	-	10,311	(12,699)	(2,388)
Balance at 31 December 2012	176,523	27,440	2,552	5,611	(85,182)	126,943

The significant accounting policies and other notes on pages 23 to 75 form an integral part of these financial statements.

Statement of cash flows for the year ended 31 December 2012

	2011 (HRK '000)	2012 (HRK '000)
Cash flow from operating activities		
Profit/(loss) before tax	(13,456)	(12,699)
Adjustments:	27,527	9,645
- depreciation and amortisation	5,134	4,670
- net foreign exchange losses	(359)	90
- impairment losses on loans and advances to customers and other assets	22,752	4,724
- provisions for liabilities and charges	-	161
Changes in operating assets and liabilities	(126,474)	15,040
Decrease/(increase) in placements with and loans to other banks	567	(534)
Decrease/(Increase) in loans and advances to customers	80,538	43,044
Decrease/(Increase) in other assets	2,421	6,320
(Decrease)/increase in deposits from banks	(17,741)	-
(Increase)/decrease in obligatory reserve with the CNB	50,256	(35,264)
(Decrease)/increase in deposits from customers	(228,371)	(1,334)
(Decrease)/increase in other liabilities	(14,144)	2.808
NET CASH (OUTFLOW)/INFLOW FROM OPERATING ACTIVITIES	(112,403)	11.986
Cash flow from investing activities		
Purchase of property and equipment and intangible assets	(3,035)	(7,961)
Increase in financial assets available for sale	25,565	32,041
Maturity/(acquisition) of financial assets held to maturity	4,011	(2,788)
NET CASH INFLOW/(OUTFLOW) FROM INVESTING ACTIVITIES	26,541	21,292
Cash flow from financing activities		
(Decrease)/increase in borrowings	71,327	(32,026)
Increase/(decrease) in share capital	(83)	-
NET CASH (OUTFLOW)/INFLOW FROM FINANCING ACTIVITIES	71,244	(32,026)
Effect of foreign exchange rate changes on cash and cash equivalents	646	(310)
NET (DECREASE)/INCREASE CASH AND CASH EQUIVALENTS	(13,972)	942
Cash and cash equivalents at the beginning of the year	102,650	88,678
Cash and cash equivalents at the end of the year	88,678	89,620

The significant accounting policies and other notes on pages 23 to 75 form an integral part of these financial statements.

Notes to the financial statements for the year ended 31 December 2012

1. SIGNIFICANT ACCOUNTING POLICIES

General data

Vaba d.d. Bank Varaždin (the "Bank") was established as Brodsko - posavska banka d.d., Slavonski Brod in 1994. On 27 December 2004 the Bank was renamed Vaba d.d. Banka Varaždin, and its headquarters were relocated from Slavonski Brod to Varaždin, Anina 2. This change was a result of the changes in the ownership structure of the Bank, whose shareholder became Validus d.d. from Varaždin, with the consent of the Croatian National Bank.

On the General Assembly dated 14 December 2006, the Bank issued a decision to increase the share capital by issuing 292 thousand of new shares, with a nominal value of HRK 100 per share through a private offer at a price of HRK 140 per share. On the General Assembly held on 18 April 2007, a decision was made to increase share capital by issuing a further 619 thousand of new shares, with a nominal value of HRK 100 per share, through a private offer to the Bank's existing shareholders at a price of HRK 140 per share. In 2007, the share capital of the Bank was increased, and the capital increased from HRK 62,226,400 to HRK 153,355,000 which was registered at the Commercial Court in Varaždin by the Court decision dated 17 August 2007.

By Decision of the General Assembly dated 18 April 2007, the Bank's headquarters were changed to Aleja kralja Zvonimira 1, Varaždin.

On 6 March 2009, the General Assembly authorised an increase in share capital by the maximum amount of HRK 31,113,200 up to a total of HRK 184,468,200. Share capital was increased by certain shareholders during March 2009 by the amount of HRK 23,167,800 to HRK 176,522,800 and registered in court on 25 March 2009. Share capital is divided into 1,765,228 ordinary shares, each with a nominal value of HRK 100.

These financial statements were approved by the Bank's Management Board on 22 April 2013 for submission to the Supervisory board.

I. Basis of presentation

(a) Statement of compliance

The financial statements have been prepared in accordance with statutory accounting requirements for banks in Croatia. The Bank's operations are subject to the Credit Institutions Act, in accordance with which the Bank's financial reporting is regulated by Croatian National Bank ("the CNB") which is the central monitoring institution of the banking system in Croatia.

The principal accounting policies applied in the preparation of these financial statements are summarised below. Where specific accounting policies are aligned with accounting principles set out in International Financial Reporting Standards ("IFRS"), reference may be made to certain Standards in describing the accounting policies of the Bank; unless otherwise stated, these references are to Standards endorsed for use in the EU at 31 December 2012.

The accounting regulations which are the basis for the preparation of these financial statements differ from IFRS, in respect of presentation, recognition and measurement. The principal differences between the accounting regulations of the CNB and recognition and measurement requirements of IFRS are as follows:

- The CNB requires banks to recognise impairment losses, in the income statement, on assets not identified as impaired (including sovereign risk assets) at prescribed rates (excluding assets carried at fair value through profit or loss). In accordance with these requirements, as of 31 December 2012 the Bank has recognised portfolio-based provisions of HRK 7,991 thousand (2011: HRK 8,151 thousand) in the balance sheet and has recognised income for the year ending 31 December 2012 in the amount of HRK 160 thousand (2010: HRK 1,295 thousand) within the movement in impairment loss on loans and advances to customers and other assets. Although, in accordance with IFRS, such provisions are more properly presented as an appropriation within equity, the Bank continues to recognise such provisions in the income statement as a substitute for unidentified impairment losses calculated in accordance with the requirements of IFRS.

Notes to the financial statements (continued)

- Although the Bank calculates impairment losses on corporate lending as the present value of the expected future cash flows, discounted at the instrument's original effective interest rate, in accordance with IFRS, the CNB requires the amortisation of the calculated discount to be presented in the income statement within the movement in impairment losses on loans and advances to customers and other assets, rather than as interest income, as required by International Financial Reporting Standards.
- Additionally the CNB prescribes minimum levels of impairment losses against certain specifically identified impaired exposures, which may be different from the impairment loss required to be recognised in accordance with IFRS.

(b) Basis of measurement

The financial statements are prepared on a fair value basis for derivative financial instruments, financial assets and liabilities at fair value through profit or loss and available for sale assets, except those for which there is no reliable measure of fair value. Other financial assets and liabilities are carried at amortized cost or historical cost.

The financial statements are prepared in a format that is commonly used and internationally recognized by banks.

The preparation of financial statements requires management to make judgments, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities and disclosures of contingent liabilities on the balance sheet date, as well as the amounts of income and expenditure for the period. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be realistic in the circumstances and information available on the date of preparation of financial statements, the results of which form the basis for judgments about carrying values of assets and liabilities that are not directly visible from other sources. Actual results could differ from these estimates.

The estimates and underlying assumptions are reviewed on a regular basis. Revisions to accounting estimates are recognized in the period in which they are incurred if affecting only that period or the period in which they are incurred and future periods if they impact current and future periods.

Judgements made by management in applying the appropriate standards that have a significant impact on the financial statements and estimates with a risk of material adjustment in the coming year, are described in Note 3.

(c) Functional and presentation currency

The Bank's financial statements are presented in the currency of the primary economic environment in which the Bank operates ("the functional currency"), Croatian kuna (HRK), rounded to the nearest thousand.

As at 31 December 2012 the exchange rates used for translation of Bank's assets and liabilities were HRK 7.546 to EUR 1 (2011: HRK 7.530 to EUR 1) and HRK 5.727 to USD 1 (2011: HRK 5.820 to USD 1).

(d) Changes in presentation or classification of items within the financial statements

Where necessary, comparative information has been reclassified to achieve consistency with amounts presented in the current financial year and other disclosures.

Notes to the financial statements (continued)

II. Specific accounting policies

(a) Interest income and expense

Interest income and expense are recognised in the income statement as they accrue for all interest earning financial instruments, including those measured at amortised cost, at fair value through profit or loss and available for sale, using the effective interest rate method. Such income and expense is presented as interest and similar income or interest expense and similar charges in the income statement. Interest income and expense also includes fee and commission income and expense in respect of loans provided to customers or borrowings from other banks, premium or discount amortisation, and other differences between the initial carrying amount of an interest-earning financial instrument and its value at maturity, recognised on a linear basis. Income and expense on all assets and liabilities held for trading is recognised as interest income and expense.

(b) Fee and commission income and expense

Fee and commission income and expense arise on financial services provided by the Bank and received by the Bank, and mainly comprise fees related to domestic and foreign payments, the issue of guarantees and letters of credit, credit card business and other services provided by the Bank. Fee and commission income and expense are recognised in the income statement when the related service is performed.

Loan commitment fees for loans that are likely to be drawn down are deferred linearly (together with related direct costs) and recognised as an adjustment to the interest rate on the loan. Commitment fees in relation to facilities where draw down is not probable are recognised over the term of the commitment. Loan syndication fees are recognised as revenue when the syndication has been completed and the Bank has retained no part for itself, or has retained a part at the same interest rate as the other participants. Portfolio and other management advisory and service fees are recognised based on the applicable service contracts upon completion of the service.

Asset management fees related to investment fund management are recognised on an accrual basis over the period in which the service is provided. The same principle is applied for custody services that are continuously provided over an extended period of time.

(c) Dividend income

Dividend income from equity securities is recognised in the income statement when the rights to receive the dividend are established.

(d) Gains less losses from financial assets through profit and loss and investment securities

Gains less losses from financial instruments at fair value through profit or loss include unrealised and realised gains and losses arising from trading with debt securities and other financial instruments designated at fair value through profit or loss.

Gains less losses arising from investment securities comprise realised gains and losses from financial instruments available for sale.

(e) Gains less losses arising from dealing in foreign currencies

Gains less losses from dealing in foreign currencies include unrealised and realised gains and losses arising from spot and forward dealings in foreign currencies.

(f) Foreign currencies

Transactions in foreign currencies are translated into HRK at the rate of exchange ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the reporting date are translated into HRK at the foreign exchange rate ruling at that date.

Notes to the financial statements (continued)

Foreign exchange differences arising on translation are recognised in the income statement. Non-monetary assets and liabilities denominated in foreign currency that are stated at fair value are translated in HRK at the foreign exchange rates ruling at the dates when the fair values were determined.

Non-monetary assets and items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction and are not retranslated at the balance sheet date.

Changes in the fair value of monetary securities denominated in foreign currency classified as available for sale are analysed between translation differences resulting from changes in the amortised cost of the security, and other changes in the carrying amount of the securities. The translation differences are recognised in the income statement as part of the foreign exchange gains or losses on the revaluation of monetary assets and liabilities presented within general and administrative expenses in the income statement or other operating income. Translation differences on non-monetary financial assets, such as equity instruments classified as available for sale, are included in the fair value reserve in equity.

(g) Financial instruments

Classification

The Bank classifies its financial instruments in the following categories: at fair value through profit or loss, loans and receivables, available for sale, held to maturity or financial liabilities. The classification depends on the purpose for which the financial instruments were acquired. The management determines the classification of financial instruments upon initial recognition.

Financial assets and financial liabilities at fair value through profit or loss

This category comprises two subcategories: financial instruments held for trading (including derivatives), and those designated by management as at fair value through profit or loss at inception. The Bank designates financial assets and liabilities at fair value through profit or loss when:

- ✦ the assets or liabilities are managed, evaluated and reported internally on a fair value basis,
- ✦ the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- ✦ the asset or liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

As of 31 December 2011 the Bank had no financial assets and financial liabilities at fair value through profit and loss (2010: nil).

Loans and receivables

This category comprises of non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise when the Bank provides money to a debtor with no intention of trading with the receivable and include loans and receivables from banks, loans and receivables from customers, and the obligatory reserve with the Croatian National Bank.

Held-to-maturity investments

This category comprises non-derivative financial assets with fixed or determinable payments and fixed maturities that the Bank has the positive intention and ability to hold to maturity. These include corporate bills of exchange.

Available for sale financial assets

This category comprises non-derivative financial assets which are defined as available for sale or are not included in loans and receivables or held-to-maturity investments, or classified as financial assets at fair value through profit or loss. Available for sale financial assets are intended to be held for an indefinite period of time, but may be sold in response to needs for liquidity or changes in interest rates, foreign exchange rates, or equity prices.

Available-for-sale financial assets include debt and equity securities, units in investment funds and units in a private equity fund.

Notes to the financial statements (continued)

Other financial liabilities

Other financial liabilities comprise of all financial liabilities which are not held for trading or designated at fair value through profit or loss.

Recognition and derecognition

Purchases and sales of financial assets and financial liabilities at fair value through profit or loss, and financial assets held to maturity and available for sale, are recognised on the settlement date which is the date when the financial instrument is delivered to or transferred from the Bank. Loans and receivables and financial liabilities at amortised cost are recognised when advanced to borrowers or received from lenders.

The Bank derecognises financial instruments (in full or part) when the rights to receive cash flows from the financial instrument have expired or when it loses control over the contractual rights over the financial instrument. It occurs when the Bank transfers substantially all the risks and rewards of ownership to another business entity or when the rights are realised, surrendered or have expired. The Bank derecognises financial liabilities only when the financial liability ceases to exist, i.e. when it is discharged, cancelled or has expired. If the terms of a financial liability change, the Bank will cease recognising of the liability and will instantaneously recognise a new financial liability, with new terms and conditions.

Realised gains and losses from the disposal of financial instruments are calculated by using the weighted average cost method.

Initial and subsequent measurement

Financial assets and liabilities are recognised initially at fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

After initial recognition, the Bank measures financial instruments at fair value through profit or loss and financial assets available for sale at their fair value, without any deduction for costs of sale. Instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured are measured at cost less impairment.

Loans and receivables and held-to-maturity investments and financial liabilities not designated at fair value through profit or loss are measured at amortised cost.

Gains and losses

Gains or losses arising from a change in the fair value of financial assets or financial liabilities at fair value through profit or loss are recognised in the income statement.

Gains or losses arising from a change in the fair value of available-for-sale monetary assets are recognised directly in a fair value reserve within equity and are disclosed in the statement of changes in equity. Impairment losses, foreign exchange gains and losses, interest income and amortisation of premium or discount on available-for-sale monetary assets are recognised in the income statement. Foreign exchange differences on equity instruments are part of the fair value of these instruments and are recognised in equity.

Upon disposal or other derecognition of financial assets available for sale all cumulative gains and losses from the financial instrument are transferred to the income statement.

Gains or losses arising from financial assets and financial liabilities carried at amortised cost are recognised as interest in the income statement over the period of amortisation.

Gains or losses may also be recognised in the income statement when a financial instrument is derecognised or when its value is impaired.

Notes to the financial statements (continued)

Determination of fair value of financial instruments

The fair values of quoted available-for-sale financial assets are based on closing prices at the reporting date. If there is no active market for the financial instrument, or if, due to any other reason, the fair value cannot be reliably measured by the market price, the Bank uses an internal evaluation model for fair value estimation.

The fair value of non-exchange-traded derivatives is estimated at the amount that the Bank would receive or pay to terminate the contract on the balance sheet date taking into account current market conditions and the current creditworthiness of the counterparties.

Impairment of financial assets

Impairment of assets identified as impaired

Financial assets are reviewed at each reporting date to determine whether there is objective evidence of impairment. If any such indication exists, the asset's recoverable amount is estimated.

The Bank estimates and performs impairment of all financial assets, except financial assets at fair value through profit or loss.

If any evidence of impairment exists for available-for-sale financial assets, the cumulative loss measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in profit or loss, is removed from equity and recognised in the income statement. Significant or prolonged decline in fair value of instruments in equity securities and investments in investment funds is considered as impairment. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement. If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss is reversed through the income statement.

The recoverable amount of financial assets measured at amortised cost is calculated as the present value of the expected future cash flows, discounted at the instrument's original interest rate. Short-term balances are not discounted. Provisions for uncollectibility are made against the carrying amount of loans and advances that are identified as being impaired based on regular reviews of outstanding balances to reduce these loans and advances to their recoverable amounts (or lower amount if required by applicable CNB regulations). The expected cash flows for portfolios of similar assets are estimated based on previous experience and considering the credit rating of the underlying customers and late payments of interest or penalties. An increase in impairment losses is recognised in the income statement. When a loan is known to be uncollectable, all the necessary legal procedures have been completed, and the final loss has been determined, the loan is written off directly. If in a subsequent period the amount of impairment loss decreases and the decrease can be linked objectively to an event occurring after the write-off, the write-off or impairment loss is reversed through the income statement.

Impairment of assets not identified as impaired

In addition to the above described impairment losses on assets identified as impaired, the Bank recognises impairment losses, in income, in on and off-balance-sheet credit risk exposures not identified as impaired at rates from 0.85 - 1.20%, in accordance with the accounting regulations of the CNB (the Bank uses the rate of 0.85%).

Debt securities carried at fair value and classified as available for sale were excluded from the basis of such calculation at the reporting date.

(h) Specific financial instruments

Cash and cash equivalents

Cash and cash equivalents comprise of cash balances on hand, cash deposited with Croatian National Bank, placements with other banks with original maturities of three months or less, and items in course of collection.

Notes to the financial statements (continued)

Derivative financial instruments

The Bank uses derivative financial instruments to hedge economically its exposure to currency risk and interest rate risk arising from operating, financing and investing activities. In accordance with its investment policies, the Bank does not hold or issue derivative financial instruments for the purpose of speculative trading. Hedge accounting has not been applied and consequently, all derivative agreements are classified as financial instruments at fair value through profit or loss.

Derivative financial instruments include foreign currency forward agreements and swaps and are initially recognised at fair value which is the value of consideration paid to acquire the instrument less transaction costs. Subsequent to initial recognition, derivatives are measured at fair value. The fair value is determined based on the quoted market price or, if more appropriate, based on the discounted cash flow. All derivative instruments are presented as assets if their fair value is positive and as liabilities if their fair value is negative.

Hybrid contracts contain both a derivative and a non-derivative component. In such cases, the derivative component is considered to represent an embedded derivative. Except as required to the contrary by the CNB, when the economic characteristics and risks of embedded derivatives are not closely related to those of the host contract and when the hybrid contract is not itself carried at fair value through profit or loss, the embedded derivative is treated as a separate derivative and classified at fair value through profit or loss with all unrealised gains and losses recognised in the income statement, unless there is no reliable measure of their fair value.

Changes in the fair value of derivatives instruments are included in gains less losses arising from dealing with foreign currencies.

Treasury bills and debt securities

Treasury bills and debt securities that the Bank holds for the short-term gain purposes are classified as available-for-sale assets, and are carried at fair value. The Bank uses treasury bills for liquidity purposes.

Equity securities and investments in open-ended investment funds

Equity securities and investments in open-ended and close-ended investment funds are classified as available-for-sale assets.

Placements with banks

Placements with banks are classified as loans and receivables and are carried at amortised cost less impairment losses.

Loans and advances to customers

Loans and advances to customers are classified as loans and receivables and are presented net of impairment allowances to reflect the estimated recoverable amounts.

Borrowings

Interest-bearing borrowings are recognised initially at fair value, less attributable transaction costs. Subsequent to initial recognition, interest-bearing borrowings are stated at amortised cost with any difference between proceeds (net of transaction costs) and redemption value being recognised in the income statement over the period of the borrowings as interest expense.

Repurchase agreements and linked transactions

The Bank enters into purchases/(sales) of investments under agreements to resell (repurchase) substantially identical investments or in a series of linked sales and buy-back transactions at a certain date in the future at a fixed price. The amounts paid are recognised in loans and advances to either banks or customers. The receivables are shown as collateralised by the underlying security. Investments sold under repurchase agreements continue to be recognised in the balance sheet and are measured in accordance with the accounting policy for the relevant financial asset at amortised cost or at fair value as appropriate. The proceeds from the sale of the investments are reported as liabilities to either banks or customers.

The difference between the sale and repurchase consideration is recognised on an accrual basis over the period of the transaction and is included in interest income or expense.

Notes to the financial statements (continued)

Offsetting of financial instruments

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis or realise the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted by the accounting standards, or for gains and losses arising from a group of similar transactions such as in the Bank's trading activity.

(i) Income tax

The income tax charge is based on taxable profit for the year and comprises of current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity. Current tax is the expected tax payable on the taxable income for the year, using the tax rates enacted or substantially enacted at the balance sheet date, and any adjustments to tax payable in respect of previous years.

Deferred taxes are calculated by using the balance sheet liability method. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Deferred tax assets and liabilities are measured by using the tax rates expected to apply to taxable profit in the years in which those temporary differences are expected to be recovered or settled based on tax rates enacted at the balance sheet date.

The measurement of deferred tax liabilities and deferred tax assets reflects the tax consequences that would follow from the manner in which the Bank expects, at the balance sheet date, to recover or settle the carrying amount of its assets and liabilities.

Deferred tax assets and liabilities are not discounted and are classified as non-current assets and/or liabilities in the balance sheet. Deferred tax assets are recognised only to the extent that it is probable that sufficient taxable profits will be available against which the deferred tax assets can be utilised. At each balance sheet date, the Bank reassesses unrecognised potential deferred tax assets and the carrying amount of recognised deferred tax assets.

(j) Property and equipment

Property and equipment are tangible assets that are held for use in the supply of services or other administrative purposes.

Recognition and measurement

Property and equipment are stated at historical cost less accumulated depreciation and impairment losses. Historical cost includes expenditure that is directly attributable to the acquisition of the items.

Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Bank and the cost of the item can be measured reliably. All other repairs and maintenance are charged to the income statement during the financial period in which they are incurred.

Land and assets under development are not depreciated. Depreciation of other assets is calculated using the straight-line method to allocate their cost over their estimated useful lives as follows:

	2012	2012
Buildings	33 years	33 years
Computers	5 years	5 years
Furniture and equipment	7-15 years	7-15 years
Motor vehicles	4 years	4 years
Other assets	10 years	10 years

Residual values are not taken into account. Depreciation methods and estimated useful lives are reassessed at the each reporting date. Gains and losses on disposals are determined by comparing proceeds with carrying amount, and are included in the income statement.

Notes to the financial statements (continued)

(k) Intangible assets

Intangible assets are stated at cost less accumulated amortization and impairment losses. Expenditure on development activities are capitalised if all of the features required by IAS 38 "Intangible Assets" are satisfied. Amortisation is provided on a straight-line basis over the estimated useful lives of intangible assets. Costs associated with maintaining intangible assets are recognised as an expense as incurred.

Intangible assets are amortised on a straight-line basis over their estimated useful economic lives as follows:

	2012	2011
Leasehold improvements	5 years	5 years
Software	5 years	5 years
Licences	5 years	5 years

(l) Impairment of non-financial assets

The recoverable amount of property and equipment and intangible assets is the higher of the asset's fair value less costs to sell and value in use. For the purpose of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset or cash-generating unit.

Non-financial assets that have suffered impairment are reviewed for possible reversal of the impairment at each reporting date. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount and to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation, if no impairment loss had been recognised.

(m) Provisions for liabilities and charges

Provisions are recognised when the Bank has a present obligation as a result of past events, and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made, or as required by the law in the case of provisions for unidentified impairment of off-balance-sheet credit risk exposures, as previously referred to in note II. (b) "Financial Instruments".

Provision for liabilities and charges are maintained at a level which management believes is adequate to absorb probable future losses. The management determines the adequacy of the provision based upon reviews of individual items, recent loss experience, current economic conditions, the risk characteristics of the various categories of transactions and other relevant factors. Provisions are released only for such expenditure in respect of which provisions are recognised at inception. If the outflow of economic benefits to settle the obligations is no longer probable, the provision is reversed.

(n) Operating leases

Leases where the Bank as a lessor retains substantially all the risks and rewards incidental to ownership are classified as financial leases. The Bank did not have any financial leases on the balance sheet date, neither as a lessee or lessor. All leases are operating leases. Rental income under operating leases is recognised in the income statement on a straight-line basis over the term of the lease. The Bank leases office space for conducting its business activities. Payments made under operating leases are recognised in the income statement on a straight-line basis over the term of the lease.

(o) Employee benefits

Pension obligations

The Bank pays contributions to state-owned institutions and obligatory pension funds managed by privately owned management companies, in accordance with legal requirements or individual choice. The Bank has no further payment obligations once the contributions have been paid. The pension contributions are recognised as employee benefits in the income statement as they accrue.

Notes to the financial statements (continued)

Other employee benefits

Liabilities based on other long-term employee benefits, such as jubilee awards and statutory termination benefits, are recorded as the net present value of the liability for defined benefits at the balance sheet date. The projected discounted present value unit method is used for the calculation of the present value of the liability, using discount rates that, in opinion of the Bank's management, best represent the time value of money.

(p) Share capital and reserves

Issued share capital represents the nominal value of paid-in ordinary shares classified as equity and is denominated in HRK.

Reserve for general banking risks

The Bank recognises a reserve for general banking risks, which represents a reserve for potential losses in excess of those expected and provided for through recognised impairment losses. The reserve is calculated in accordance with applicable regulations which require that a certain percentage of net profit for the year be set aside as a reserve within equity if the growth of risk assets on an annual basis exceeds a specific level. The reserve for general banking risk cannot be transferred to retained earnings or be otherwise distributed until the expiry of a consecutive three year period in which the Bank has recorded annual growth not exceeding 15%.

Accumulated losses

Profit for the year is transferred to accumulated loss. Accumulated losses include losses from previous periods, the profit for the year and expenditures related to acquisition of property in the prior period.

Earnings per share

The Bank presents earnings per share (EPS) data for its ordinary shares. EPS is calculated by dividing the net profit attributable to ordinary shareholders of the Bank by the weighted average number of ordinary shares outstanding during the period.

(q) Off-balance-sheet commitments and contingent liabilities

In the ordinary course of business, the Bank enters into credit-related commitments which are recorded in off-balance-sheet records and primarily comprise guarantees, letters of credit and undrawn loan commitments. Such financial commitments are recorded in the Bank's balance sheet if and when they become payable.

(r) Funds management for and on behalf of third parties

The Bank manages funds for and on behalf of corporate and retail customers. These amounts do not represent the Bank's assets and therefore are excluded from the balance sheet. For the services rendered, the Bank charges a fee which is recognised in the income statement on an accruals basis.

Notes to the financial statements (continued)

2. RISK MANAGEMENT

2.1 Internal assessment of risk of the Bank's operations

This section provides details of the Bank's exposure to risk and describes the methods used by management to identify, measure and manage risk in order to safeguard capital. The most important types of financial risk to which the Bank is exposed are credit risk, liquidity risk, market risk and operational risk.

2.1.1 Credit risk

The Bank is subject to credit risk through its lending and investing activities and in cases where it acts as an intermediary on behalf of customers or other third parties. Credit risk can be defined as a risk of financial loss of the Bank by a counterparty failing to discharge its obligation.

To manage the level of credit risk, the Bank evaluates debtors' creditworthiness, and in order to minimise credit risk, obtains appropriate collateral. Also, the risk that counterparties to financial instruments might default on their obligations is monitored on an ongoing basis.

The Bank's primary exposure to credit risk arises from loans to and receivables from customers. The amount of credit exposure in this regard, and in respect of held-to-maturity securities recognised at amortised cost, is represented by the carrying amounts of the assets on the balance sheet. In addition, the Bank is exposed to the credit risk in respect of the off-balance-sheet items, through commitments arising from unused facilities and guarantees issued.

The Bank manages its credit risk exposure in accordance with the legislative requirements and regulations of the Croatian National Bank, as well as in accordance with its internal procedures.

Assessment of credit risk of the placements

Process of credit risk rating of placements comprises the following:

- ✦ debtors' creditworthiness,
- ✦ debtors' timeliness in meeting their obligations and
- ✦ collateral quality.

Assessment of creditworthiness is performed on each loan application, that is, minimum once a year subsequent to the delivery of the annual financial reports by the clients to which the Bank is exposed and who have not filed a loan request for a new risky product.

Creditworthiness implies the ability of a client to comply with credit terms or potential obligations and to ensure fulfilment of accepted obligation towards the Bank with its own funds, in the manner and within period determined by the contract and that client's operations comply with laws and regulations.

Assessment of creditworthiness of a corporate customer is performed at least by following criteria:

1. the nature of the debtor
2. the debtor's capital
3. creditworthiness of the debtor
4. liquidity and profitability
5. cash flow of the debtor
6. the general business terms and conditions and the outlook of the debtor
7. the debtor's exposure to currency indicated credit risk.

Monitoring of placements and contingent obligations includes continuous assessment whether elements exist which would indicate a deterioration of the customer's financial position, the customer's exposure to currency risk or an increase in risk due to the decrease of collateral value.

Notes to the financial statements (continued)

Classification of placements into risk categories

The process and criteria for the classification of placements into risk categories and calculation of impairment losses is defined by the By-law on classification of placements and contingent liabilities of Vaba d.d. banka, in accordance with the CNB's Decision on Classification of Placements and Contingent Liabilities of Banks.

The Bank assesses quality of placements and contingent liabilities continuously and classifies them based on the following general criteria:

- a) creditworthiness of the debtor,
- b) debtors' timeliness in meeting their obligations and
- c) collateral quality.

The Bank uses all of the criteria in the process of classification of placements, in line with general practice of credit risk management.

Exceptionally, in accordance with the CNB's Decision on Classification of Placements and Contingent Liabilities of Banks, the Bank classifies placements from the "small loan portfolio" into risk categories based on the debtors' timeliness in meeting their obligations and/or their collateral quality with individually significant placements being classified based on the collateral quality if the key criteria for the approval of the placement was not the creditworthiness of the debtor, but the collateral quality (with obligatory assessments of fair value and marketability of the collateral).

Based on the criteria and the classification of the placements and contingent liabilities which are defined separately for the "small loan portfolio" (total exposure toward one counterparty or a group of related counterparties less than 200,000 kuna at the assessment date) and for the individually significant exposures (total exposure toward one counterparty or a group of related counterparties more than 200,000 kuna at the assessment date), the Bank classifies all its placements into risk categories with impairment losses as follows:

1. **Risk category A** – newly approved placements upon initial approval and placements that the Bank estimates are fully recoverable – with no impairment losses on individual basis (impairment losses for risk category A placements are calculated on the group basis).
2. **Risk category B** – partly recoverable placements – **risk category B**, which are classified into three subcategories, depending on the percentage of the impairment losses in relation to the initial amount of placements:
 - B1** – losses ranging from 1% to 29.99%,
 - B2** – losses ranging from 30.00% to 69.99%,
 - B3** – losses ranging from 70.00% to 99.99%.
3. **Risk category C** – non-recoverable placements with impairment losses of 100%.

Classification into risk categories is done at least on quarterly basis. Risk categories for "small loan portfolio" are applied systematically with control of Sector for risk management. Assessment of recoverability of placements which are not part of "small loan portfolio" is done continuously and risk categories are updated at least on quarterly basis on suggestion of Sector for risk management.

Assets exposed to credit risk

Based on the applicable acts, the Bank uses the usual instruments as collaterals: bank guarantees, fiduciary right on real estate and movable assets, insurance policies, fiduciary rights on securities and shares in open-ended investment funds, cessions of receivables from companies and governments, bills of exchanges and pledges of accounts. Fair value appraisals of real estate and movable assets are done by certified appraisers from the Bank's list of certified appraisers. Fair value of collateral is revised based on usual business practice and market movements.

Notes to the financial statements (continued)

Assets	Notes	31.12.2011 (HRK '000)	31.12.2012 (HRK '000)
Deposits with Croatian National Bank	4	112,218	122,683
Placements with and loans to other banks	5	19,424	43,159
Financial assets available for sale	6	221,734	200,146
Financial assets held to maturity	7	13,430	16,248
Loans and advances to customers	8	792,731	722,828
Other assets	11	13,232	30,029
Total assets exposed to credit risk		1,172,768	1,135,094
Guarantees		32,029	49,380
Letters of credit		252	348
Unused loan commitments		34,196	32,562
Other contingent liabilities		1,803	6,353
Total off balance sheet exposure to credit risk	32	68,280	88,643
Total credit exposure		1,241,048	1,223,737

Notes to the financial statements (continued)

Uncollected due receivables

Uncollected due receivables include gross receivables based on maturity of both due and not due principal, on individual basis, including due but uncollected interest. Total amount of individual placement is allocated to the maturity class of the oldest uncollected receivable, relating to either principal or the interest.

[000 HRK]	31.12.2011.				
	Gross	Not due and due up to 90 days	%	Due over 90 days	%
Deposits with Croatian National Bank	112,218	112,218	100%	-	0%
Placements with and loans to other banks	19,424	19,424	100%	-	0%
Financial assets held to maturity	14,108	14,033	13%	75	1%
Loans and advances to customers	863,174	624,292	72%	238,882	28%
Other assets	14,558	13,447	92%	1,111	8%
TOTAL	1,023,482	783,414	77%	240,068	23%

[000 HRK]	31.12.2012.				
	Gross	Not due and due up to 90 days	%	Due over 90 days	%
Deposits with Croatian National Bank	122,683	122,683	100%	-	0%
Placements with and loans to other banks	43,157	43,157	100%	-	0%
Financial assets held to maturity	16,983	15,696	92%	1,287	8%
Loans and advances to customers	776,408	538,648	69%	237,760	31%
Other assets	48,608	21,207	44%	27,401	56%
TOTAL	1,007,839	741,391	74%	266,448	26%

Notes to the financial statements (continued)

[000 HRK]	31.12.2012.								
	Gross	%	Impairment loss for identified losses	Impairment loss for unidentified losses	Total impairment loss	Total impairment loss / gross	Net	Collateral value	Collateral value / net
	1	2	3	4	5 = 3 + 4	6 = 5 / 1	7 = 1 - 6	8	9 = 8 / 7
ASSETS									
Deposits at CNB	122,683		-	-	-	-	122,683	-	-
A	122,683	100.00%	-	-	-	-	122,683	-	-
Placements at and loans to other banks	43,157		-	-	-	-	43,157	-	-
A	43,157	100.00%	-	-	-	-	43,157	-	-
Financial assets held to maturity	16,983		584	150	734	4.32%	16,248	-	-
A	16,398	96.56%	-	150	150	0.91%	16,248	-	-
B, C	584	3.44%	584	-	584	100.00%	-	-	-
Loans and advances to customers	776,408		46,508	7,072	53,580	6.90%	722,828	317,138	43.87%
A	660,422	85.06%	-	7,072	7,072	1.07%	653,350	266,034	40.72%
B, C	115,986	14.94%	46,508	-	46,508	40.10%	69,478	51,104	73.55%
Retail	173,508		25,634	1,514	27,148	15.65%	146,360	48,012	32.80%
A	141,391	81.49%	-	1,514	1,514	1.07%	139,877	45,446	32.49%
B, C	32,117	18.51%	25,634	-	25,634	79.81%	6,483	2,566	39.58%
Corporate	602,899		20,874	5,558	26,432	4.38%	576,468	269,126	46.69%
A	519,030	86.09%	-	5,558	5,558	1.07%	513,472	220,588	42.96%
B, C	83,869	13.91%	20,874	-	20,874	24.89%	62,995	48,538	77.05%
Other assets	48,608		18,579	-	18,579	38.22%	30,029	-	-
A	-	-	-	-	-	-	-	-	-
B, C	48,608	100.00%	18,579	-	18,579	38.22%	30,029	-	-
TOTAL	1,007,838		65,671	7,222	72,893	7.23%	934,945	317,138	33.92%

Notes to the financial statements (continued)

[000 HRK]	31.12.2011								
	Gross	Impairment loss %	Impairment loss for identified losses	Impairment loss for unidentified losses	Total impairment loss	Total impairment loss / Gross	Net	Collateral value	Collateral value / net
	1	2	3	4	5 = 3 + 4	6 = 5 / 1	7 = 1 - 6	8	9 = 8 / 7
ASSETS									
Deposits at CNB	112,218		-	-	-	-	112,218	-	-
A	112,218	100.00%	-	-	-	-	112,218	-	-
Placements at and loans to other banks	19,424		-	-	-	-	19,424	-	-
A	19,424	100.00%	-	-	-	-	19,424	-	-
Financial assets held to maturity	14,108		558	120	678	4.80%	13,430	-	-
A	13,550	96.05%	-	120	120	0.89%	13,430	-	-
B, C	558	3.95%	558	-	558	100.00%	-	-	-
Loans and advances to customers	863,174		63,086	7,357	70,443	8.16%	792,731	338,171	42.66%
A	700,399	81.14%	-	7,357	7,357	1.05%	693,042	266,065	38.39%
B, C	162,775	18.86%	63,086	-	63,086	38.76%	99,689	72,106	72.33%
Retail	201,554		22,777	1,787	24,565	12.19%	176,989	56,367	31.85%
A	170,148	84.42%	-	1,787	1,787	1.05%	168,361	53,215	31.61%
B, C	31,406	15.58%	22,777	-	22,777	72.53%	8,628	3,152	36.53%
Corporate	661,620		40,309	5,570	45,879	6.93%	615,741	281,804	45.77%
A	530,251	80.14%	-	5,570	5,570	1.05%	524,681	212,850	40.57%
B, C	131,369	19.86%	40,309	-	40,309	30.68%	91,060	68,954	75.72%
Other assets	14,559		1,327	-	1,327	9.12%	13,232	-	-
A	13,216	90.78%	-	-	-	-	13,216	-	-
B, C	1,343	9.22%	1,327	-	1,327	98.82%	16	-	-
TOTAL	1,023,482		64,971	7,477	72,448	7.08%	951,034	338,171	35.56%

Notes to the financial statements (continued)

2.1.2 Market risks

The exposure to market risk occurs in respect of positions recognised at fair value and refers to securities and other financial instruments held for trading, securities and other financial instruments available for sale and positions denominated in foreign currency.

2.1.2.1 Foreign exchange risk

Foreign exchange operations of the Bank are subject to risks due to changes in intercurrency relationships, as well as changes in foreign currency rates in relation to the domestic currency. The Bank monitors changes in the foreign currency sub ledger on a daily basis by monitoring the relationship between the foreign currency receivables and liabilities, in accordance with the regulations of the CNB on the open foreign exchange position.

The Bank uses the open foreign exchange position (gap analysis) to measure and report exposure to currency risk in accordance with the methodology prescribed by the Croatian National Bank. Operational management of foreign currency position, within the prescribed limits is responsibility of the Treasury Department, which has the ability to propose measures to eliminate currency gap through a reduction or increase in loans and deposits with a currency clause, selling or buying the currency, or through arbitration - selling one currency for another.

The Risk Management Division controls the compliance with limits on a daily basis, and monthly reports to Asset and Liability Management Committee on foreign exchange risk exposure.

Foreign exchange risk

	[000 HRK]				
	HRK	HRK with FC clause	EUR	Other foreign currencies	Total
31.12.2012					
ASSETS					
Cash and deposits with Croatian National	119,673	-	9,043	15,636	144,353
Placements with and loans to other banks	24,151	-	17,154	1,853	43,157
Financial assets available for sale	60,520	2,743	136,883	-	200,146
Financial assets held to maturity	16,248	-	-	-	16,248
Loans and advances to customers	202,019	455,143	65,666	-	722,828
Property and equipment	30,536	-	-	-	30,536
Intangible assets	16,971	-	-	-	16,971
Other assets	29,650	-	15	364	30,029
TOTAL ASSETS	499,768	457,886	228,761	17,853	1,204,268
LIABILITIES					
Deposits from banks	-	-	-	-	-
Deposits from customers	271,320	2,177	560,163	29,520	863,181
Borrowings	92,658	11,108	94,217	-	197,983
Hybrid instruments	-	-	3,018	-	3,018
Provisions for liabilities and charges	889	-	-	-	889
Other liabilities	8,161	4,094	-	-	12,255
TOTAL LIABILITIES	373,028	17,379	657,398	29,520	1,077,325
EQUITY					
Share capital	176,523	-	-	-	176,523
Share premium	27,440	-	-	-	27,440
Other reserves	2,552	-	-	-	2,552
Fair value reserve	5,610	-	-	-	5,610
Accumulated losses	(85,183)	-	-	-	(85,183)
TOTAL EQUITY	126,943	-	-	-	126,943
TOTAL LIABILITIES AND EQUITY	499,971	17,379	657,398	29,520	1,204,269
NET FOREIGN EXCHANGE POSITION	(203)	440,507	(428,637)	(11,667)	-

Notes to the financial statements (continued)

[000 HRK]	31.12.2011				Total
	HRK	HRK with FC clause	EUR	Other foreign currencies	
ASSETS					
Cash and deposits with Croatian National Bank	106,519	-	5,644	19,328	131,491
Placements with and loans to other banks	6,370	-	8,684	4,371	19,424
Financial assets available for sale	59,022	2,271	160,441	-	221,734
Financial assets held to maturity	13,430	-	-	-	13,430
Loans and advances to customers	228,145	494,489	70,098	-	792,731
Property and equipment	27,116	-	-	-	27,116
Intangible assets	17,100	-	-	-	17,100
Other assets	11,321	-	1,908	2	13,232
TOTAL ASSETS	469,023	496,760	246,774	23,701	1,236,258
LIABILITIES					
Deposits from banks	-	-	-	-	-
Deposits from customers	289,420	4,872	541,219	27,921	863,431
Borrowings	45,901	13,565	170,792	-	230,259
Hybrid instruments	-	-	3,012	-	3,012
Provisions for liabilities and charges	729	-	-	-	729
Other liabilities	8,540	144	241	570	9,496
TOTAL LIABILITIES	344,590	18,581	715,264	28,492	1,106,927
EQUITY					
Share capital	176,464	-	-	-	176,464
Share premium	27,440	-	-	-	27,440
Other reserves	2,611	-	-	-	2,611
Fair value reserve	(4,701)	-	-	-	(4,701)
Accumulated losses	(72,484)	-	-	-	(72,484)
TOTAL EQUITY	129,331	-	-	-	129,331
TOTAL LIABILITIES AND EQUITY	473,921	18,581	715,264	28,492	1,236,258
VALUTNA NEUSKLAĐENOST	(4,898)	478,179	(468,490)	(4,790)	-

Notes to the financial statements (continued)

2.1.2.2 Position risk

The exposure to position risk relates to risk arising from changes in value of a financial instrument or changes in underlying variable of derivatives.

Financial instruments held for trading are exposed to general position risk, which is the risk of loss due to price change of financial instruments which can occur due to interest rate changes, or more significant changes on capital markets not related to any specific characteristics of financial instruments. Related instruments are also exposed to specific position risk which arises from price changes of individual financial instruments due to factors related to its issuer.

Asset and Liability Management Committee of the Bank establishes limits to exposures to financial assets available for sale. Decision on purchase/sale of a financial instrument and its classification into a category is made by the Management Board. Treasury Division does the transaction while the Risk Management Division controls the compliance with the internal acts and monitors fair values of the financial instruments on daily basis, if available.

The Risk Management Division calculates: market risk exposure, usage of exposure to market risk limits and capital requirements for exposure to market risks.

In the measurement of the market risk exposure, the Bank relies on regulations set out by the Croatian National Bank and monitors the following:

- ✦ Capital requirements calculated by the standard method calculated in accordance with the Croatian National Bank's Decision on capital adequacy;
- ✦ Internal models of monitoring exposure to interest rate risk in the Bank's records.

The Risk Management Division reports daily to the Treasury Division on the usage of market risk exposure limits and reports to the Asset and Liability Management Committee monthly.

2.1.2.3 Interest rate risk

The Bank's operations are subject to the risk of loss which arises from potential interest rate fluctuations which affects positions in the Bank's records.

In line with cautious interest rate risk management, the Bank defines responsibilities in accordance with generally accepted standards and defined limits for maintaining an acceptable level of economic capital and achieving satisfactory financial results.

The majority of placements and deposits are initially contracted at variable interest rate in accordance with the Bank's Decision, except when, for competitive reasons, fixed interest rates are contracted.

The Bank utilises the following measures for measurement of interest rate risk exposure:

1. repricing gap analysis;
2. standard interest shock on net interest income;
3. "what if" simulation; and
4. economic value of capital simulation (duration analysis).

Since 31 March 2010, based on the Decision on interest rate management, Risk Management Division reports on interest rate exposure on quarterly basis. For each reporting period in 2012, economic value of capital in relation to capital adequacy was in line with the regulatory requirements.

Measuring exposure to interest rate risk

The Bank measures the exposure to interest rate risk from two perspectives; profit perspective and the perspective of economic value of capital.

Notes to the financial statements (continued)

Profit perspective

When calculating the effect of interest rate change on net interest income, the Bank uses standard interest shock on net interest income for a 12 month period. The simulation is based on parallel movements in all interest rates, increase/decrease by 2 percentage points for HRK and increase/decrease by 1 percentage point for EUR and all other currencies.

[000 HRK]	2012	2011
Potential decrease in net interest income (HRK 000)	-474	-1,345
% of budgeted net interest income	-0,67%	-2,77%

Perspective of economic value of capital

The perspective of economic value of capital (duration analysis) represents a long term measure of interest rate risk exposure in the balance sheet. The effect of interest rate changes on economic value of capital is measured by economic value of capital simulation. This model is based on duration analysis and the hypothesis is that economic value of capital is expressed as the difference between the present value of assets and the present value of liabilities. The calculation is based on balance sheet positions which are distributed according to repricing criteria.

The Bank calculates the market value of capital by discounting the balance sheet positions using a rate of 5%. The economic value of capital is expressed as the difference between the present value of assets and the present value of liabilities. The simulation of change in economic value of capital is based on a simultaneous parallel increase of interest rates by 1%.

Risk Management Division reports the results of the interest rate risk exposure to the Asset and Liability Management Committee.

[000 HRK]	2012	2011
Net book value of capital (HRK 000)	119,961	129,331
Economic value of capital (HRK 000)	100,388	102,379
Change in economic value of capital (HRK 000)	-4.54%	-4.66%
Limit of change in market value of capital (HRK 000)	10.00%	10.00%

Interest rate risk stress test

Interest rate risk stress test is performed at least on yearly basis. It represents sensitivity analysis of net interest income and net interest margin on changes in interest rates based on repricing of sensitive positions. Risk Management Division selects at least two scenarios, informing the Asset and Liability Committee on the results.

Notes to the financial statements (continued)

Interest rate gap analysis

The following table shows the Bank's exposure to interest rate risk, analysed on the basis of the contracted maturity, or, with the instruments whose interest rate changes before maturity (administrative interest rate), in the period until the next date of the interest rate change.

[000 HRK]	31.12.2012						Total	Fixed interest rate
	0 - 30 days	31 - 90 days	91 - 360 days	1 - 3 years	over 3 years	Interest free		
ASSETS								
Cash and deposits with Croatian National Bank	48,803	-	73,880	-	-	21,670	144,353	-
Placements with and loans to other banks	40,992	-	-	-	-	2,166	43,157	-
Financial assets available for sale	15,091	22,637	28,677	69,547	47,877	16,316	200,146	183,830
Financial assets held to maturity	898	2,559	6,075	-	-	6,717	16,248	9,532
Loans and advances to customers	68,762	57,596	530,302	8,730	5,678	51,760	722,828	34,368
Property and equipment	-	-	-	-	-	30,536	30,536	-
Intangible assets	-	-	-	-	-	16,971	16,971	-
Other assets	-	-	-	-	-	30,029	30,029	-
TOTAL ASSETS	174,546	82,792	638,933	78,277	53,555	176,164	1,204,268	227,730
LIABILITIES								
Deposits from banks	-	-	-	-	-	-	-	-
Deposits from customers	91,196	122,831	541,901	91,529	1,895	13,828	863,181	323,258
Borrowings	133,568	34,161	21,019	5,118	3,806	309	197,982	178,809
Hybrid instruments	-	-	-	3,018	-	-	3,018	3,018
Provisions for liabilities and charges	-	-	-	-	-	889	889	-
Other liabilities	-	-	-	-	-	12,255	12,255	-
TOTAL LIABILITIES	224,765	156,992	562,920	99,665	5,702	27,282	1,077,325	505,085
TOTAL EQUITY	-	-	-	-	-	126,943	126,943	-
TOTAL LIABILITIES AND EQUITY	224,765	156,992	562,920	99,665	5,702	154,225	1,204,268	505,085
INTEREST GAP	(50,218)	(74,200)	76,013	(21,388)	47,854	21,940	-	(277,355)

Notes to the financial statements (continued)

[000 HRK]	31.12.2011						Interest free	Total	Fixed interest rate
	0 - 30 days	31 - 90 days	91 - 360 days	1 - 3 years	over 3 years				
ASSETS									
Cash and deposits with Croatian National Bank	77,300	-	34,918	-	-	-	19,273	131,491	-
Placements with and loans to other banks	11,645	-	-	-	-	-	7,779	19,424	-
Financial assets available for sale	22,696	7,531	171,997	-	-	-	19,510	221,734	202,224
Financial assets held to maturity	2,150	4,194	6,602	-	-	-	484	13,430	12,946
Loans and advances to customers	59,785	58,453	621,743	11,645	7,226	-	33,879	792,731	45,500
Property and equipment	-	-	-	-	-	-	27,116	27,116	-
Intangible assets	-	-	-	-	-	-	17,100	17,100	-
Other assets	-	-	-	-	-	-	13,232	13,232	-
TOTAL ASSETS	173,576	70,178	835,260	11,645	7,226	-	138,372	1,236,258	260,670
LIABILITIES									
Deposits from banks	-	-	-	-	-	-	-	-	-
Deposits from customers	158,287	97,940	566,186	24,838	2,665	-	13,515	863,431	374,399
Borrowings	106,766	109,121	10,662	1,621	1,146	-	943	230,259	200,190
Hybrid instruments	-	-	-	-	-	3,012	-	3,012	3,012
Provisions for liabilities and charges	-	-	-	-	-	-	729	729	-
Other liabilities	-	-	-	-	-	-	9,496	9,496	-
TOTAL LIABILITIES	265,053	207,061	576,848	26,459	6,823	-	24,683	1,106,927	577,601
TOTAL EQUITY	-	-	-	-	-	-	129,331	129,331	-
TOTAL LIABILITIES AND EQUITY	265,053	207,061	576,848	26,459	6,823	-	154,014	1,236,258	577,601
INTEREST GAP	(91,476)	(136,884)	258,412	(14,813)	403	-	(15,642)	-	(316,931)

Notes to the financial statements (continued)

2.1.2.4 Liquidity risk

Liquidity risk arises in the general funding of the Bank's activities and in the management of its positions. The main categories of liquidity risk to which the Bank is exposed are:

- ✚ inability to settle liabilities as a result of the maturity gap between cash inflow and outflow - structural liquidity risk, and
- ✚ risk of being unable to sell or acquire liquid asset at market in an appropriate timeframe and at a reasonable price - liquidity risk of financial instruments.

The liquidity risk management is conducted in compliance with regulatory requirements, and is also defined with the following internal acts:

- ✚ liquidity risk management policy,
- ✚ liquidity stress test procedure,
- ✚ procedure for the Bank's liquidity management,
- ✚ liquidity risk (crisis) plan.

Internal acts are proposed by the Risk Management Division and approved by the Bank's Management Board. In accordance with proposals by the Risk Management Division, a revision of internal acts is made.

The liquidity monitoring system is aimed at assessing the Bank's short-term liquidity and its ability to comply with future financing requirements. The Bank continuously aims its activities on improving the quality of the model and the entire process of liquidity management by upgrading the monitoring system, its related assumptions and by enhancing technical support in the procedural process.

The key purpose of the liquidity policy is to ensure that the Bank operates in a way to achieve an optimal balance between the Bank's safety and shareholders return on investment. Framework for a appropriate liquidity risk management comprises of: liquidity management strategy approved by the Management Board within budget and strategic plans, efficient supervision by Asset and Liability Management Committee and the Management Board, clearly defined responsibilities and conducts operations in line with agreed limits, management of assets and liabilities by matching their maturities, an established evaluation system of all current and future inflows and outflows, liabilities structure management, specifically in monitoring concentration of large deposits, sustained development of liquidity stress tests, assessment of access to financial markets and available funds under usual and stressed conditions and a crisis plan.

As part of it's business activities the Bank monitors liquidity risk and complies with regulations, following measures are part of liquidity risk management:

- ✚ prescribed ratio of short-term foreign currency receivables in relation to payables, which are monitored on a daily basis;
- ✚ reserve requirements - HRK;
- ✚ reserve requirements - foreign currency; and
- ✚ minimum liquidity ratio.

The purpose of management liquidity funds is compliance with regulatory minimum in a method to maintain minimum cost of liquidity funds.

The following liquidity risk indicators are monitored by the Bank:

- ✚ financial and structural indicators;
- ✚ deposit concentration;
- ✚ cash flow notice and projection system; and
- ✚ liquidity stress tests.

The Bank raises funds using a broad range of instruments including deposits, borrowings, subordinated loans and share capital. The Bank continuously assesses its liquidity risk by identifying and monitoring changes in the level of funding required to achieve business goals and strategic targets. Diverse funds enable flexibility, decrease dependence on a single source of funding and enable straightforward management of financing costs.

Notes to the financial statements (continued)

Liquidity stress test

Liquidity stress tests are done based on analysis of different scenarios, i.e. assessment of effects of simultaneous changes in several different factors of risk for the financial position of the Bank in clearly defined stress circumstances. The Bank performs liquidity stress tests adapted to business size and characteristics, strategic goals and plans, internal Bank's organization and its environment, to ensure sufficient liquidity funding. The aim of the liquidity stress test is to recognise a situation and to prepare relevant function of the Bank for prompt reaction in the case of a liquidity crisis. The development of the liquidity stress test represents the Bank's internal policy and is good practice for liquidity management. Management of the long term liquidity is accomplished by position maintenance with regards to liquidity risk exposure limits.

Stress scenario is arbitrarily selected, approved by the Risk Management Division. Two scenarios are selected, at minimum, one including Bank specific factors, the other including market factors. Different combinations of the factors are possible as well.

Selection of scenarios is usually affected by:

- current market movements;
- other movements historically significant for the Bank's liquidity;
- future predictions based on available information significant for the Bank's liquidity.

Upon selection of stress scenario, Treasury Division analyses the scenario or does the sensitivity analysis, depending on whether one or more factors on the financial position of the Bank are analysed. Risk Management Division and the Treasury Division report the results of the stress tests to the Asset and Liability Management Committee.

Notes to the financial statements (continued)

Maturity analysis

[000 HRK]	31.12.2012						Interest free	Total
	0 - 30 days	31 - 90 days	91 - 360 days	1 - 3 years	over 3 years			
ASSETS								
Cash and deposits with Croatian National Bank	144,353	-	-	-	-	-	-	144,353
Placements with and loans to other banks	43,157	-	-	-	-	-	-	43,157
Financial assets available for sale	27,242	22,637	30,958	70,939	48,370	-	-	200,146
Financial assets held to maturity	6,168	2,471	7,119	443	47	-	-	16,248
Loans and advances to customers	62,610	65,346	194,881	251,794	148,196	-	-	722,828
Property and equipment	-	-	-	-	30,536	-	-	30,536
Intangible assets	-	-	-	-	16,971	-	-	16,971
Other assets	826	5	30	10,569	18,599	-	-	30,029
TOTAL ASSETS	284,356	90,460	232,988	333,745	262,720	-	-	1,204,269
LIABILITIES								
Deposits from banks	-	-	-	-	-	-	-	-
Deposits from customers	93,536	125,640	493,564	146,790	3,650	-	-	863,180
Borrowings	132,083	33,275	-	6,082	26,543	-	-	197,982
Hybrid instruments	-	-	-	3,018	-	-	-	3,018
Provisions for liabilities and charges	-	-	889	-	-	-	-	889
Other liabilities	10,823	215	88	504	625	-	-	12,255
TOTAL LIABILITIES	236,442	159,130	494,541	156,394	30,818	-	-	1,077,325
TOTAL EQUITY	-	-	-	-	-	-	126,943	126,943
TOTAL LIABILITIES AND EQUITY	236,442	159,130	494,541	156,394	30,818	126,943	-	1,204,268
MATURITY GAP	47,914	(68,670)	(261,552)	177,350	231,901	(126,943)	-	-

Notes to the financial statements (continued)

[000 HRK]	31.12.2011						Interest free	Total
	0 - 30 days	31 - 90 days	91 - 360 days	1 - 3 years	over 3 years			
ASSETS								
Cash and deposits with Croatian National Bank	131,491	-	-	-	-	-	-	131,491
Placements with and loans to other banks	19,424	-	-	-	-	-	-	19,424
Financial assets available for sale	22,976	22,595	37,585	17,847	120,731	-	-	221,734
Financial assets held to maturity	2,631	4,195	6,605	-	-	-	-	13,430
Loans and advances to customers	70,995	61,357	221,710	249,518	189,151	-	-	792,731
Property and equipment	-	-	-	-	27,116	-	-	27,116
Intangible assets	-	-	-	-	17,100	-	-	17,100
Other assets	5,812	1,620	505	5,295	-	-	-	13,232
TOTAL ASSETS	253,329	89,767	266,404	272,660	354,098	-	-	1,236,258
LIABILITIES								
Deposits from banks	-	-	-	-	-	-	-	-
Deposits from customers	236,811	99,381	437,117	85,160	4,961	-	-	863,431
Borrowings	106,573	90,513	-	6,574	26,599	-	-	230,259
Hybrid instruments	-	-	-	-	3,012	-	-	3,012
Provisions for liabilities and charges	-	-	729	-	-	-	-	729
Other liabilities	9,496	-	-	-	-	-	-	9,496
TOTAL LIABILITIES	352,880	189,894	437,846	91,734	34,572	-	-	1,106,927
TOTAL EQUITY	-	-	-	-	129,331	-	-	129,331
TOTAL LIABILITIES AND EQUITY	352,880	189,894	437,846	91,734	163,903	-	-	1,236,258
MATURITY GAP	(99,551)	(100,127)	(171,442)	180,926	190,195	-	-	-

Notes to the financial statements (continued)

2.1.3 Operational risks

Operational risk is defined as the risk of loss due to inadequate or incorrect internal processes, human or system errors or events caused by external factors (natural disasters, fire, flood, attack, changes of legislation, embezzlement).

Operational risk exists in every segment of the Bank's operations, requiring knowledge and continuous monitoring of all business processes. Organisational model of operational risk management is set up on centralised and decentralised levels of operational risk management.

Operational risk is managed in accordance with applicable legislation and is defined by the following internal acts:

- policy on operational risk management
- procedure on operational risk management
- methodology for operational risk management
- directive on reporting of operational losses and operational risks

When measuring exposure to the operational risk, The Bank, based on the consequences of a risk event, differs the following:

Loss from operational risk, which represents operational losses affecting the balance sheet and assumes known amount of losses in the Bank's records.

Significant operational risk, which is present in business processes and has not resulted in operational losses, but there is a possibility of future operational losses resulting from it.

Self Risk Assessment is performed for every Bank's business process. Self Risk Assessment is done on yearly basis based on questionnaires prepared in accordance with Basel guidelines. Based on the collected data, each reported event which could result in operational risk is quantified and classified into a risk category. For events for which risks are high and very high, business processes owners, in coordination with the Risk Management Division, propose action for reducing exposure to an operational risk using methods for reduction of effects, i.e. damages and probability of occurrence or transferring the risk to a counterparty. Risk Management Division reports the results of the Self Risk Assessment to the Management Board once a year.

Risk Management Division reports the Management Board quarterly on recorded operational losses, i.e. events which resulted in losses recorded in the Bank's records due to exposure to operational risk. Report on operational losses contains, at minimum, data on amounts of losses, recovered amounts, unrecovered amounts, operational losses per type of event and cause and share of different organisational parts of the Bank in operational losses.

For operational risk management, The Bank has secured the following:

- adequate IT system management by using the following internal acts: Safety policy and Bylaw on adequate use of IT systems
- adequate risk management related to externalisation by using the following internal acts: Bylaw on externalisation and Procedure for externalisation
- adequate compliance risk management by using the following internal acts: Bylaw on compliance monitoring and implementation and Methodology for controls of organisational compliance of processes with internal and external processes
- adequate business continuity management by using the following internal acts: Business continuity policy and Business continuity procedure
- adequate system for prevention of money laundry and financing of terrorism by using the following internal acts: Policies and procedures for prevention of money laundry and financing of terrorism.

Notes to the financial statements (continued)

2.1.4 Concentration risks

Risk of concentration is every individual, direct or indirect exposure toward one counterparty or group of related parties or group of exposures connected by common risk factors such as industry, geographical area, operations or goods, i.e. application of techniques for credit risk reduction, which can cause such losses which could put the Bank's operations in question.

The Bank analyses and reports on concentration risk present both on the asset side of the balance sheet, i.e. loan portfolio, as well as on the capital and liability side of the balance sheet.

The Bank analyses concentration risk on the basis of each individual, direct or indirect exposure toward one counterparty or group of related parties and has regulated identification of related parties by internal acts, determining:

- 1) control, i.e. relationship between the parent company and its subsidiary or similar relationship between any entity or individual and
- 2) economical and financial ties.

Relationship is established mainly on the basis of information/data received from the client, but also by checking other available sources. Groups of related parties are entered into Registry of related parties, comprehensive database.

Identification and measurement of concentration relates to group of exposures connected by common risk factors such as common industry, geographical area or similar operations.

In order to maintain diversified and stable base of financing and to avoid overdependence on only certain sources, concentration is monitored for the following:

- clients or groups of related parties whose deposits make more than 2% of the Bank's total liabilities on both individual and group basis
- deposits from companies and other financial institutions: individual deposit and 10 biggest deponents in relation to the total deposits from companies and financial institutions and relating to the total deposits
- retail deposits: 10 and 100 biggest deponents from retail sector as a percentage
- total retail deposits as a percentage of total deposits.

Risk Management Division reports the concentration risk to the Asset and Liability Management Committee on monthly basis.

Concentration risk is also monitored on sector basis, as shown in the following table:

[000 HRK] Gross exposure	2011	%	2012	%
Retail	198,455	19%	169,902	17%
Agriculture and mining	55,934	5%	50,580	5%
Processing industry	185,764	18%	197,838	20%
Construction industry	76,201	7%	98,753	10%
Wholesale and retail sale	131,195	13%	109,476	11%
Financial services and insurance	148,880	15%	188,309	19%
Scientific and technical services	53,957	5%	67,745	7%
Health and social welfare services	15,060	1%	17,398	2%
Other	158,036	15%	107,838	11%
	1,023,482	100%	1,007,839	100%

Notes to the financial statements (continued)

2.1.5 Business continuity management

The Bank has adopted internal acts regulating the plan for business continuity management for the main business processes. The plan contains data on key personnel contacts, alternative locations in case of operations discontinuity, descriptions of key processes and strategies for their emergency recovery and documentation to be prepared in the case of operations discontinuity.

2.2 The Bank's general acts

2.2.1 General acts regulating credit policy

General acts regulating credit policy and asset and liability management are given as follows.

2.2.1.1 Credit policy objective

Credit policy objective includes the following:

- establishment of adequate credit risk management environment
- operations in accordance with generally accepted procedure for loan approval
- maintenance of adequate procedures for administration, measurement and monitoring of loans
- maintenance of adequate controls over credit risk
- maintenance of adequate assessment of the quality of assets
- recognition of adequate impairment allowances for identified and unidentified losses.

2.2.1.2 General articles of credit policy

The Bank's credit policy is based on applicable legislation and mission, vision and business policy of the Bank. It includes all important factors needed for ensuring development and reputation of the Bank, realisation of profit and maintenance of real value of capital based on safety, liquidity and profitability principles.

2.2.1.3 Definitions, principles and standards

Intention of the credit policy is establishment of basic principles for approving loans and other placements, relating to implementation of segregation of responsibilities for execution and for controls of activities into processes and procedures.

Basic principles of the credit policy are:

- safety of placements through realistic insight into the client's operations, assessment of its business capacity and its capability of servicing liabilities to the Bank,
- stable liquidity through assessment of repayments of placements in scheduled timeframe, expected inclusion of the debtor's funds into the Bank's deposit system as well as usage of the Bank's other services,
- profitability, i.e. satisfying the investors interests and enhancing self-financing of sales activities,
- quality service and satisfied customer,
- cross selling and enhancing deposit bases through private and corporate banking,
- capital adequacy maintenance through adequate rating of primary credit risk and reduction of the need for capital coverage through collaterals for loans.

Notes to the financial statements (continued)

2.2.1.4 Approval of placements

The Bank has established formal procedure for rating and approval of placements with the objective of maintenance of quality loan portfolio. Approvals are given in accordance with internal acts and are given by an appropriate organisational level. Each placement's approval procedure and the level of approval is properly documented. Segregation of duties of recommendations, approval and execution of a risk product ensures the adequacy of the approval process.

2.2.1.5 Monitoring of placements

Monitoring of placements process includes assessment of creditworthiness of a debtor, the group of its related parties and the quality of collateral during the lifespan of the legal relationship representing the exposure. Adequate system for placement monitoring includes measures:

- ensuring Bank's understanding of the current financial position of the debtor
- for assessment of the current collateral coverage in relation to the debtor's current position
- for identification of overdue payments

Internal acts define organisational units and responsible personnel ensuring all necessary information for undertaking of corrective actions as well as deadlines in which to act, considering potential conflicts of interest.

2.2.1.6 Loan portfolio analysis and process of monitoring of credit risk

The Bank has established the system for monitoring of entire structure and quality of the loan portfolio. Credit Committee, Supervisory Board and Audit Committee are regularly informed on the quality of the portfolio. Analysis of the loan portfolio includes, at minimum, analysis of risk categories, overdue days and the total exposure. Loan portfolio report is prepared by the Risk Management Division / Credit Risk Management Division. Based on the analysis results, decisions are made on the Bank's strategy toward the counterparty, group of related parties, certain industry or economic sector, geographical region, certain type of collateral etc.

2.2.1.7 Non-performing loans

Continuous monitoring of collection is an integral part of the loan process. If the borrower does not pay its liabilities before due date, overdue liability exists. The Bank has internally defined actions and procedures for collection of overdue receivables. Primary goal is swift action and the objective is maximum collection with optimal solution for the Bank. Within the process of non-performing loans management, the Bank's objectives are improvement of its loan portfolio, timely reaction to identified collection issues, limitation of impairment losses to minimum and loan portfolio management.

2.2.1.8 Credit risk control and stress test

Credit risk control is one of the Bank's functions organised as a separate organisational part, functionally and organisationally separated from other organisational parts of the Bank and is directly responsible to the Bank's Management Board.

The objective of establishment of the credit risk control is maintenance of the Bank's exposure to the credit risk within the parameters established by the Management Board. Credit risk control assists in ensuring the credit risk stays within the limits acceptable to the Bank.

Credit risk control ensures independent, continuous check of the application and effectiveness of the methods and procedures for the credit risk management. Also, credit risk control includes establishment of measurement and assessment of credit risk which the Bank is or could be exposed to, and making recommendations for adequate credit risk management.

In order to function effectively, the credit risk control has the authorization for unlimited and permanent access to all documents, evidences and personnel of the Bank, with strict confidentiality.

Credit risk control function keeps evidence on performed work and reports the results of each separate review to the Management Board.

Notes to the financial statements (continued)

Stress test

Risk Management Division / Credit Risk Management Division tests the effects of two different factors, at minimum. Stress situation simulated in a test is usually determined by indicators on the market or within the Bank which point to a possibility of occurrence of significant changes in the loan portfolio, resulting in changes to the financial results of the Bank and to the regulatory indicators.

Risk Management Division reports the results of the stress tests to the Credit Committee and recommends the risk management strategy to be maintained or changed, depending on the stress test results.

Notes to the financial statements (continued)

3. SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGEMENTS

The Bank makes estimates and assumptions about uncertain events, including estimates and assumptions about the future. Such accounting assumptions and estimates are regularly evaluated, and are based on historical experience and other factors. Key sources of estimation of uncertainty are described below.

Impairment losses on loans and receivables

The Bank monitors the creditworthiness of its customers on an ongoing basis. In accordance with the CNB regulations, the need for impairment of the Bank's on and off-balance-sheet credit risk exposure is assessed at least quarterly. Impairment losses are made mainly against the carrying value of loans and advances to corporate and retail customers as described in Note 2.1.1. "Credit risk", while provisions for liabilities and charges arise from off-balance-sheet risk exposure to customers, mainly in the form of guarantees, documentary credits and undrawn loan commitments as described in Note 32.

Financial assets carried at amortized cost

Financial assets carried at amortised cost include financial investments held to maturity and loans and advances to customers.

The Bank initially assesses whether objective evidence of impairment exists. Assets for which impairment is not individually assessed are included in group of assets with similar credit risk characteristics. These portfolios are then assessed collectively for impairment.

The Bank estimates impairment losses when it estimates that the observable data indicates the likelihood of a measurable decrease in the estimated future cash flows of the asset or portfolio of assets.

The Bank also seeks to recognise impairment losses which are known to exist at the balance sheet date, but which have not yet been specifically identified. In estimating unidentified impairment losses existing in collectively assessed portfolios, and in the absence of reliable data on historical loss rates and the emergence period for the identification of these impairment losses, the Bank considers the range of impairment loss rates from 0.85% to 1.20% prescribed by the CNB to be calculated on all credit risk exposures except those carried at fair value, including off-balance-sheet amounts and Croatian sovereign risk. Amounts assessed as impaired on an individual basis are excluded from this calculation.

Fair value of the financial instruments quoted in an active market

In estimating the fair value of quoted financial instruments, the Bank uses closing prices at the date of estimation. If the market for a financial asset is not active (and for unlisted securities), or if, for any other reason, the fair value cannot be reliably measured by market prices, the Bank establishes fair value by using valuation techniques.

Provisions for court cases

The Bank performs individual assessment of outcome of court cases. Initial assessment is made by the Legal department of the Bank. The Bank is defendant in the total of 7 court cases, 6 of which are litigations and 1 violations arising from the daily operations of the Bank. In 2 out of 6 litigations, the Bank has first instance rulings in its favour. All 7 cases have been classified in risk group A.

Regulatory requirements

The CNB is entitled to carry out regulatory inspections of the Bank's operations and can request changes to the carrying values of assets and liabilities, in accordance with the underlying regulations.

Notes to the financial statements (continued)**4. CASH AND DEPOSITS WITH CROATIAN NATIONAL BANK**

[000 HRK] CASH AND DEPOSITS WITH CNB	31.12.2011	31.12.2012
Cash	19,273	21,670
in HRK	12,896	11,737
in foreign currency	6,378	9,933
Current accounts with CNB	58,705	34,056
in HRK	58,705	34,056
in foreign currency	-	-
Obligatory reserve with CNB	53,513	88,626
in HRK	34,918	73,880
in foreign currency	18,595	14,746
Accrued interest	-	-
due	-	-
not due	-	-
TOTAL	131,491	144,353

The CNB determines the requirement for banks to hold obligatory reserves, both in the form of amounts required to be deposited with the CNB and held in the form of other liquid receivables. The obligatory reserve with the CNB represents the amount required to be deposited with the CNB.

The rate of the obligatory reserve at 31 December 2012 amounted to 15% (2011: 14%; CNB changed the rate of the obligatory reserve from 13% to 14% in September 2011 and from 14% to 15% in January 2012) of HRK and foreign currency deposits, borrowings and issued debt securities.

At 31 December 2012 the required minimum rate of maintenance of the obligatory reserve in the Croatian kuna with the CNB amounted to 70% (2011: 70%), while the remaining 30% (2011: 30%) could be held in the form of other liquid receivables. This includes the part of foreign currency obligatory reserve required to be held in HRK. Based on the Decision made on 9 March 2011 CNB pays no interest on the obligatory reserve funds.

70% of the foreign currency obligatory reserve (2011: 70%) is maintained with the CNB, while the remaining 30% (2011: 30%) must be held in the form of other liquid receivables, after adjusting for the obligatory reserve requirement arising from foreign currency funds from non-residents and related parties (which is required to be held in full with the CNB). 75% of the foreign currency obligatory reserve (2011: 75%) is included in the HRK obligatory reserve and is required to be held in HRK. In accordance with CNB decision in force from 11 November 2009, the CNB pays no interest on foreign currency obligatory reserve.

Notes to the financial statements (continued)**5. PLACEMENTS WITH AND LOANS TO OTHER BANKS**

[000 HRK] PLACEMENTS WITH AND LOANS TO OTHER BANKS	31.12.2011	31.12.2012
Short-term	10,699	34,434
with foreign banks	9,193	15,374
with domestic banks	1,506	19,060
Long-term	8,721	8,717
with foreign banks	1,812	2,567
with domestic banks	6,909	6,151
Accrued interest	4	8
due	-	-
not due	4	8
TOTAL	19,424	43,159

Out of total placements with other banks at 31 December 2012, the Bank had deposits in the total amount of HRK 37,008 thousand (2011: HRK 13,054 thousand) and loans (HBOR – programme A for support of entrepreneurs) in the amount of HRK 6,151 thousand (2011: HRK 6,370 thousand).

6. FINANCIAL ASSETS AVAILABLE FOR SALE

[000 HRK] FINANCIAL ASSETS AVAILABLE FOR SALE	31.12.2011	31.12.2012
Debt securities	202,123	183,593
Croatian MoF bonds	116,709	99,212
Croatian MoF treasury bills	-	-
Foreign government bonds	45,603	15,813
Foreign government treasury bills	37,658	66,405
Corporate bonds	2,153	2,163
Shares in investment funds	11,945	12,151
Equity securities	3,500	-
Accrued interest	4,166	4,403
due	-	-
not due	4,166	4,403
TOTAL	221,734	200,146

The Bank recognises available-for-sale financial assets at fair value with changes in fair value recognised in a fair value reserve in equity, i.e. in the other comprehensive income.

Based on Article 3 of the Decision on Classification of Placements and Contingent Liabilities of Banks (Official Gazette (1/2009, 75/2009 and 2/2010) which became effective on 31 March 2010, the Bank classifies its "loans and receivables" and "held to maturity" placements in accordance with IAS 39 under the scope of the Decision. Based on the Article 4 of the Decision, financial assets classified as "at fair value through profit and loss" and "financial assets available for sale" in accordance with IAS 39 do not fall under the scope of the Decision. In accordance with the Decision, no impairment losses on group basis are calculated for financial assets classified as "available for sale".

Notes to the financial statements (continued)**7. FINANCIAL ASSETS HELD TO MATURITY**

[000 HRK] FINANCIAL ASSETS HELD TO MATURITY	31.12.2011	31.12.2012
Debt securities	13,624	16,314
Bills of exchange	13,624	16,314
Accrued interest	484	669
due	484	669
not due	-	-
Impairment	(678)	(734)
identified losses - Bills of exchange	(75)	(75)
identified losses - accrued interest	(483)	(510)
identified losses on group basis	(120)	(150)
TOTAL	13,430	16,248

Financial assets held to maturity consist of discounted bills of exchange from companies.

8. LOANS AND ADVANCES TO CUSTOMERS

[000 HRK] LOANS AND ADVANCES TO CUSTOMERS	31.12.2011	31.12.2012
Gross loans	842,318	753,128
retail	198,455	169,902
corporate	643,863	583,226
Accrued interest	20,856	23,280
due	16,054	18,935
not due	4,802	4,345
Impairment	(70,443)	(53,580)
identified losses - gross loans	(57,494)	(40,866)
identified losses - accrued interest	(5,592)	(5,642)
identified losses on group basis	(7,357)	(7,072)
TOTAL	792,731	722,828

Notes to the financial statements (continued)

[000 HRK] MOVEMENT IN IMPAIRMENT ALLOWANCES	Identified losses	2012 Identified losses on group basis	TOTAL
Movement in impairment allowances			
As at 1 January	63,086	7,357	70,443
(Decrease) / Increase in impairment losses	(12,494)	(285)	(12,779)
Write-offs	(4,093)	-	(4,093)
Collected impaired interest	-	-	-
Net gain / (loss) on foreign exchange differences	8	-	8
As at 31 December	46,508	7,072	53,580

[000 HRK] MOVEMENT IN IMPAIRMENT ALLOWANCES	Identified losses	2011 Identified losses on group basis	TOTAL
Movement in impairment allowances			
As at 1 January	40,548	8,628	49,176
(Decrease) / increase in impairment losses	23,974	(1,271)	22,703
Write-offs	(927)	-	(927)
Collected impaired interest	-	-	-
Net gain / (loss) on foreign exchange differences	(509)	-	(509)
As at 31 December	63,086	7,357	70,443

The Bank applies the rate of 0.85% on balance sheet and off balance sheet exposures which are subject to the credit risk and for which no identified impairment losses have been recognised.

Notes to the financial statements (continued)

9. PROPERTY AND EQUIPMENT

[000 HRK]	2012					Total
	Land and buildings	IT equipment	Office furniture and equipment	Motor vehicles and other	Assets under construction	
Cost						
At 1 January	21,882	8,535	11,137	1,902	34	43,490
Additions	5,906	-	-	-	572	6,478
Write offs	-	-	(13)	-	-	(13)
Disposals	-	-	-	(346)	-	(346)
Transfers	-	187	72	293	(552)	0
As at 31 December	27,788	8,722	11,196	1,849	54	49,609
Accumulated depreciation						
At 1 January	2,890	5,414	6,605	1,466	-	16,375
Charge for the year	674	1,119	1,011	79	-	2,883
Write offs	-	-	(4)	-	-	(4)
Disposals	-	-	-	(181)	-	(181)
As at 31 December	3,564	6,533	7,612	1,364	-	19,073
Carrying value	24,224	2,189	3,584	485	54	30,536

[000 HRK]	2012					Total
	Land and buildings	IT equipment	Office furniture and equipment	Motor vehicles and other	Assets under construction	
Cost						
At 1 January	21,136	6,350	11,143	1,766	1,536	41,931
Additions	746	-	-	-	926	1,672
Write offs	-	(24)	(80)	(9)	-	(113)
Transfers	-	2,209	74	145	(2,428)	-
As at 31 December	21,882	8,535	11,137	1,902	34	43,490
Accumulated depreciation						
At 1 January	2,254	4,421	5,627	1,337	-	13,639
Charge for the year	636	1,017	1,051	138	-	2,842
Write offs	-	(24)	(74)	(9)	-	(107)
As at 31 December	2,890	5,414	6,604	1,466	-	16,374
Carrying value	18,992	3,121	4,533	436	34	27,116

The increase in land and buildings in 2012 is described in the note 11.

Notes to the financial statements (continued)

10. INTANGIBLE ASSETS

[000 HRK]	2012					Total
	Software	Goodwill	Leasehold improvements	Licences	Assets under construction	
Cost						
Balance at 1 January	1,307	2,300	8,857	4,941	11,728	29,133
Additions	-	-	-	-	1,655	1,655
Transfers	-	-	38	203	(241)	-
Write offs	-	-	-	-	-	-
Balance at 31 December	1,307	2,300	8,895	5,144	13,142	30,788
Accumulated depreciation						
Balance at 1 January	1,217	-	7,469	3,346	-	12,032
Charge for the year	67	-	949	769	-	1,785
Write offs	-	-	-	-	-	-
Balance at 31 December	1,284	-	8,418	4,115	-	13,817
Net book value at 31 December	23	2,300	477	1,029	13,142	16,971

[000 HRK]	2011					Total
	Software	Goodwill	Leasehold improvements	Licences	Assets under construction	
Cost						
Balance at 1 January	1,307	2,300	9,093	4,824	10,689	28,213
Additions	-	-	-	-	1,375	1,375
Transfers	-	-	86	251	(337)	-
Write offs	-	-	(322)	(134)	-	(456)
Balance at 31 December	1,307	2,300	8,857	4,941	11,727	29,132
Accumulated depreciation						
Balance at 1 January	1,083	-	6,462	2,644	-	10,189
Charge for the year	134	-	1,334	836	-	2,304
Write offs	-	-	(327)	(134)	-	(461)
Balance at 31 December	1,217	-	7,469	3,346	-	12,032
Net book value						
Balance at 1 January	224	2,300	2,631	2,180	10,689	18,024
Balance at 31 December	90	2,300	1,388	1,595	11,727	17,100

Notes to the financial statements (continued)**11. OTHER ASSETS**

[000 HRK] OTHER ASSETS	31.12.2011	31.12.2012
Other assets	14,559	48,608
Fees receivable	864	856
Prepaid expenses	627	1,100
Reposessed assets	8,162	16,698
Inventories	505	540
Other receivables	4,401	29,413
Impairment allowances	(1,327)	(18,579)
TOTAL	13,232	30,029

During 2012 the Bank reposessed assets in the total amount of HRK 15,049 thousand (2011: HRK 2,346 thousand), of which HRK 7,048 thousand relates to land (2011: HRK 44 thousand), HRK 7,263 thousand relates to buildings (2011: HRK 970 thousand) and HRK 738 thousand relates to flats (2011: HRK 1,332 thousand).

During 2012 reposessed assets sold amounted to HRK 653 thousand (2011: nil) and entirely relate to flats.

Although the Bank actively works on selling reposessed assets, during 2012 assets in the amount of HRK 5,860 thousand (2011: HRK 738 thousand) were reclassified to property and equipment due to time period of 2 years passing from the repossession. In such cases the Bank starts to recognize depreciation of these assets (note 9).

The movement in the impairment allowance of other assets is presented below:

[HRK 000] MOVEMENT IN IMPAIRMENT ALLOWANCES	2011	2012
As at 1 January	2,817	1,327
Increase / decrease	(64)	17,335
Write offs	(1,426)	(51)
As at 31 December	1,327	18,611

Notes to the financial statements (continued)**12. DEPOSITS FROM CUSTOMERS**

[HRK 000] DEPOSITS FROM CUSTOMERS	31.12.2011	31.12.2012
Demand deposits	74,034	63,388
retail	16,427	16,024
<i>in HRK</i>	9,781	9,913
<i>in foreign currency</i>	6,646	6,111
corporate	57,607	47,364
<i>in HRK</i>	54,225	42,238
<i>in foreign currency</i>	3,383	5,126
Restricted deposits	508	379
Term deposits	775,882	785,967
retail	629,432	685,999
<i>in HRK</i>	125,770	145,775
<i>in foreign currency</i>	503,662	540,224
corporate	146,450	99,968
<i>in HRK</i>	100,044	72,368
<i>in foreign currency</i>	46,406	27,600
Accrued interest	13,007	13,449
due	157	72
not due	12,850	13,377
TOTAL	863,431	863,182

Notes to the financial statements (continued)**13. BORROWINGS**

[HRK 000] BORROWINGS	31.12.2011	31.12.2012
Short-term	215,237	186,088
from banks	196,411	161,224
<i>in HRK</i>	44,772	86,100
<i>in foreign currency</i>	151,639	75,124
from other financial institutions	18,826	18,864
<i>in HRK</i>	-	-
<i>in foreign currency</i>	18,826	18,864
from other	-	6,000
<i>in HRK</i>	-	6,000
<i>in foreign currency</i>	-	-
Long-term	14,078	11,585
from banks	14,078	11,585
<i>in HRK</i>	14,078	11,585
<i>in foreign currency</i>	-	-
from other financial institutions	-	-
<i>in HRK</i>	-	-
<i>in foreign currency</i>	-	-
from other	-	-
<i>in HRK</i>	-	-
<i>in foreign currency</i>	-	-
Accrued interest	943	309
due	71	-
not due	872	309
TOTAL	230,259	197,982

Borrowings include repurchase agreements in the total amount of HRK 158,224 thousand (2011: HRK 193,411 thousand). Out of the total amount of the repurchase agreements, HRK 75,124 thousand relate to borrowings denominated in euro (2011: HRK 151,639 thousand) while HRK 83,100 thousand relate to borrowings denominated in kuna (2011: HRK 41,772 thousand).

Borrowings also include a loan from EIF (European Investment Fund) in the amount of HRK 18,864 thousand (2011: HRK 18,826 thousand). These funds relate to credit line for financing of small entrepreneurship.

Notes to the financial statements (continued)**14. HYBRID INSTRUMENTS**

[000 HRK] HYBRID INSTRUMENTS	31.12.2011	31.12.2012
Hybrid instruments	3,012	3,018
in HRK	3,012	3,018
TOTAL	3,012	3,018

In September 2009 the Bank received a hybrid instrument with maturity of 5.5 years and fixed interest rate of 7.75%. The hybrid instrument is included in to the Bank's additional capital. These amounts may be used for covering losses from current operations, in bankruptcy or liquidation, and if the Bank's capital adequacy falls below $\frac{3}{4}$ of the capital adequacy ratio prescribed by law (or some other ratio prescribed by the CNB) and if shareholders of the Bank do not acquire of additional shares within 90 days, the Bank will convert hybrid instruments into shares, which, in accordance with Decision on capital adequacy, are to be included in share capital.

15. PROVISIONS FOR LIABILITIES AND CHARGES

[HRK 000] PROVISIONS FOR LIABILITIES AND CHARGES	31.12.2011	31.12.2012
Provisions for court cases	54	120
Provisions for pensions and other liabilities to employees	-	-
Provisions for contingent and other liabilities	674	769
TOTAL	729	889

The movement in provisions for liabilities and charges is presented below:

[HRK 000] MOVEMENT IN PROVISIONS FOR LIABILITIES AND CHARGES	2011	2012
As at 1 January	2,164	729
Increase / decrease	(799)	160
Utilised during the period	(636)	-
Balance at 31 December	729	889

16. OTHER LIABILITIES

[000 HRK] OTHER LIABILITIES	31.12.2011	31.12.2012
Trade payables	190	309
Liabilities for salaries, deductions from salaries, taxes and contributions	1,973	1,925
Deffered fee income	4,268	4,141
Other liabilities	3,065	5,881
TOTAL	9,496	12,255

Notes to the financial statements (continued)

17. EQUITY

17.1. Share capital

31.12.2012	Share capital [000 HRK]	Ownership share (%)
VALIDUS D.D.	51,348	29.09
BALKAN FINANCIAL SECTOR EQUITY FUND C.V.	29,200	16.54
PLURIS D.D.	15,869	8.99
Small shareholders	80,106	45.38
UKUPNO	176,523	100.00
31.12.2011	Share capital [000 HRK]	Ownership share (%)
VALIDUS D.D.	51,348	29.09
BALKAN FINANCIAL SECTOR EQUITY FUND C.V.	29,200	16.54
PLURIS D.D.	15,869	8.99
Small shareholders	80,106	45.38
UKUPNO	176,523	100.00

17.2. Share premium

Share premium relates to capital gain incurred on issuance of new shares at a price higher than the nominal value during the recapitalization process in 2006 and 2007.

17.3. Other reserves

Other reserves as at 31 December 2012 amount to HRK 2,522 thousand (2011: HRK 2,611 thousand) and are created in accordance with the General Assembly decision.

17.4. Fair value reserve

The fair value reserve includes unrealised gains and losses on changes in the fair value of financial assets available for sale.

17.5. Accumulated losses

Accumulated loss comprise previous year accumulated losses and property acquisition cost related to capitalised costs incurred during sale and repurchase transactions of property owned by the Bank in prior years.

17.6. Statutory reserve

The Bank is required to create a statutory reserve by allocating 5% of its net profit for the year, until the reserve reaches 5% of share capital. The legal reserve can be used to cover losses from previous years if the losses are not covered by current year profits or if other reserves are not available.

17.7. Reserves for general banking risks

Reserve for general banking risks represents a reserve for potential losses in excess of planned and already established allowances for identified losses.

In accordance with the regulations of the Croatian National Bank, the Bank is required to create provision for general banking risks, if the growth in the Bank's balance-sheet and off-balance-sheet exposure exceeds 15% of balance sheet and off-balance-sheet exposure at the previous year end.

The Bank did not recognised provision for general banking risks.

17.8. Proposed dividends

Dividends payable are not recognized until they are approved at the General Assembly. The Management will not propose a dividend payment for 2012 (2011: nil).

Notes to the financial statements (continued)

17.9. Capital adequacy

Basic parameters of the capital management policy are given by the Credit Institutions Act.

Basic objectives of the capital management are ensuring of:

- going concern assumption and
- meeting of the regulatory capital adequacy requirements (regulatory capital adequacy ratio is currently set at 12%).

Regulatory capital is calculated as the capital category the Bank manages, being at the level which ensures capital adequacy ratio for cover of capital requirements for operational risks, i.e. minimal regulatory capital adequacy ratio.

Regulatory capital is calculated based on the CNB regulations.

[HRK 000]	CAPITAL ADEQUACY	31.12.2011	31.12.2012
	Share capital	176,464	176,523
	Reserves and retained earnings	(42,432)	(55,191)
	Intangible assets	(3,895)	(3,905)
	Unpaid loans for shares purchases	(1,272)	(423)
	Unrealised losses from financial assets available for sale	(4,885)	(2)
	BASIC CAPITAL	123,980	117,002
	Supplementary capital I	3,012	3,018
	Deductions	-	-
	Supplementary capital II	-	-
	REGULATORY CAPITAL	126,992	119,961
	CAPITAL REQUIREMENTS	122,567	118,401
	CAPITAL ADEQUACY RATIO	12.43%	12.16%

On 31 January 2013 an extraordinary meeting of the General Assembly was held in which the increase of the share capital in the amount of HRK 50,000 thousand was approved. The increase was done by Alternative upravljanje d.o.o. and the money was paid onto escrow account on 31 January 2013.

After the share capital increase was registered in the Trade court and at Central Depository Clearing Company, the Bank's capital adequacy was increased (as noted in the note 37, events after the reporting period).

Notes to the financial statements (continued)**18. INTEREST AND SIMILAR INCOME**

[000 HRK] INTEREST AND SIMILAR INCOME	2011	2012
Analysis by product	97,833	73,106
Loans and advances to customers	87,149	64,893
<i>retail</i>	17,916	15,410
<i>corporate</i>	69,233	49,484
Deposits	153	20
Debt securities	10,327	8,215
Other	204	(22)
Analysis by source	97,833	73,106
Retail	17,916	15,410
Corporate	66,570	47,302
State and public sector	9,110	7,320
Financial institutions	311	250
Other	3,926	2,824

19. INTEREST EXPENSE AND SIMILAR CHARGES

[000 HRK] INTEREST EXPENSE AND SIMILAR CHARGES	2011	2012
Analysis by product	49,389	42,100
Deposits from customers	44,674	35,665
<i>retail</i>	35,498	29,950
<i>financial institutions</i>	3,457	266
<i>corporate and other</i>	5,719	5,448
Borrowings	4,481	6,217
Hybrid instruments	223	225
Other	11	(6)
Analysis by recipient	49,388	42,101
Retail	35,721	30,176
Corporate	4,182	4,130
State and public sector	133	475
Financial institutions	7,938	6,483
Other	1,414	836
TOTAL		

Notes to the financial statements (continued)**20. FEE AND COMMISSION INCOME**

[000 HRK] FEE AND COMMISSION INCOME	2011	2012
Payment transaction fees	4,361	3,872
Letter of credit and guarantee fees	1,128	1,478
Impairment losses	(29)	(2)
Other	1,186	867
TOTAL	6,646	6,215

21. FEE AND COMMISSION EXPENSE

[000 HRK] FEE AND COMMISSION EXPENSE	2011	2012
Payment transaction fees	1,541	1,304
Other	641	400
TOTAL	2,182	1,704

22. GAINS LESS LOSSES FROM FINANCIAL ASSETS AVAILABLE FOR SALE

[000 HRK] GAINS LESS LOSSES FROM FINANCIAL ASSETS AVAILABLE FOR SALE	2011	2012
Realised	1,057	88
Equity	-	(739)
Bonds	1,055	826
Treasury bills	2	1
Investment funds	-	-
TOTAL	1,057	88

Notes to the financial statements (continued)**23. GAINS LESS LOSSES FROM FOREIGN CURRENCIES**

[000 HRK] GAINS LESS LOSSES FROM DEALING IN FOREIGN CURRENCIES	2011	2012
Net gains / (losses) from translation of monetary assets and liabilities	551	(90)
Net gains / (losses) from currency trading	5,797	3,504
TOTAL	6,348	3,415

24. OTHER OPERATING INCOME

[000 HRK] OTHER OPERATING INCOME	2011	2012
Dividend income	2	-
Other	2,398	1,916
TOTAL	2,400	1,916

25. GENERAL AND ADMINISTRATIVE EXPENSES

[000 HRK] GENERAL AND ADMINISTRATIVE EXPENSES	2011	2012
Personnel expenses	26,032	24,097
Savings deposit insurance expenses	2,088	1,905
Other	19,789	18,175
TOTAL	47,909	44,176

At 31 December 2012 the Bank had 163 employees (2011: 170).

26. IMPAIRMENT LOSSES

[000 HRK] IMPAIRMENT LOSSES	2011	2012
Identified losses	24,312	4,881
Deposits	-	-
Financial assets held till maturity	75	-
Loans and advances to customers	21,834	(12,525)
Interest receivables	2,449	73
Other receivables	(46)	17,333
Identified losses	(1,295)	(255)
Assets	(1,295)	(255)
TOTAL	23,017	4,626

Notes to the financial statements (continued)**27. INCOME TAX EXPENSE**

Income tax expense recognised in the income statement:

[000 HRK] INCOME TAX EXPENSE	2011	2012
Profit / (loss) before tax	(13,456)	(12,699)
Income tax at 20% rate	(2,691)	(2,540)
Expenses not deductible for tax purposes	2,131	2,067
Income not subject to tax	(1,102)	(1,154)
(Tax losses)/ tax benefit	(1,662)	(1,627)

In previous years the Bank incurred tax losses. Such tax losses can be carried forward over the following five years in which are incurred. Tax losses and their expiry dates at 31 December 2012 and 2011 were as follows:

Incurred	[000 HRK] TAX LOSSES	Year of expiry	2011		2012	
			Gross tax losses	Tax effect at 20%	Gross tax losses	Tax effect at 20%
2008		2013	26,430	5,286	23,653	4,731
2010		2015	7,303	1,461	7,303	1,461
2011		2016	8,312	1,662	8,312	1,662
2012		2017	-	-	8,137	1,627
TOTAL			42,045	8,409	47,405	9,481

28. BASIC AND DILUTED EARNINGS/(LOSS) PER SHARE

For the purposes of calculating earnings per share, earnings are calculated as the profit for the period attributable to shareholders of the Bank. The number of ordinary shares is the weighted average number of ordinary shares circulating during the year after deducting the number of ordinary treasury shares.

Given that there is no effect of options, convertible bonds or similar effect, the weighted average number of ordinary shares used for diluted earnings per share was the same as used to calculate basic earnings per share. The Bank has no preference shares.

	2011	2012
Profit / (loss) for the year [000 HRK]	(13,456)	(12,699)
Weighted average number of shares	1,764,638	1,765,228
BASIC AND DILUTED EPS	(7.63)	(7.19)

Notes to the financial statements (continued)**29. CONCENTRATION OF ASSETS AND LIABILITIES**

[HRK 000]	31.12.2011	31.12.2012
Giro account with the CNB	58,705	34,056
Obligatory reserves with Croatian National Bank	53,513	88,626
Bonds issued by the Ministry of Finance	116,709	99,212
Borrowings from CBRD	(16,494)	(38,485)
TOTAL	212,433	183,409

The Bank's exposure towards local government and state institutions not directly funded from the State Budget (excluding companies owned by state) is presented below:

[HRK 000]	31.12.2011	31.12.2012
Loans	10,533	11,659
Deposits	(7,854)	(9,995)
TOTAL	2,679	1,664

30. CASH AND CASH EQUIVALENTS

[HRK 000]	31.12.2011	31.12.2012
Cash and amounts due from banks	88,678	89,620
Placements to banks with original maturity up to 90 days	-	-
TOTAL	88,678	89,620

Notes to the financial statements (continued)**31. COMMITMENTS AND CONTINGENCIES**

[000 HRK] COMMITMENTS AND CONTINGENCIES	31.12.2011	31.12.2012
Guarantees	32,029	49,380
in HRK	28,207	45,815
in currency clause	183	-
in foreign currency	3,638	3,564
Letters of credit	252	348
in HRK	-	-
in currency clause	-	-
in foreign currency	252	348
Unused loan commitments	34,196	32,562
in HRK	34,190	32,556
in currency clause	-	-
in foreign currency	6	6
Other	1,803	6,353
in HRK	99	-
in currency clause	-	-
in foreign currency	1,704	6,353
TOTAL	68,280	88,643

At 31 December 2012, the Bank recognised unidentified impairment losses for off-balance-sheet risks arising from the issue of guarantees, letters of credit and undrawn lending commitments in the amount of HRK 769 thousand (2011: HRK 674 thousand).

Notes to the financial statements (continued)

32. RELATED PARTY TRANSACTIONS

The key shareholders of the Bank are Validus d.d. and Balkan Financial Sector Equity Fund which together owned 54.62 % (2011: 54.62 %) of the Bank's shares at year end. The remaining 45.38% (2011: 45.38%) of the shares are publicly traded. The Bank considers that it has an immediate related party relationship with its key shareholders; the Supervisory and Management Board members and other executive management (together "key management personnel"); close family members of key management personnel; and entities controlled, jointly controlled or significantly influenced by key management personnel and their close family members, in accordance with the definitions contained in International Accounting Standard 24 "Related Party Disclosures" ("IAS 24").

32.1. Key transactions with immediate related parties

At 31 December 2012 the Bank has no high risk product exposure towards its key shareholders (2011: nil). All transactions with key shareholders during the year were generated from deposit activities, while transactions with key management personnel were generated from deposit, lending activities and given benefits. Gross exposure to key shareholders at 31 December 2012 was nil (2011: HRK 131 thousand).

Liabilities towards the Bank's key shareholders at 31 December 2012 amounted to HRK 1 thousand and relate to demand deposits held with the Bank (2011: HRK 1 thousand).

Except for salaries, there was no other compensation to the key management in 2012 and 2011. The Bank had no reward policy for 2012 and 2011.

[000 HRK] RELATED PARTIES TRANSACTIONS	2011				2012			
	exposure	liabilities	revenue	expenses	exposure	liabilities	revenue	expenses
Key shareholders	131	1	40	10	-	1	117	267
Key management	1,597	41	93	2,782	21	50	2	2,165
Compensation paid	-	41	-	2,765	-	50	-	2,163
Loans granted	1,597	-	93	18	21	-	2	2
TOTAL	1,728	42	133	2,792	21	51	119	2,432

33. MANAGED FUNDS FOR AND ON BEHALF OF CORPORATE AND RETAIL CUSTOMERS

The Bank manages funds for and on behalf of corporate and retail customers, whereby it holds and manages assets or invests funds received in various financial instruments at the direction of the customer. The Bank receives fee income for providing these services. These assets are not assets of the Bank and are not recognised in the balance sheet of the Bank. The Bank is not exposed to any credit risk relating to such placements, as it does not guarantee these investments.

Further, the Bank manages credit exposure of third parties as follows:

[000 HRK] MANAGED FUNDS ON BEHALF OF CORPORATE AND RETAIL CUSTOMERS	31.12.2011	31.12.2012
Assets	96,898	96,991
Corporate	63,796	63,996
Retail	33,097	32,990
Giro accounts	5	5
Liabilities	96,898	96,991
Corporate	57,849	59,318
Republic of Croatia	9,212	-
HBOR	29,461	29,043
Local authorities	376	801
Retail	-	7,829

Notes to the financial statements (continued)

34. AVERAGE INTEREST RATES

Average interest rates calculated based on the weighted average for each category of interest-earning assets and interest-bearing liabilities, are presented below:

[HRK 000]	2011	2012
Assets		
Obligatory reserve with Croatian National Bank	0.05%	0.00%
Placements with and loans to other banks	0.92%	2.10%
Available for sale financial assets	3.65%	3.31%
Held to maturity investments	11.21%	10.60%
Loans and advances to customers	9.67%	8.72%
Liabilities		
Deposits	4.28%	4.29%
Borrowings	2.21%	3.04%
Hybrid instruments	7.49%	7.50%

35. OPERATING LEASE COMMITMENTS

[000 HRK] OPERATING LEASE COMMITMENTS	31.12.2011	31.12.2012
Up to 1 year	4,452	4,999
From 1 to 5 years	16,637	14,018
Over 5 years	10	-
	21,099	19,017

36. FAIR VALUE OF FINANCIAL ASSETS

Fair value represents the amount at which an asset could be exchanged or a liability settled on an arm's length basis.

The Management Board believes that the fair value of financial assets and liabilities are not significantly different from their carrying values at 31 December 2012.

The following methods were used to estimate the fair value of financial instruments of the Bank:

Cash and amounts due from banks, amounts held with the CNB

Carrying values of cash, amounts due from banks, amounts held with the CNB generally approximate their fair values.

Placements and loans other banks

Estimated fair value of placements and loans to other banks represents a discounted value of future cash flows.

Notes to the financial statements (continued)

Financial assets available for sale

Fair value of financial assets available for sale is based on their market prices. Financial instruments non quoted on active markets are evaluated through discounted cash flows method or by an alternative method used for fair value estimation.

Loans and advances to customers

Fair value of loans and advances to customers is based on analysis of discounted cash flows of loans by applying current interest rates for loans with similar conditions or characteristics. Fair value of non-performing loans is estimated based on analysis of discounted cash flow or the appraised value of the collateral. Considering that insignificant part of loans and advances to customers is contracted with fixed interest rate or the one which deviates from market rates, The Bank considers the fair value of loans and advances to customers to approximate their carrying value.

Deposits from banks and customers

Fair value of deposits maturing on demand is the carrying amount of obligation payable at the balance sheet date. Fair value of term deposits with variable interest rates approximates their carrying amount at the balance sheet date. Fair value of deposits with fixed interest rate is estimated by discounting future cash flows using interest rates currently used for deposits of similar remaining maturities. The Bank estimates that the fair value of bank and customer deposits do not significantly deviate from their carrying value.

37. EVENTS AFTER THE REPORTING PERIOD

On 31 January 2013 an extraordinary meeting of the General Assembly was held in which the increase of the share capital in the amount of HRK 50,000 thousand was approved. The increase was done by Alternative upravljanje d.o.o. and the money was paid onto escrow account on 31 January 2013.

After the share capital increase was registered in the Trade court and at Central Depository Clearing Company, the Bank's capital adequacy was increased to 16%.

In March 2013, the Bank has made value adjustment of the receivable from legal case (Note 11 Other Assets) in the amount of HRK 9,214 thousand.