Pursuant to Article 17, paragraph 1, point 2 of the Law on the Central Bank of Montenegro (“OG RoM” No. 52/00 and 47/01) and Article 62, paragraph 3 of the Law on Banks (“OG MNE”, 17/08), the Council of the Central Bank of Montenegro, on its meeting held on 17 and 18 October 2008, passed the following

DECISION
On Minimum Standards for Market Risks Management in Banks

1. General Provision

Subject of the Decision

Article 1

This Decision shall establish in more details minimum standards for market risks management that the banks shall follow in their operations.

Terms and Definitions

Article 2

Individual terms used in this Decision shall have following meanings:

1) **“Net open foreign currency position”** – means mismatch between the volume of assets, liabilities and off-balance sheet positions in the same foreign currency;
2) **“Long foreign currency position”** – means the gross sum of assets and positive off-balance sheet positions in a foreign currency including the sum of purchased, yet unsettled, currency deals;
3) **“Short foreign currency position”** – means the gross sum of liabilities and negative off-balance sheet positions in a currency including the sum of sold, yet unsettled, currency deals;
4) **“Long securities position”** – means the gross sum of securities held as assets including securities within margin accounts;
5) **“Short securities position”** – means the gross sum of securities held as liabilities including securities within margin accounts and those securities sold that are not owned by the bank;
6) **“Net open securities position”** – means the difference between gross long and short securities positions;
7) **“Hedging”** – means making neutral certain sources of risk or the protection from higher exposure to individual risks»;
8) **“Interest rate spread”** – means the difference between interest rates that the bank gets on balance positions of assets and contractual interest rates that the bank pays for sources of funds;

9) **“Margin Account”** – means an account held that allows the bank to buy securities or foreign currency on credit or borrow against the securities or foreign currency held in the account.;
10) **“Interest Rate Index”** – means the basis reference for the price of lending or borrowing money. For example, interest rate indices include Euribor and Libor among others;
11) **“Backtesting”** – means the process of evaluating the validity of a risk measurement tool by comparing the estimates calculated by the tool against actual results.

2. Market Risks Management

Types of risk

Article 3

A bank shall perform management of all market risks in its operations, especially:
1) position risks (price risk and interest rate risk);
2) foreign exchange risk;, and
3) market risks associated with credit risk (counterparty risk and settlement risk).

Regulating risk management

Article 4

Banks shall in their own regulations, define:
1) the coverage of trading book, which describes the activities considered as trade;
2) criteria, procedures and authorities for inclusion of positions into the trading book and their exclusion;
3) limits for positions from the trading book and the schedule of their revision;
4) organization units authorized for opening/management of positions in the trading book and the competences of some employees for opening/management of positions within the prescribed limits and in accordance to the prescribed trade strategy;
5) process of monitoring positions from trading book, from the aspect of compliance with trade strategy;
6) reporting system to bank’s top management about the positions and the utilization of limit, integrated in the everyday process of risk management in the bank;
7) follow-up process of positions, from the aspect of their liquidity or possibility to hedge their positions or some risks originating from them;
8) methods for calculation of bank’s exposure to some types of market risks.

Responsibility for risk management

Article 5

A bank shall designate, within its organizational structure, a body or a person, depending on the size or complexity of the bank’s operations, directly responsible for market risks management referred to in Article 3 in paragraphs 1-2 of this Decision.

The body or a person that is directly responsible for credit risk management in the bank shall be responsible for market risks management referred to in Article 3 paragraph 3.

2.1. Position risks

Valuing positions in trading book

Article 6

Bank shall present all positions in the trading book on a daily basis according to their market value, on the basis of prices and other market factors published by independent source (marking-to-market).

In the process of valuing positions, banks shall either apply the international accounting standard 39 or internal valuing model in the trading book.

Banks shall perform the market prices evaluation of positions in trading book or input data of position valuing model at least monthly, and if necessary more often, depending on the characteristics of reference markets, i.e. the strategy of bank's trade with some positions in the trading book.

If banks use the internal model for positions valuing in the trading book, besides the provisions of the International accounting standard 39, the following minimum requirements should be met:

1) banks shall document all quality and quantity elements of the model and shall prescribe procedures in the case of changes of the model;
2) banks shall identify all important risks arising from positions valued through the internal model and shall estimate the possibility of hedging by applying the instruments with existing active markets;
3) banks shall perform internal model testing, which will be performed by persons who did not participate in the development process of the model and shall at least include the relevance check of mathematical formulas, the validity of presumptions as well as the quality of the model software support;
4) responsible persons in the bank are familiar with parts of the trading book which market value is established by applying the internal model, as well as with the influence of such type of valuing to the reliability level of the report on risks to which the bank is exposed, i.e. the results of operations originating from positions in the trading book;
5) the body or a person directly responsible for market risk management has to be familiar with the drawbacks of the applied model, in order to adequately estimate the influence of the drawbacks to the results of the model valuing.

Banks shall periodically examine the validity and, if necessary, improve the internal model of valuing positions in the trading book.

Risk measurement

Article 7

Banks shall measure the position risks for all positions in bank's trading book.

The measurement of position risks must provide data on the influence of these risks to bank's revenues and equity, both from normally expected and big changes in the market factors and prices.

Limiting the exposure

Article 8

Banks are obliged to establish the following exposure limits to position risks, with the minimum of:

1) for exposure to owner's securities:
- maximum amount of net market value of all owner's securities for all markets where it operates,
- maximum long and short positions of all owner's securities for all markets where it operates,
- maximum amount of net market value of each type of owner's securities;
- maximum long and short positions for each individual security for all markets where it operates;

2) for exposure to debt securities:
- maximum amount of net market value of all debt securities for all markets where it operates,
- maximum long and short positions of all debt securities for all markets where it operates,
- maximum amount of net market value of each type of debt securities;
- maximum long and short positions for each type of security;

3) for exposure to financial derivatives:
- maximum premium which may be paid for positions in call options;
- limits for financial derivatives which are not options.

Banks are obliged to determine additional exposure limits if the characteristics and factors that may have important influence to the price of owner's or debt security appear.

Starting base for limiting

Article 9

Banks shall determine the reasonable level of limits they establish referred to in Article 8 above considering the following:

1) specific factors referring to:
- bank's earnings stability and level,
- realistic budget plans,
- level of capital and its adequacy,
- quality of bank's risk management;

2) general factors referring to:

- the liquidity of the product, which is determined depending on its ability to be sold and/or hedged,
- costs to hedge,
- number of counterparties available to the bank for dealing.

Risk measurement schedule

Article 10

Banks shall perform interest rate risk measurement at least monthly applying the established methodologies, at least using GAP reports.

Notwithstanding paragraph 1 of this Article, a bank shall measure interest rate risk in shorter intervals if it establishes the existence of material changes in interest rates, volume and/or type of bank's assets, liabilities or off balance sheet items, and/or upon Central Bank of Montenegro's recommendation (hereinafter referred to as: the Central Bank).

GAP reports

Article 11

Banks shall prepare GAP reports in order to measure interest rate risk for all assets, liabilities and off balance sheet items, as well as for other fees or expenses that are exposed to interest rate risk (including the positions from the banking book sensitive to interest rate risk).

When preparing GAP reports referred to in the paragraph 1 of this Article, bank shall at least provide the following:

1) rate sensitive items must be allocated to time buckets based on their expected reprising timeframe;
2) the number of time buckets (gaps) used and the date range of the time buckets established must be supported;
3) expected reprising for assets and liabilities items that do not have clearly defined maturities or where maturities may vary must be documented and supported with the assumptions, and
4) GAP reports must also be prepared to reflect a significant lengthening and shortening of the expected reprising timeframes.

2.2. Foreign Exchange Risk

Risk measurement

Article 12

In foreign exchange risk measurement, the bank shall, as a minimum provide the following:

1) foreign exchange risk measurement shall incorporate all items that are included in calculation of the necessary capital for foreign exchange risk, according to Central Bank's regulation;

2) foreign exchange risk exposures shall be daily measured and limited on an aggregate basis and individually by currency;
3) risk measurement shall be performed on the basis of assumptions on normally expected and large changes in currency rates to evaluate the impact of these changes to the bank's earnings and capital;
4) daily profits or losses from foreign exchange activities shall be calculated by currency;
5) the results from the translation impact on the net open position, the spread earned from dealing, the gain/loss from previously closed positions and any fees/commissions earned for retail conversions shall be separately identified;
6) daily valuations shall be performed using end-of-day closing market rates of exchange that are obtained independently of the area/staff who have authority to manage foreign exchange risk.

Open position limits

Article 13

Net end-of-day open position limits by currencies quoted daily by the European Central Bank as a Euro Foreign Exchange Reference Rate are limited to a maximum of 15% of the core capital on an individual basis.

Net end-of-day open position limits by currencies quoted daily by the European Central Bank as a Euro Foreign Exchange Reference Rate are limited to a maximum of 20% of the core capital on an aggregate basis.

Net end-of-day open position limits by currencies not meeting the criteria stated in the paragraph 1 of this article are limited to a maximum of:

- 5% of the core capital on an individual basis per currency;
- 10% of the core capital on an aggregate basis.

Banks shall, within limits referred to in the paragraphs 1 through 3, as a minimum, establish limits for maintaining foreign currency exposures within acceptable levels for:

1) Net open positions by currency and for all currencies;
2) long position by currency and for all currencies;
3) short position by currency and for all currencies.

Banks shall determine the reasonable level of limits they establish referred to in paragraph 4 above considering the following:

1) specific factors referring to:
    - bank's earnings stability and level,
    - realistic budget plans,
    - level of capital and its adequacy,
    - quality of bank's risk management;
2) specific factors referring to:
    - the liquidity of the currency, which is determined depending on its ability to be sold and/or hedged ,

- costs to hedge,
- number of counterparties available to the bank for dealing.

2.3 Other market risks

Risk measurement

Article 14

Banks shall measure counterparty, issuer and settlement risks for all positions in the trading book from which these risks appear.

Limiting

Article 15

Banks shall, as minimum establish counterparty and settlement limits not only as percentage of bank's capital, but fixed limits must be established as well:

1) establish fixed limits that are appropriate for the quality of the counterparty and incorporate all exposures to that entity,
2) establish separate risk limits for settlement exposures,
4) establish tenor limits by counterparty for its exposures,
5) establish limits for all domestic and foreign counterparties.

The establish limits must be in compliance with the credit policy of a bank and subject to comprehensive monitoring process.

3. Final Provisions

Article 18

This Decision shall supersede the Decision on Minimum Standards for Market Risks Management in Banks ("OG RoM" No. 81/04).

Article 19

This Decision becomes effective on the 8th day of its publication in the "Official Gazette of Montenegro".

THE COUNCIL OF THE CENTRAL BANK OF MONTENEGRO

PRESIDENT OF THE COUNCIL
Ljubiša Krgović

Decision No. 0101-323/11-13

Podgorica, 18 September 2008